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Preface

Attorneys who represent real property investors often find themselves reinventing their practices to meet the challenges of an ever-changing economy—but one constant is the client's desire to defer gain and income taxes on the disposition of real property. For 20 years real property and tax attorneys have relied on this book in planning and executing real property exchanges. It combines a thorough discussion of substantive tax law with flowcharts, examples, and practice tips that both clarify the intricate maze of statutes, regulations, rulings, releases, and cases that govern exchanges and supply practical aids for structuring and implementing exchanges.

This third edition of Real Property Exchanges continues and expands this substantive and practical discussion by expanding the coverage of sophisticated tax-planning vehicles such as deferred, reverse, and construction exchanges. The specific problems facing partnerships and corporations are explored as are the use of qualified intermediaries and qualified exchange accommodation arrangements. New state-of-the-art forms provide drafting guidance.

The two authors of this third edition, Louis S. Weller and Cecily A. Drucker, have applied their formidable legal expertise and practical insight to simplify this complex area of the law and to provide numerous practice tips and examples to assist the practitioner. They have been the update authors for this book for many years, and CEB is extremely grateful to them for taking time from their busy schedules to create this new edition. Their biographies can be found in the About the Authors section of this book.

CEB and the authors wish to thank the authors of the previous editions, Richard A. Goodman (first edition) and Stephen B. Fainsbert, John A. Mase, and Lawrence A. Snyder (second edition), whose biographies can be found in the Acknowledgments section. Portions of this third edition were excerpted or adapted from these earlier editions.

The authors would also like to extend their thanks and appreciation to Joyce L. Welch and Neal D. Sacon for their expert assistance in the writing of this new edition. Mr. Sacon is an attorney in private practice in Portland, Oregon. Ms. Welch is a Director in the National Real Estate Tax Services group at Deloitte Tax LLP, based in San Diego.

Legal editing was performed by CEB attorneys. Janis LaRoche Blanchette served as project manager for this new edition. Legal editing was performed by Ann Davis.

Senior editor Cinda Ely was responsible for copyediting and production. Legal research analysis was provided by Kenneth Marr, Adriana Paula, and Shawn Ridgell.

The book was designed by Grier Thornburg. Diana Krevsky designed the diagrams and flowcharts. Robert Burke prepared the index. Composition was performed by CEB's Electronic Publishing staff.

CEB plans to update this book on a regular basis. We solicit your suggestions and comments to help us keep it accurate and up to date.

September 2009 Update

CEB wishes to thank the authors of this update: Louis S. Weller, a principal in Deloitte Tax LLP, San Francisco, and Gregory A. Marques, a tax manager at Deloitte Tax LLP, San Francisco. For more information about these authors, see About the 2009 Update Authors, below.

CEB Attorney Editors Kay F. Rubin (Managing Editor) and Janis L. Blanchette and Legal Editors Philip Weverka and Ken Marr contributed to this title. Administrative support was provided by Kenya Denman and Nila Kanzaria. Elizabeth J. Asborno handled copyediting and production. Robert W. Burke updated the index. Composition was performed by CEB's Electronic Publishing staff.

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Authors' Foreword

We undertook the task of creating this new edition of Real Property Exchanges so that the book would adequately reflect changes in practice, transaction structures, and developments in the law since the second edition was written. Although much has changed, much has stayed the same, and we have liberally borrowed from both the organization and text of the previous editions. The exemplary work of our predecessor authors Richard Goodman, Stephen Fainsbert, John Mase, and Lawrence Snyder served as both an inspiration and guide.

We have tried to be thorough in our coverage of basic concepts relating to this subject but have not attempted to explore every nook and cranny in the fascinating world of like-kind exchanges. Despite more than 80 years of experience with the like-kind exchange concept, the law governing these transactions is still under development and many seemingly obvious questions do not have clear answers. We have tried to indicate this where possible, to express our opinions about the correct answer where appropriate, but to make clear when we are expressing opinion rather than reciting clear rules or principles. We expect that some experts may disagree with our conclusions and we welcome a continuing dialogue on open issues associated with like-kind exchanges, hoping that out of such dialogue will emerge clearer and more definitive guidelines for taxpayers and their advisers attempting to plan and implement transactions with confidence that they can predict the related tax consequences.

We would be remiss if we did not briefly mention our debt to Marvin Starr, who should be considered the godfather of like-kind exchanges in California and who inspired our respective interests in this area of tax law and brokered the creation of a professional association between us that has now passed the quarter-century mark.

We view this book as a work in progress and hope to add continued improvements in coverage and content through the annual supplementation process. We encourage readers to contact us with their suggestions and ideas on ways to improve the volume, and thank CEB for the opportunity that working on this project has given us.

Louis S. Weller
Cecily A. Drucker
San Francisco, California
May 2002

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CEB is grateful to the following members of the California State Bar, who served as authors of this book:

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Acknowledgments

CEB wishes to thank the authors of the first and second editions of Real Property Exchanges, on which much of this book is based.

The following attorneys were the authors of the second edition of Real Property Exchanges:

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Selected Developments

September 2009 Update

Since Previous Update: Subsection (i) was added to Internal Revenue Code §1031 to provide that the restriction on exchanges of "stock" contained in §1031(a)(2)(B) does not include shares of certain mutual ditch, reservoir, or irrigation companies. See §§1.2, 1.4, 2.11.

IRS Letter Rulings 200807005 and 200909008 confirm that acquisitions of all interests in a partnership not already owned by the taxpayer are regarded as asset purchases, not purchases of partnership interests, and are treated as outside the exclusion established by IRC §1031(a)(2)(D) with respect to replacement property acquisition. See §2.14A.

Congress amended IRC §470(c)(2) to add IRC §470(c)(2)(B), providing that "tax-exempt use property" does not include property owned by a partnership that was deemed tax-exempt "solely by reason of §168(h)(6)." See §2.18B.

In IRS Letter Ruling 200812012, the IRS approved a postexchange transfer of replacement property that was a product of technical termination of a limited liability company under IRC §708(b)(1)(B). See §§2.31, 7.11.

IRC §121 was amended to limit the availability of an exclusion from gross income on certain transfers of residences when the property is used for "nonqualified use" before it is used as a principal residence. IRC §121(b)(4)[5]. See §2.38.

In *Moore v Commissioner,* TC Memo 2007-134, the Tax Court denied §1031 treatment on an exchange of vacation properties that it deemed were not held primarily for trade or business or for investment by the taxpayers. See §2.39A.

In February 2008 the IRS issued Rev Proc 2008-16, 2008-1 Cum Bull 547, which provides a safe harbor for exchanges of vacation homes, effective for exchanges occurring on or after March 10, 2008. Under this safe harbor, the IRS will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under IRC §1031. See §§2.39B-2.39H.

In IRS Letter Rulings 200805012 and 200901020, the exchange of transferable development rights associated with real property for a fee interest in real property was considered to be a like-kind real property exchange. See §2.42.

In Chief Counsel Memorandum 200911006, the IRS announced that it has reversed its earlier conclusion that trademarks, trade names, and other types of "customer based intangibles" such as mastheads and advertiser and subscriber accounts are automatically excluded from §1031 as varieties of goodwill. See §2.49A.

In IRS Letter Ruling 200921009, the IRS expanded its view that certain exchanges can be completed when there is an intervening change in the organization of an entity. See §§2.69A, 7.20A.

In IRS Letter Ruling 200730002, the IRS implied that it would take a literal approach to the question of who are related parties for IRC §1031(f) purposes and held that as a result of this preexchange change in relationships, IRC §1031(f)(1) would not apply. See §§2.73, 2.83.

IRS Letter Rulings 200820017 and 200820025 discussed the consequences of a taxpayer's sale of property to a third party and the use of a qualified intermediary (QI) to acquire replacement property from a related party. See §2.82A.

In *Ocmulgee Fields v Commissioner* (2009) 132 TC 6, the Tax Court denied §1031 treatment when replacement property was purchased from a related party in a prearranged transaction. See §2.82B.

Statutory changes effective in 2009 increased the California assumed tax rate applicable in the case of the recognized gain elections. Rev & T C §§18535-18536 (Stats 2008, ch 305). See §3.86.

Treasury Regulation §301.7508A-1(d)(1) was amended to add an eighth category of taxpayers affected by a "terroristic or military action" as defined in IRC §692(c)(2): any individual or entity not located in the covered disaster area but who has records in the disaster area that are necessary to meet a covered filing deadline. See §4.18A.

In IRS Letter Ruling 200908005, the IRS ruled that change of a QI's tax status from disregarded entity to regarded entity does not cause the safe harbor to be lost. See §4.53.

In 2008 the IRS issued final regulations under IRC §468B(g), as well as companion provisions under IRC §7872 (TD 9413, Reg §§1.468B-6, 1.7872-5, 1.7872-16), addressing the tax treatment of income earned on escrow accounts, trusts, and other funds held

by QIs and escrow holders, trustees, and other parties during deferred like-kind exchanges of property. See §§4.57B, 4.60-4.61.

In IRS Letter Ruling 200724007, the IRS that held a QI organized as a limited liability company could have members that were disqualified persons under Reg §1.1031(k)-1(k)(1)-(4) (as regards certain taxpayers) using the QI's services without the QI itself being deemed a disqualified person with respect to those taxpayers. See §4.65.

In IRS Letter Rulings 200803003 and 200803014, QIs that were wholly owned members of bank-controlled groups were not disqualified persons under Treas Reg §1.1031(k)-1(k)(1) even though the banks, through other subsidiaries, provided investment advisory, brokerage, private planning, insurance, trust, and retail banking services to the exchange customers. See §4.67A.

In response to failures of QIs, California has enacted a statutory scheme for the regulation of QIs operating within the state. See §4.68A.

In IRS Letter Ruling 200813019, involving boot received from a QI in a subsequent tax year as a result of a failed §1031 exchange, the IRS allowed a taxpayer to revoke an inadvertently made election of the installment method. See §4.70.

In IRS Letter Ruling 200718028, the IRS held that valid identification of relinquished property had occurred when a taxpayer assigned its rights as seller to the QI who transferred the relinquished property to the buyer before the end of the reverse exchange identification period. See §5.20.

In IRS Letter Ruling 200901004, the IRS held that a facility to be constructed on a taxpayer's right-of-way easements could qualify as valid replacement property. See §5.39A.

In Chief Counsel Advice 200836024, the IRS approved an Exchange Last reverse exchange followed by a deferred exchange that began after the sale of the relinquished property. See §6.31.

In Letter Ruling 200829023, the IRS ruled that both the book-equals-tax-gain methodology and the "last in, first out" methodology for allocating taxable gain when there were reverse §704(c) gain layers were appropriate under Reg §1.704-3(a)(8). The ruling also stated specifically that no inference should be drawn that there are not other appropriate methods to allocate taxable gain under Reg §1.704-3(a)(8). See §7.3.

In 2008 the IRS issued a revised Form 1065 (the form used by partnerships and certain other entities treated like partnerships to report income and losses), which became final for reporting years 2008 and beyond. See §7.11.

IRS Letter Rulings 200826005, 200829012, and 200829013 applied the criteria in Rev Proc 2002-22 to two-party tenancy-in-common (TIC) structures. In all three rulings, the IRS concluded that the TIC interest property did not constitute an interest in a business entity under Reg §301.7701-2(a) for purposes of qualification as replacement property under §1031(a), despite slight deviations from Rev Proc 2002-22. See §§7.22, 7.33-7.35.

In 2009 the Securities and Exchange Commission (SEC) issued a "No-Action Letter" stating that it considers TIC interests in real estate in two common investment models to be "securities" under the Securities Act of 1933. *Omni Brokerage, Inc.*, SEC No-Action Letter (Jan. 14, 2009) 2009 SEC No-Act Lexis 21. See §7.23.

Internal Revenue Code §857(b)(6)(C), which provides safe harbors under which the term "prohibited transaction" does not include the sale of property that is a real estate asset, has been amended to reduce the qualification time in which a trust must have held property and the time in which aggregate expenditures must be made by the trust. See §7.46.

In Letter Ruling 200824018, the IRS held that the holding period of replacement property acquired in a §1031 like-kind exchange includes the holding period of the relinquished property for purposes of IRC §857(b)(6)(C)(i). See §7.46.

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Cutoff Dates and CEB Citation

Cutoff Dates

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§1.1 I. GOVERNING LAW

The Internal Revenue Code provides that neither gain nor loss is recognized when property held for productive use in a trade or business or for investment is exchanged solely for like-kind property. IRC §1031(a). See §§2.40-2.50 for a description of like-kind property. Although §1031 generally defers the recognition of gain or loss on the exchange of like-kind property, a taxpayer who receives money or other property in addition to the like-kind property recognizes gain, but not loss, to the extent of the sum of the money and the fair market value of the other property received. IRC §1031(b)-(c). See §§3.6-3.11 on partial recognition of gain. Losses are not recognized even if the taxpayer receives money or other non-like-kind property in the exchange. IRC §1031(c). If, however, a taxpayer gives up non-like-kind property (other than cash) together with the like-kind property, loss is recognized to the extent that the adjusted basis of the non-like-kind property transferred exceeds its fair market value (just as loss would be recognized if the non-like-kind property were sold). Reg §1.1031(d)-1(e). See §3.33 on recognition of gain.

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§1.2 A. Internal Revenue Code §1031

Internal Revenue Code §1031 has nine subsections:

- Subsection (a) provides the general rule for the nonrecognition of gain or loss from exchanges in which solely like-kind property is received, lists the types of real and personal property that are expressly excluded from the statute, and states the time requirements for deferred (nonsimultaneous) exchanges. See chap 2 for a complete discussion of the statutory requirements of like-kind exchanges, chap 3 for a discussion of the tax consequences of the exchange, chap 4 for a complete discussion of deferred exchanges, and chap 5 for a discussion of reverse exchanges.
- Subsection (b) sets forth the recognition rules for exchanges in which money or other property is received in addition to qualifying like-kind property. See §§3.6-3.32.
- Subsection (c) states that losses are never recognized in a qualifying exchange. See §§1.1, 1.34.
- Subsection (d) contains the rules for ascertaining the taxpayer's basis in property acquired in an exchange. See §§3.59-3.68.
- Subsection (e) states that livestock of different sexes are not like-kind property. See §2.49.
- Subsection (f) requires that exchanged property be held for 2 years following certain exchanges between taxpayers and "related persons"; otherwise, the taxpayer will recognize gain on the date of the second disposition. See §§2.70, 3.34-3.35.
- Subsection (g) provides that the 2-year holding period required by subsection (f) is extended in certain situations when the taxpayer's risk of loss is substantially diminished. See §2.76.
- Subsection (h) provides that real or personal property located in the United States and foreign real or personal property are not like-kind property. See §2.43.
- Subsection (i) provides that the restriction on exchanges of "stock" contained in §1031(a)(2)(B) does not include shares of certain mutual ditch, reservoir, or irrigation companies. See §2.11.

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§1.3 1. Mandatory Application

The gain nonrecognition provisions of IRC §1031 are mandatory and nonelective. IRC §1031(a)(1). When a taxpayer's transfer and receipt of property meets the requirements of §1031, no gain or loss is recognized regardless of the taxpayer's lack of intent to effect a like-kind exchange. In *James Godine, Jr.,* TC Memo 1977-393, the court held that a loss was not recognized on the exchange of real properties even though the taxpayer did not consider or intend the tax-deferred consequences of an exchange. In *U.S. v Vardine* (2d Cir 1962) 305 F2d 60, 66, the court held that a like-kind exchange of machinery and trucks could not be waived by a taxpayer who erroneously claimed depreciation deductions on the incorrect higher basis amount of the replacement property as if §1031 did not apply.

Section 1031 is not satisfied, however, merely because the taxpayer intended to exchange properties. *Swaim v U.S.* (ND Tex 1979) 79-2 USTC ¶9462, 45 AFTR2d 1276, aff'd (5th Cir 1981) 651 F2d 1066; *Robert G. Young,* TC Memo 1985-221. Although numerous cases discuss the taxpayer's intent to consummate an exchange qualifying under §1031, intent is only one factor the courts consider in deciding whether an exchange qualifies under §1031 when the taxpayer does not otherwise clearly satisfy or fails to satisfy §1031. Other factors courts consider include the following:

- The documentation of the transaction as an exchange;
- Whether the taxpayer was in actual or constructive receipt of the net sales proceeds on the transfer of the relinquished property (see §§2.53, 4.36-4.73); and
- Whether allowing nonrecognition treatment would satisfy or thwart the continuity-of-investment rationale that underlies the statute (see §§2.31, 3.27, 3.54).

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§1.4 2. History of Exchange Provisions

The Revenue Act of 1918 (Pub L 65-254, 40 Stat 1057)—the first legislation to impose income taxes—required the recognition of gain or loss on any disposition of property, including like-kind property. Section 202(c) of the Revenue Act of 1921 (Pub L 67-98, §202(c), 42 Stat 227), the forerunner of IRC §1031, in part provided that

> For purposes of this title, on an exchange of property, real, personal or mixed, for any such other property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in the exchange has a readily realizable market value, no gain or loss shall be recognized… when any such property held for investment, or for productive use in a trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of like-kind or use.

When §202(c) was first enacted, the investing public recognized the opportunity to avoid the recognition of gain on highly appreciated stocks and bonds by swapping them for other stocks and bonds. Investors could recognize losses, however, by selling their stocks or bonds for cash. Consequently, in 1923, Congress excluded from the nonrecognition provisions the exchange of stocks, bonds, notes, choses in action, trust certificates, and other securities. See H Rep No. 1432, 67th Cong, 4th Sess (1923), reprinted in 1939-1 (pt 2) Cum Bull 554, 845. For discussion of these exclusions, see §§2.6-2.18. Section 203(b)(1) of the Revenue Act of 1924 (Pub L 68-176, §203(b)(1), 43 Stat 253) omitted the provision for nonrecognition treatment of exchanges of non-like-kind properties, apparently because of the difficulty in determining whether a particular piece of property has a readily realizable market value. See *Jordan Marsh Co. v Commissioner* (2d Cir 1959) 269 F2d 453. The Revenue Act of 1928 (Pub L 70-562, 45 Stat 791, 816) made minor changes to §203(b)(1) and changed its section number to IRC §112(b)(1). The substantive provisions of former IRC §112(b)(1) were incorporated into the current IRC §1031(a), and have remained functionally identical since 1928.

The Deficit Reduction Act of 1984 (Pub L 98-369, 98 Stat 494) made the following substantive changes to IRC §1031, in addition to reorganizing the section:

- Partnership interests were added to the list of assets that are ineligible for nonrecognition treatment (IRC §1031(a)(2)(D)); and
- Deferred exchanges were explicitly authorized within specific statutory time limits (IRC §1031(a)(3)).

Section 7601 of the Revenue Reconciliation Act of 1989 (Pub L 101-239, 103 Stat 2106) amended IRC §1031 by adding new subsections (f), (g), and (h). See §1.2.

The Omnibus Budget Reconciliation Act of 1990 (Pub L 101-508, 104 Stat 1388) then made two minor changes to §1031:

- An amendment to IRC §1031(a)(2) provided that an exchange of an interest in a partnership that has elected under IRC §761(a) not to be treated as a partnership is eligible for nonrecognition treatment under §1031; the taxpayer must be treated as owning an interest in each asset of the partnership (see §2.14); and
- The definition of "related person" in IRC §1031(f) was expanded to include certain controlled partnerships under IRC §707(b)(1). See §2.71.

The Taxpayer Relief Act of 1997 (TRA 1997) (Pub L 105-34, 111 Stat 788) amended §1031 by adding subsection (h)(2), which establishes special rules for exchanges of personal property predominantly used in the United States and personal property predominantly used outside the United States. See §2.48.

The Miscellaneous Trade and Technical Corrections Act of 1999 (Pub L 106-36) amended §1031(d) by directly cross-referencing the statutory guideline for determining when a taxpayer's liabilities are assumed in a like-kind exchange. See §3.9.

In 2008, subsection (i) was added to IRC §1031, which provides that the restriction on exchanges of "stock" contained in §1031(a)(2)(B) does not include shares of certain mutual ditch, reservoir, or irrigation companies. Pub L 110-246, §15342, 122 Stat 1651.

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Source: Real Property/Real Property Exchanges/1 Introduction to Exchanges/§1.5 3. Statutory Rationale

§1.5 3. Statutory Rationale

At least two rationales have been posited for the enactment of IRC §1031 and its predecessors. These are reflected in the two components of the original §202(c) of the Revenue Act of 1921:

- An administrative convenience rationale that applies when properties in an exchange lack readily realizable market value (see §1.6); and
- A continuity-of-investment rationale that applies when like-kind property is exchanged (see §1.7).

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§1.6 a. Administrative Convenience Rationale

The administrative convenience rationale is derived from the presumed administrative burden of valuing property received in exchange for "thousands of horse trades and similar barter transactions," which is not justified by the increased revenues to be derived from taxing such exchanges. *James Godine, Jr.,* TC Memo 1977-393*,* quoting H Rep No. 704, 73d Cong, 2d Sess (1934), reprinted in 1939-1 (pt 2) Cum Bull 554, 564. This rationale's continuing viability is questionable because valuing the respective properties is essential whenever a taxpayer receives any other non-like-kind consideration in the exchange. Further, the taxpayer may need to compute any realized gain (whether recognized or not) by placing a value on the like-kind property received. The administrative convenience rationale is sound, however, when a taxpayer exchanges properties (either simultaneously or nonsimultaneously), with no other consideration given or received in the exchange based on an agreement that the properties involved are of equal value.

The House Committee Report (H Rep No. 432, 98th Cong, 2d Sess (1984), reprinted in 1984 US Code Cong & Ad News 697) on the Tax Reform Act of 1984 (Pub L 98-369, 98 Stat 494) cited the administrative convenience rationale to justify restricting deferred (nonsimultaneous) exchanges, because the taxpayer's property must be valued at a dollar amount to calculate the value of replacement property that the taxpayer may receive, unless the taxpayer has already designated the replacement property to be received and consummation of the deferred exchange is merely a function of time. The amount of the replacement property credit will determine either the aggregate value of the properties that the taxpayer may receive in the future or the equity credit available to acquire replacement property, with the balance made up of additional cash contributions or debt. In most modern exchanges, the administrative convenience rationale has limited application. See H Rep No. 432 at 896.

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§1.7 b. Continuity-of-Investment Rationale

The continuity-of-investment or liquidity rationale is reflected in H Rep No. 704, 73d Cong, 2d Sess (1934), reprinted in 1939-1 (pt 2) Cum Bull 554, 564, which states that

> if the taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, [the taxpayer] is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with the tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind having a fair market value.

In many cases, the courts cited H Rep No. 704 as well as other formulations of the continuity-of-investment rationale. See, *e.g., Magneson v Commissioner* (9th Cir 1985) 753 F2d 1490; *Biggs v Commissioner* (5th Cir 1980) 632 F2d 1171; *Starker v U.S.* (9th Cir 1979) 602 F2d 1341; *Smith v Commissioner* (8th Cir 1976) 537 F2d 972; *Jordan Marsh Co. v Commissioner* (2d Cir 1959) 269 F2d 453; *Century Elec. Co. v Commissioner* (8th Cir 1951) 192 F2d 155.

The continuity-of-investment rationale apparently also reflected congressional concern that taxpayers would not have the cash to pay the tax if the exchange triggered the recognition of gain. See *Starker v U.S.* (9th Cir 1979) 602 F2d 1341, 1352.

The House Committee Report (H Rep No. 432, 98th Cong, 2d Sess (1984), reprinted in 1984 US Code Cong & Ad News 697) on the Tax Reform Act of 1984 (Pub L 98-369, 98 Stat 494) cited the continuity-of-investment rationale to justify restricting the time to acquire replacement property in nonsimultaneous exchanges. According to the Report, the right to defer completion of the transaction makes the transaction resemble a sale of the taxpayer's property followed at a later date by the purchase of the replacement property, rather than a like-kind exchange. The Committee found this to be particularly true when, as in *Starker,* the exchange documentation gave the taxpayer the right to receive non-like-kind property (cash) rather than like-kind property at a later date. H Rep No. 432.

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§1.8 4. Liberal or Strict Construction

Internal Revenue Code §1031 is an exception to the general rule of IRC §1001 that all gain or loss is recognized on the disposition of property. In applying §1031 to diverse facts and circumstances, the courts have applied inconsistent standards of construction. In several cases, the courts stated that §1031 should be strictly construed, based on former Reg §1.1002-1(b), which provided that any exception to the general recognition rule of §1001 should be applied only when both the specific requirements and the underlying purpose of the exception are satisfied. See *Leslie Co.* (1975) 64 TC 247, nonacq 1978-2 Cum Bull 3, aff'd (3d Cir 1976) 539 F2d 943; *Estate of Rollin E. Meyer* (1972) 58 TC 311, nonacq 1975-2 Cum Bull 3, aff'd per curiam (9th Cir 1974) 503 F2d 556; *Ethel Black* (1960) 35 TC 90; *George M. Bernard,* TC Memo 1967-176.

In *Starker v U.S.* (9th Cir 1979) 602 F2d 1341, however, the Ninth Circuit rejected application of the strict construction requirement of former Reg §1.1002-1(b) to like-kind exchanges. 602 F2d at 1353. The court held that IRC §1031 should be liberally construed, primarily because its underlying purpose is unclear and because a long line of cases liberally construed it.

Similarly, in *Estate of Alexander S. Bowers* (1990) 94 TC 582, the Tax Court stated that taxpayers have been given considerable latitude in structuring exchange transactions under IRC §1031. In *Magneson v Commissioner* (9th Cir 1985) 753 F2d 1490, the court discussed former Reg §1.1002-1(b) and cited *Starker v U.S., supra,* to liberally construe §1031 by refusing to rule that the taxpayer must hold the replacement property in the exact form of ownership in which it was acquired. Several courts have stated, however, that the liberal interpretation of §1031 should be limited. See, *e.g., Earlene T. Barker* (1980) 74 TC 555. Other courts have occasionally stated that §1031, like all exceptions to the general rule requiring the recognition of gain and loss, must be strictly construed. See *Robert G. Young,* TC Memo 1985-221; *Frederick W. Behrens,* TC Memo 1985-195, aff'd without published opinion (8th Cir 1986) 786 F2d 1170.

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§1.9 5. Substance Versus Form

The general rule of tax law is that the substance of a transaction prevails over its form. See *Commissioner v Court Holding Co.* (1945) 324 US 331, 89 L Ed 981, 65 S Ct 707; *Delwin G. Chase* (1989) 92 TC 874, 881. The conceptual distinction between a like-kind exchange and a transaction in which a sale of one property is immediately followed by reinvestment in another is largely one of form: In both situations the taxpayer disposes of the relinquished property and receives a replacement property. In fact, the only discernible difference between transactions with economically identical results may be the form in which the transactions are cast. It is therefore vital that a practitioner entering the like-kind exchange arena understand that virtually all attempted exchanges found *not* to satisfy IRC §1031 fail because either

- the form of the transaction results in a sale of relinquished property and purchase of replacement property rather than an exchange; or
- inadequate documentation causes the taxpayer to constructively receive the sale proceeds of the relinquished property.

In short, form matters: Taxpayer intent, common sense, and economic result may not prevent a taxpayer from recognizing gain when the transaction is correct in substance but not in form. See, *e.g., Maxwell v U.S.* (SD Fla 1988) 88-2 USTC ¶9560, 62 AFTR2d 5406; *Joanne H. Greene,* TC Memo 1991-403; *Garbis S. Bezdjian,* TC Memo 1987-140, aff'd (9th Cir 1988) 845 F2d 217; *Robert G. Young,* TC Memo 1985-221. See §§2.51-2.55, 4.36. But see §§2.25, 3.17. Indeed, a primary purpose of this book is to describe the transactional forms in which a like-kind exchange of real estate should succeed, and to discuss those that might well fail.

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Source: Real Property/Real Property Exchanges/1 Introduction to Exchanges/§1.10 B. Treasury Regulation §1.1031

§1.10 B. Treasury Regulation §1.1031

The Treasury Department has issued substantial and complex regulations dealing with IRC §1031. Regulation §1.1031 has seven major subsections:

- Subsection (a) provides the general rules for deferral of gain under §1031; it defines like-kind property, cites examples of the types of properties that qualify for or are excluded from §1031 treatment, and sets forth rules for exchanges of tangible, intangible, and nondepreciable personal property.
- Subsection (b)-1 clarifies the amount and extent of gain that a taxpayer will recognize when money and other property are received in addition to like-kind property, and cites examples of the boot-offset rules. See §§3.14, 3.19-3.32. Subsection (b)-2 contains a "safe harbor" for simultaneous exchanges that use qualified intermediaries, and permits the taxpayer who receives a promissory note from the qualified intermediary's transferee to qualify for installment sale reporting under IRC §453. See §§4.53-4.57.
- Subsection (c) states that losses are not recognized in exchanges of like-kind property, even when the taxpayer receives other property or money in addition to the like-kind property. See §§1.1, 1.34.
- Subsection (d) contains examples of, and rules for, computing the basis in replacement property acquired as part of an exchange; coordinates §1031 with IRC §1060 (which has special allocation rules for certain asset acquisitions; see Temp Reg §1.1031(d)-1T); and cites examples of offsetting liabilities involved in exchanges. See §§3.2, 3.21-3.32, 3.59-3.61.
- Subsection (e) clarifies that IRC §1031(e), which provides that livestock of different sexes are non-like-kind property, applies to taxable years to which the Internal Revenue Code of 1986 applies.
- Subsection (j) sets forth rules for calculating both gain in and basis of multiple property exchanges by separating the properties into exchange groups. In a real property exchange qualifying as a multiple property exchange under Reg §1.1031(j)-1(a)(1), all real property is allocated to the same exchange group. Reg §1.1031(j)-1(d), Examples 3, 5. See §§3.36-3.42, 3.63-3.65.
- Subsection (k) sets forth rules concerning the treatment of deferred (nonsimultaneous) exchanges. These rules include clarification of the time requirements; determination of basis; partial recognition of gain; and safe harbors for security or guaranty arrangements, qualified escrow accounts or qualified trusts, qualified intermediaries, and interest or growth factors. Subsection (k)-1(j)(2) coordinates IRC §1031(a)(3) on deferred exchanges with IRC §453 on installment sale reporting. See §3.45.

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§1.11 C. Revenue Rulings

The National Office of the Internal Revenue Service has issued and continues to issue Revenue Rulings dealing with like-kind exchanges. A Revenue Ruling is an official interpretation by the IRS that is published in the Internal Revenue Bulletin. Revenue Rulings are the IRS's conclusion on the application of the law to a specific set of facts. They are issued only by the National Office and are published for the information and guidance of taxpayers, IRS officials, and others. Reg §601.601(d)(2)(i)(*a*). Both taxpayers and IRS personnel are expected to rely on these Revenue Rulings as guidance. Rev Proc 2009-4 §3.07, 2009-1 Int Rev Bull 118. The taxpayer must consider, however, whether the facts of the taxpayer's particular transaction are "substantially the same" as those set forth in the Revenue Ruling and whether the Ruling has been revoked, modified, declared obsolete, distinguished, clarified, or otherwise affected by subsequent legislation or other authority.

Unless there are special circumstances, the Tax Court consistently regards Revenue Rulings as nothing more than the position of one party to the litigation—the IRS—with respect to specific factual situations. See, *e.g., Nelda C. Stark* (1986) 86 TC 243, 250. Other courts generally do not regard Revenue Rulings either as substantive authority or as binding on them. See, *e.g., Canisius College v U.S.* (2d Cir 1986) 799 F2d 18, 22 n8. Some courts give an agency's interpretations and practices considerable weight as a "body of experience and informed judgment." See, *e.g., Davis v U.S.* (1990) 495 US 472, 109 L Ed 2d 457, 470, 110 S Ct 2014 (Supreme Court gives agency's interpretations considerable weight when they involve contemporaneous construction of a statute and have been in long use); *Magneson v Commissioner* (9th Cir 1985) 753 F2d 1490, 1493 (Revenue Ruling based on facts similar to those before the court is entitled to consideration but is not binding on court).

For discussion, see Galler, *Emerging Standards for Judicial Review of IRS Revenue Rulings*, 72 BU L Rev 841 (1992).

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§1.12 D. Revenue Procedures

A Revenue Procedure is a statement of procedure that affects the rights or duties of taxpayers or other members of the public under the Internal Revenue Code and related statutes, or information that, although not necessarily affecting the rights and duties of the public, should be a matter of public knowledge. 26 CFR §601.601(d)(2)(i)(b). The National Office of the Internal Revenue Service issues Revenue Procedures and uses this format to issue guidance on like-kind exchanges. See Rev Proc 2000-37, discussed in chap 5, or Rev Proc 2002-22, discussed in chap 7. Unlike Revenue Rulings, which represent the IRS's formal interpretation of the law on a particular issue or set of facts and circumstances, Revenue Procedures are typically intended to provide taxpayers with guidance on procedural rules affecting taxpayers' rights and duties or, sometimes, to establish safe harbor guidance allowing taxpayers who conform to particular requirements to have certainty about the IRS's treatment of a transaction or structure.

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§1.13 E. Letter Rulings, Technical Advice Memorandums, and Chief Counsel Advice

The Internal Revenue Service (IRS) provides written advice in the form of letter rulings, technical advice memorandums, and Chief Counsel advice. The utility and effect of each varies according to the context in which it is used.

Letter rulings, also called private letter rulings and private rulings, are issued to taxpayers on written request regarding the tax treatment of their specific, prospective transactions.

A technical advice memorandum is a written statement issued by an IRS associate office to an IRS field agent on a closed and completed transaction in connection with the examination of a taxpayer's return or consideration of a taxpayer's refund claim. Both letter rulings and technical advice memorandums may be relied on by the taxpayers involved. Rev Proc 2009-1, 2009-1 Int Rev Bull 1; Rev Proc 2009-2, 2009-1 Int Rev Bull 87.

Letter rulings and technical advice memorandums may not be used or cited as precedent by anyone other than the taxpayer involved, however, unless the IRS establishes otherwise by regulations. IRC §6110(k)(3); *Donald DeCleene* (2000) 115 TC 457, 471 n6. Ordinarily, the IRS will not modify or revoke letter rulings or technical advice memorandums, even if subsequent authority would result in a different conclusion.

"Chief Counsel advice" refers to any written advice prepared by the National Office of the Chief Counsel of the IRS. Chief Counsel advice includes Chief Counsel memoranda (CCM), general counsel memoranda (GCM), field attorney advice (FAA), and field service advice (FSA). Unlike letter rulings and technical advice memorandums, Chief Counsel advice is not binding, although it can influence an agent or appellate conferee's evaluation of a matter. Chief Counsel advice may not be cited as authority or precedent in any tax controversy. IRC §6110(k)(3).

A substantial number of letter rulings have been issued under IRC §1031. These rulings provide an opportunity to analyze the IRS's position and the authority applicable to a particular set of facts. This information may help in structuring an exchange when no other authority exists. However, because letter rulings, technical advice memorandums, and Chief Counsel advice have no precedential value, attorneys structuring like-kind exchanges should not rely on rulings issued to other taxpayers or memorandums issued to an IRS field agent.

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§1.14 F. California Revenue and Taxation Code

For California income tax purposes, Rev & T C §18031 provides that gain or loss on disposition of property must be determined under Subchapter O of Chapter 1 of Subtitle A of the Internal Revenue Code (IRC §§1001-1092, which includes IRC §1031), except as otherwise provided. Former Rev & T C §18081 previously governed like-kind exchanges but was repealed, effective July 28, 1983, with the simultaneous enactment of §18031. Revenue and Taxation Code §24941 specifically adopts IRC §1031 by reference, except as otherwise provided, for entities subject to California's bank and corporation tax.

Although no reported cases have construed §18031 or former §18081 as they pertain to like-kind exchanges, the federal cases construing IRC §1031 control for California purposes because the state code incorporates the federal law by reference. In other areas of tax law, California courts have held that federal interpretations of federal statutes are also incorporated into the state statutes. See, *e.g.*, *Holmes v McColgan* (1941) 17 C2d 426, 110 P2d 428 (gain from sale of real property); *Fullerton Oil Co. v Johnson* (1934) 2 C2d 162, 39 P2d 796 (depletion allowances); *Sweetland v Franchise Tax Bd.* (1961) 192 CA2d 316, 13 CR 432 (corporate reorganization). Thus, federal cases construing §1031 apply for California purposes.

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§1.15 II. TERMINOLOGY

Exchanges under IRC §1031 have a unique terminology briefly described in §§1.16-1.22. For a complete list of definitions of exchange terms used in this book, see the Glossary.

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§1.16 A. Like-Kind, Tax-Deferred, Tax-Free, and Nontaxable Exchanges

Exchanges under IRC §1031 are alternatively referred to as "like-kind," "tax-deferred," "tax-free," and "nontaxable" exchanges. "Like-kind exchange" is the most accurate term used to refer to transactions that are the subject of IRC §1031. Although "tax-deferred exchange" is also quite common, it should not be confused with "deferred exchange," which refers to a nonsimultaneous exchange transaction governed by IRC §1031(a)(3). Furthermore, "tax-free exchange" and "nontaxable exchange" can be misleading because the taxpayer's gain is deferred—not forgiven—as a result of a like-kind exchange. As a rule, the taxpayer will eventually pay tax on the deferred gain on disposition of the replacement property in a subsequent taxable transaction. The taxpayer's gain can sometimes escape income taxation altogether if the taxpayer dies before disposing of the replacement property because of the effect of the provisions for stepped-up basis on death (see Note below). See IRC §1014.

NOTE: Under current law, stepped-up basis (*i.e.,* basis adjustment to fair market value at the date of death) will result when the taxpayer's death occurs before January 1, 2010. This rule is expected to continue to apply for deaths occurring after January 1, 2010, but Congress has not yet acted to repeal IRC §1014(f), which provides that §1014 shall not apply to decedents dying after December 31, 2009, or IRC §1022, which will provide for a modified and comparatively limited form of basis step-up. A full discussion of the mechanics of this prospectively effective rule is beyond the scope of this book but will be necessary if the rule is repealed. Readers should familiarize themselves with the current rules for basis step-up on death in connection with any tax planning. For discussion of income tax basis of property acquired from decedent, see California Estate Planning §12.2 (Cal CEB 2002).

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B. Properties Involved in the Transaction

§1.17 1. Relinquished and Replacement Property

Only certain types of property will qualify for like-kind exchange treatment. There are three principal criteria:

- The properties transferred and received cannot be of a type specifically excluded by IRC §1031(a)(2). See §§1.18, 2.6-2.18.
- Each of the properties must be held by the exchanging taxpayer for a "qualified use." IRC §1031(a)(1). See §§2.20-2.39.
- Both the properties relinquished and the replacement properties received must be of "like-kind." IRC §1031(a)(1). See §§2.40-2.50.

Like-kind property that the taxpayer relinquishes in the exchange is usually referred to in this book as "relinquished property." Like-kind property received in the exchange is usually referred to as "replacement property."

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Source: Real Property/Real Property Exchanges/1 Introduction to Exchanges/§1.18 2. Excluded Property

§1.18 2. Excluded Property

Internal Revenue Code §1031(a)(2) and Reg §§1.1031(a)-1(a)(1) and 1.1031(a)-2(c) list certain types of property to which the section does not apply:

- Inventory;
- Property held primarily for sale;
- Stocks, bonds, notes, or other evidence of indebtedness or interest;
- Partnership interests;
- Trust certificates or beneficial interests in trusts;
- Choses in action; and
- Goodwill.

Such property is sometimes referred to as "excluded property" in this book. See §§2.6-2.18.

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§1.19 3. Other Property ("Boot")

In IRC §1031, "other property" refers to excluded property, property that is not held for the required business or investment purpose, and property that is not like in kind to property traded in the exchange. IRC §1031(b)-(c); Reg §1.1031(b)-1. See §3.10. For example, a taxpayer may relinquish only real property but receive in exchange real property plus personal property (*e.g.,* an apartment building containing appliances, or land plus a boat). In such transactions, the personal property would be "other property" under IRC §1031(b)-(c). Exchange property that is not like-kind is commonly referred to as "boot," and the amount of boot received may be offset by the amount of boot given in calculating gain recognized.

Boot and boot offset rules are discussed more fully in chap 3.

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§1.20 C. Parties to the Exchange

The terminology used to denote the different parties to an exchange can vary, but the party seeking like-kind exchange treatment is usually referred to as the "taxpayer" or "exchanger."

In multiple party deferred and reverse exchanges, the ultimate purchaser of the relinquished property is called the "buyer." The owner of the replacement property is the "seller." A party who facilitates the transaction by acquiring the replacement property solely to transfer it to the taxpayer, or by acquiring the relinquished property solely to transfer it to the buyer, is the "intermediary." In some exchanges, the party who serves as the intermediary may be the buyer or the seller but is usually an independent party. An independent intermediary is also known as the "accommodator" or "facilitator." See chap 2 for a detailed discussion of these parties.

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Source: Real Property/Real Property Exchanges/1 Introduction to Exchanges/§1.21 D. Partially Taxable Exchanges

§1.21 D. Partially Taxable Exchanges

An exchange under IRC §1031 is fully tax-deferred if a taxpayer exchanges qualifying property solely for like-kind property to be held for qualified use. IRC §1031(a). If a taxpayer receives in the exchange money or other property that is excluded property under IRC §1031(a)(2), property that is not held for the required business or investment purpose, or property that is not like in kind to property traded in the exchange, then the taxpayer's gain is recognized, but for no more than the sum of the money and the fair market value of the other property received in the exchange. IRC §1031(b).

NOTE: Ultimate taxability of the recognized gain depends on the taxpayer's overall taxable income and available deductions for the year of the exchange (or subsequent years if IRC §453 applies).

Calculating the amount of gain subject to recognition under IRC §1031 is a two-step process. Gain on the transfer of relinquished property is recognized only when the taxpayer

- has realized gain (see §§3.2-3.5); and
- receives money or other property that is (1) excluded property under IRC §1031(a)(2) (see §§2.6-2.18), (2) property that is not held for the required business or investment purpose (see §§2.21-2.22), or (3) property that is not like in kind to property relinquished in the exchange (see §§2.20-2.50).

Realized gain is recognized to the extent of the sum of money and the fair market value of other nonqualifying property received in the exchange. IRC §1031(b). See §§3.6-3.53 on calculating amount of recognized gain.

EXAMPLE: A taxpayer exchanges property having a fair market value of $1 million and an adjusted basis of $800,000 for like-kind replacement property having a fair market value of $900,000 plus $100,000 in cash. The taxpayer realizes a $200,000 gain, of which $100,000 will be recognized and $100,000 will be deferred.

WARNING: Gain is not recognized pro rata to the extent of replacement property received when a taxpayer also receives boot. In the above example, if the taxpayer's basis in the exchange property had been $900,000, the taxpayer realizes $100,000 gain but will recognize *all* the realized gain and obtain no tax benefit from the exchange because the amount of cash received equals the realized gain. The taxpayer could have sold the property outright with the same tax consequences.

No losses are recognized in an exchange of like-kind properties under IRC §1031, even if money or other (nonqualifying) property is received in the exchange. See IRC §1031(c); §1.1.

PRACTICE TIP: Generally, a taxpayer should not structure a property transfer as an exchange if the sale of the relinquished property would result in a realized loss. A taxpayer with an expiring net operating loss (NOL), however, might choose to defer the loss under IRC §1031(a) so that it would be realized when the investment in the replacement property is liquidated, rather than recognizing the loss on the immediate sale of the property, subject to the NOL carry-forward limitation.

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§1.22 E. Simultaneous, Deferred, and Reverse Exchanges

A simultaneous exchange involves the concurrent transfer of relinquished property and receipt of replacement property. Exchanges that do not occur concurrently or simultaneously and exchanges in which relinquished property is transferred before replacement property is received are variously known as "nonsimultaneous," "deferred," "delayed," or "Starker" exchanges. The term "deferred exchange" was adopted by the Internal Revenue Service in Reg §1.1031(k)-1(a), which defines a "deferred exchange" as a nonsimultaneous exchange of qualifying, like-kind property. A "reverse exchange" refers to any exchange in which replacement property must be acquired from a seller before the relinquished property is conveyed to a buyer. See chap 5.

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§1.23 III. NONTAX CONSIDERATIONS IN REAL ESTATE LIKE-KIND EXCHANGES

It is axiomatic that undertaking a like-kind exchange of real property means that the taxpayer will continue to own real property when the exchange is completed. Taxpayers who intend to sell property should consider many tax and nontax factors before deciding whether a like-kind exchange is the best option. The following are examples of nontax reasons for continuing to invest in real property following a sale:

- Consolidating investments by exchanging several small properties for one larger replacement property;
- Diversifying investments by exchanging one property for several smaller replacement properties in different locations;
- Eliminating property management problems on one property by acquiring either a problem-free property or an interest in a larger property that employs a third party property management company;
- Replacing property having limited potential for appreciation with property having greater potential for appreciation;
- Realigning some or all of a real estate investment portfolio by exchanging high-risk, high-yield property for low-risk, low-yield property, or vice versa;
- Increasing cash flow by exchanging property with limited cash flow for property with greater cash flow;
- Relocating a business by exchanging the property on which it is located for property in a different area;
- Replacing an aging commercial facility with a modern, newly constructed commercial facility;
- Increasing investment leverage by acquiring property with a smaller ratio of equity to fair market value; and
- Terminating a problem joint ownership by exchanging joint interests for separate properties (but see §§2.13-2.14, 2.29-2.31, chap 7 on risks of trading cotenant or partnership interests).

Nontax considerations may also lead the taxpayer to liquidate, rather than continue, an investment. The taxpayer may need cash liquidity or wish to invest in another form of investment. The taxpayer may be willing to pay the tax on the gain to obtain steady income with less risk. For example, a taxpayer may prefer a passive investment such as bonds or treasury bills rather than real estate.

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IV. TAX CONSIDERATIONS OF LIKE-KIND EXCHANGES

A. Tax Advantages

§1.24 1. Tax Obligation Will Be Deferred

The major reason for undertaking a like-kind exchange of property qualifying under IRC §1031, as opposed to an outright sale and subsequent reinvestment, is to defer paying income taxes on the disposition of the old property. The income tax liability resulting from a taxable sale of property reduces the amount of funds available to reinvest in new property. By exchanging old property for new, the taxpayer retains the use of nearly all equity until the occurrence of a future taxable event, such as a sale of the replacement property.

The taxpayer who is an individual may continue to avoid recognizing gain until his or her death, at which time the gain may escape income taxation because of the stepped-up basis that the taxpayer's heirs may obtain in the property. The fair market value of the property held at death, however, is includable in the taxpayer's estate and subject to estate tax. IRC §2033.

PRACTICE TIP: A transaction may qualify as a like-kind exchange even if it was not completed before one spouse's death. In Letter Ruling 9829025, a husband and wife held real property as trustees of a revocable trust. The property was community property. At the time of the husband's death, they had identified replacement property for only one of the two properties that had been sold as relinquished properties. The wife, as trustee, completed the acquisition of the identified replacement property and identified and acquired a second replacement property. Because the IRS treated the husband as owning a one-half interest in both replacement properties when he died, the exchange qualified as a like-kind exchange for the husband (rather than the receipt of income in respect of a decedent under IRC §691). The surviving spouse received a stepped-up basis adjustment for both properties.

Since the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Pub L 108-27, 117 Stat 752) reduced tax rates on capital gains, it has occasionally become advantageous for some taxpayers to make taxable, rather than nontaxable, dispositions of real property in certain situations. For tax years ending after May 6, 2003, capital gains tax rates are 15 percent except for gain attributable to unrecaptured IRC §1250 depreciation, which is taxed at 25 percent. Sales or exchanges of assets held less than 1 year remain taxable at the taxpayer's rate for ordinary income.

WARNING: One popular alternative to a like-kind exchange of property is a "synthetic exchange," which employs a private annuity trust (PAT). The transaction exchanges appreciated real estate for an annuity contract. Earlier rulings have used both an open transaction approach as well as a ratable recovery method to characterize the payments made on the annuity. See *Lloyd v Commissioner* (1936) 33 BTA 903, nonacq XV-2 Cum Bull 39 (1936), withdrawal nonacq and acq 1950-2 Cum Bull 3 and Rev Rul 69-74, 1969-1 Cum Bull 43. The open transaction approach allows a taxpayer to take in annuity payments as recovery of basis first, before any income is realized, because the amount realized from the sale cannot be determined with certainty. The ratable recovery method allows a taxpayer to recognize determinable gain ratably over the taxpayer's life expectancy.

On October 18, 2006, the IRS issued proposed regulations in an attempt to restrict synthetic exchanges employing *PATs*. Prop Treas Reg §1.1001-1(j), 2006-2 Cum Bull 947. The proposed regulations are designed to prevent taxpayers from exchanging appreciated property for annuity contracts issued by family members (or by business entities controlled by family members) in order to gain favorable tax treatment. Under the proposed regulations, most exchanges of property for annuities are characterized as if the taxpayer had sold the property and used the proceeds to purchase the annuities. The amount realized is the fair market value of the annuity determined under IRC §7520. Any gain from the exchange of the property for the annuity contract will be recognized immediately. If adopted, these regulations will be retroactive, affecting most exchanges taking place after October 18, 2006. Payments received from transactions before that date would be unaffected.

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Source: Real Property/Real Property Exchanges/1 Introduction to Exchanges/§1.25 2. Exchange May Be Combined With Installment Sale

§1.25 2. Exchange May Be Combined With Installment Sale

A like-kind exchange under IRC §1031 may be combined with an installment sale. If a taxpayer receives boot in a like-kind exchange in the form of a new promissory note executed by the buyer of the relinquished property, the taxpayer must report the gain attributable to the note using the installment method under IRC §453, unless the taxpayer elects out of installment sale reporting under IRC §453(d). See IRC §453(f).

The results of an exchange combined with an installment sale are as follows:

- The taxpayer may escape income taxation altogether during the year in which the taxpayer disposes of the relinquished property (IRC §1(h));
- Gain will be recognized only when and to the extent that principal payments on the installment note are received (IRC §61(a); see §§3.43-3.45); and
- Interest on the note is currently taxable (IRC §63).

For a complete discussion of the interplay between IRC §1031 and IRC §453, see chap 3.

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§1.26 3. Depreciation Recapture May Be Transferred

Internal Revenue Code §§1245(b)(4) and 1250(d)(4) provide exceptions to the general rule of IRC §§1245 and 1250, which "recaptures" as ordinary income the gain from dispositions of certain depreciable property. Potential recapture will be "carried over" or "transferred" to the replacement property to the extent of IRC §1245 or §1250 property received in a like-kind exchange, and income attributable to recapture is not recognized at the time of the exchange. IRC §§1245(b)(4), 1250(d)(4). See §3.46 for a description of §1245 and §1250 property.

NOTE: If improved real property subject to recapture is exchanged solely for vacant land, all gain subject to recapture will be recognized in the year of disposition to the extent of the realized gain. Gain recognized as the result of the taxpayer's receipt of boot (see §3.12) will be taxed as ordinary income to the extent of depreciation recapture. IRC §§1245, 1250. However, because straight-line depreciation under §1250 is not subject to recapture, this principle generally will not apply to real property.

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§1.27 4. Conversion of Gain or Loss Character

With proper planning, a taxpayer may be able to convert certain tax attributes associated with the relinquished property to different tax attributes of the replacement property. For example, a taxpayer may be able to convert a capital loss to an ordinary loss.

EXAMPLE: If a taxpayer holds unimproved real property for investment purposes with an adjusted basis of $200,000, but a fair market value of only $100,000, a sale would result in a $100,000 capital loss. If there are no capital gains from other transactions in the same year, this capital loss would be nondeductible to a C corporation under IRC §1211(a) and would be limited to a $3000-per-year deduction for an individual taxpayer under IRC §1211(b). If, however, the land is exchanged under IRC §1031 for replacement property that is IRC §1231 property (*e.g.,* commercial rental property used in the taxpayer's trade or business), the subsequent sale of the replacement property in a taxable transaction may convert the former capital loss to an ordinary loss under §1231.

Like-kind exchanges can also offer taxpayers an opportunity to convert "active" or "portfolio" gain to "passive" gain under IRC §469.

EXAMPLE: If a taxpayer owns unimproved real property with a basis of $100,000 and a fair market value of $200,000, a taxable sale of the land would result in a $100,000 nonpassive capital gain. If the taxpayer has suspended passive loss from other activities, this nonpassive capital gain would not offset the passive loss. If, however, the land is exchanged under IRC §1031 for rental property that qualifies as a passive activity, the subsequent sale of the replacement property would result in a passive capital gain. This gain could then be sheltered by the taxpayer's suspended passive loss carried forward.

PRACTICE TIP: Care must be taken in structuring exchange transactions to achieve recharacterization of tax attributes. If the IRS determines that the exchange is merely an interim step in a plan to liquidate the replacement property, the exchange could be disallowed because the taxpayer did not have the requisite intent to hold the replacement property as an investment or for use in a trade or business. See §§2.23-2.28.

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§1.28 5. Basis Shifting

Related or affiliated taxpayers who hold in separate entities nondepreciable real estate with a high tax basis and depreciable real estate with a low tax basis may shift the high tax basis to the depreciable property through a like-kind exchange. This exchange allows the taxpayer to depreciate the tax basis that would otherwise remain capitalized in the nondepreciable property. To reach this result, taxpayers must be mindful of IRC §1031(f), which was added to the Internal Revenue Code in 1989 to prevent tax-deferral of gain in transactions entered into for the purpose of "basis shifting," *i.e.,* exchanges of higher basis property for low basis property to reduce or avoid the recognition of gain on the subsequent sale, or to accelerate a loss on retained property.

EXAMPLE: An individual (A) owns 100 percent of an S corporation (S) that owns a parcel of nondepreciable land (Land) with a basis of $100,000 and a fair market value (FMV) of $100,000. A also owns an apartment building (Building) with a basis of $40,000 (improvements fully depreciated) and a fair market value of $100,000. A exchanges the Building for S's Land. Result: A has realized gain of $100,000, and S has realized gain of $0. A has Land with a $40 basis and S has a depreciable basis of $80,000 (80 percent of value) in the Building with a 27.5-year depreciable life. Under IRC §1031(f), however, if the Land or the Building is sold during the two years after the exchange, the deferred $100,000 gain will be recognized by A.

Although a basis shift is an attainable objective, exchanges intended to reach this result must be carefully structured.

In *True v U.S.* (10th Cir 1999) 190 F3d 1165, the court recharacterized a series of transactions in which the taxpayer had exchanged land for depreciable assets attempting to achieve a basis shift. The court was not persuaded that any of the transactions had any independent business significance and collapsed the taxpayers' multiple transaction sequence into a single transaction whose end result and sole purpose was to give one family-controlled company a depreciable interest in oil and gas leases that had been fully depreciated by Oil, a related company. The court applied step-transaction doctrines and noted that "the fundamental principles of taxation dictate that 'a given result at the end of a straight path is not made a different result because reached by following a devious path.'" 190 F3d at 1179, citing *Minnesota Tea Co. v Helvering* (1938) 302 US 609, 82 L Ed 474, 58 S Ct 393.

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B. Tax Disadvantages

§1.29 1. Basis in Replacement Property Will Be Reduced

The major tax disadvantage of exchanging real estate under IRC §1031 is that the taxpayer's basis in the replacement property is reduced by the amount of gain deferred on disposition of the relinquished property, resulting in lower depreciation or cost recovery deductions. Reg §1.1031(d)-1. The consequence of a taxable sale followed by reinvestment of "after-tax" proceeds into a replacement property is a stepped-up basis in the replacement property. The benefit of greater depreciation deductions associated with the stepped-up basis will be ordinary income deductions that can offset ordinary income at ordinary income tax rates. When the passive activity loss limitation rules of IRC §469 or the at-risk rules of IRC §465 do not bar use of the deduction, a taxable sale can create an income tax rate arbitrage benefit because the ordinary income deductions from the depreciation will ultimately be offset by taxation at capital gain rates. When depreciation is available on relatively rapid recovery rates, such as the 15 years allowed for certain land improvement under IRC §168(e), the advantage of a taxable sale and reinvestment over a like-kind exchange may be even more pronounced. See §§3.59-3.68. Since 1986, for noncorporate taxpayers, however, this benefit of sales over exchanges has been muted by IRC §469's limitation on losses from passive activities (see §1.30), the effects of the at-risk limitations of IRC §465 (see §1.31), and the current 27.5- and 39-year recovery periods for most real estate depreciation deductions under IRC §168. See §1.24. In most instances, the net overall after-tax financial effect of a like-kind exchange is more advantageous than is a sale and reinvestment.

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§1.30 a. Effect of Passive Activity Rule

Internal Revenue Code §469(c) generally provides that the activity of renting real property is a per se ″passive" activity, regardless of whether the taxpayer materially participates in the operation and management of the property. Because losses from passive activities can be used to offset only income from other passive activities (IRC §469(a), (d)), tax losses from rental real estate generally cannot be used to offset nonpassive taxable income from salaries, commissions, or nonrental activities in which the taxpayer materially participates. Accordingly, unless the taxpayer has substantial passive income, the disadvantage of a carryover basis as a result of the exchange is significantly reduced because the lower depreciation deductions and resulting passive losses may not be used to shelter the taxpayer's active or portfolio income.

There are two exceptions to the general rule that losses from rental real property activities are per se "passive" and do not offset "active" income:

- A real property investor with adjusted gross income (AGI) of $100,000 or less can offset up to $25,000 of passive losses from rental real property activities against all types of income if the investor actively participates in the real property activity. For taxpayers with AGI between $100,000 and $150,000, the offset is phased out. IRC §469(i).
- For certain taxpayers, referred to as "real estate professionals," the term "passive activity" will not include rental activities if (a) more than half of the personal services performed by the taxpayer in trades or businesses during a taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and (b) the taxpayer performs more than 750 hours of service during the taxable year in real property trades or businesses in which the taxpayer materially participates. IRC §469(c)(7). For these purposes, "real property trade or business" means "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." IRC §469(c)(7)(C). For closely held C corporations, the passive activity rules will be eased if more than 50 percent of the corporation's gross receipts for the taxable year come from real property trades or businesses in which the corporation materially participates. Taxpayers who meet these requirements are exempt from the per se passive loss rule generally applicable to rental activities and may be able to generate active income or loss through material participation in the activity or activities.

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§1.31 b. Effect of At-Risk Limitations

Since 1986, the at-risk limitations of IRC §465 apply to real property. Thus a taxpayer can deduct losses from a real property investment only to the extent of the amounts actually invested and the amounts for which the taxpayer is personally liable (*i.e.,* recourse debt). In California, a buyer of real property may not be held personally liable for purchase-money borrowings or for debts to third parties financing the purchase of one-to-four-unit residential property if the buyer occupies one of the units. See CCP §580b; California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 5 (4th ed Cal CEB 2009). Under the IRC §465(b)(6) exception for qualified nonrecourse financing, borrowers are still considered at risk for tax purposes for certain nonrecourse amounts borrowed from a qualified person who is actively and regularly engaged in the business of lending money but who is not the seller of the property. IRC §§49(a)(1)(D)(iv), 465(b)(6).

The at-risk rules may limit the amount of losses deductible from replacement property. Thus, the disadvantage of a lower basis and lower depreciation deductions may not be important if the overall losses from the replacement property are limited by the at-risk rules of IRC §465.

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§1.32 2. Capital Gain May Be Converted to Ordinary Income

An exchange under IRC §1031 converts what may have otherwise been a capital gain into ordinary income when the taxpayer acquires replacement property that will ultimately be converted into property used in the ordinary course of a trade or business (called "dealer" property). IRC §1031(a)(2)(A). See §2.7.

EXAMPLE: A like-kind exchange may not yield the best tax result for a taxpayer seeking to dispose of a substantially appreciated apartment project and acquire another apartment project that will ultimately be converted to condominiums to be sold to end users. If the taxpayer sells the first apartment building, purchases the second, and then converts and sells the individual condominium units, the gain from the first sale is treated as capital gain and only the excess of the aggregate sale price of the condominium units over their aggregate cost is treated as ordinary income. If, however, the taxpayer exchanges the first apartment building for the second one and later converts it to condominiums that are individually sold, all gain on the sales, including both the originally deferred capital gain and the newly created gain, will be treated as ordinary income.

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§1.33 3. Suspended Losses Will Not Be Released

A taxpayer may release suspended losses from a passive activity on disposing of the taxpayer's entire interest in the activity in a fully taxable transaction. IRC §469(g)(1). A taxpayer with suspended passive losses under IRC §469 may prefer to sell (rather than exchange) the relinquished property, because any gain recognized from the sale could be offset against the suspended passive losses. This offset could reduce or eliminate tax on the sale and will result in a full-cost tax depreciable basis in new property purchased. If a taxpayer disposes of his or her entire interest in an activity but recognizes less than all the realized gain (*e.g.,* in a qualified IRC §1031 exchange), the suspended losses under §469 will offset gain recognized on the disposition but are not otherwise released and carry over to the replacement property. IRC §469(g)(1).

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§1.34 4. Losses Cannot Be Recognized

Losses cannot be recognized in like-kind exchanges. IRC §1031(a), (c). If sale treatment is desired for loss recognition, care must be taken to avoid an exchange. See §1.3. Taxpayers trying to take loss deductions on the disposition of their properties have sometimes unwittingly transacted exchanges. See *Redwing Carriers, Inc. v Tomlinson* (5th Cir 1968) 399 F2d 652; *Century Elec. Co. v Commissioner* (8th Cir 1951) 192 F2d 155. This problem is of decreasing importance owing to the prevalence of deferred rather than simultaneous exchanges.

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§1.35 5. Deferral May Cause Bunching of Income in Subsequent Year

A relatively minor disadvantage of a like-kind exchange is that the previous deferral of income may cause a bunching of income into the single year when the replacement property is sold, unless the taxpayer sells on an installment basis. See §3.43. In some cases, this could cause the marginal rate applicable to the gain to increase. In most situations, the earlier deferral of gain and postponement of tax will offset this subsequent cost.

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§1.36 V. CLASSIFICATION OF EXCHANGE TRANSACTIONS

The professional's first steps in structuring an exchange should be to

- identify the parties and properties involved (see §§1.37-1.40);
- define the sequence of the conveyancing transactions (see §§1.41-1.44); and
- identify the terms of sale and purchase of all properties involved in those transactions (see §1.45).

Because like-kind exchanges are usually tax-motivated transactions, the professional adviser should calculate the tax basis of the relinquished property and ascertain both the client's prior use of the property and the intended use of replacement property.

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§1.37 A. By Parties to the Exchange

A like-kind exchange involves multiple parties. Some exchanges may consist of a simple exchange between two taxpayers; others may be complex exchanges involving three, four, or more parties. There is no limit to the number of parties to the exchange, and some parties to the exchange may qualify for like-kind exchange treatment, while others do not. Rev Rul 75-291, 1975-2 Cum Bull 333.

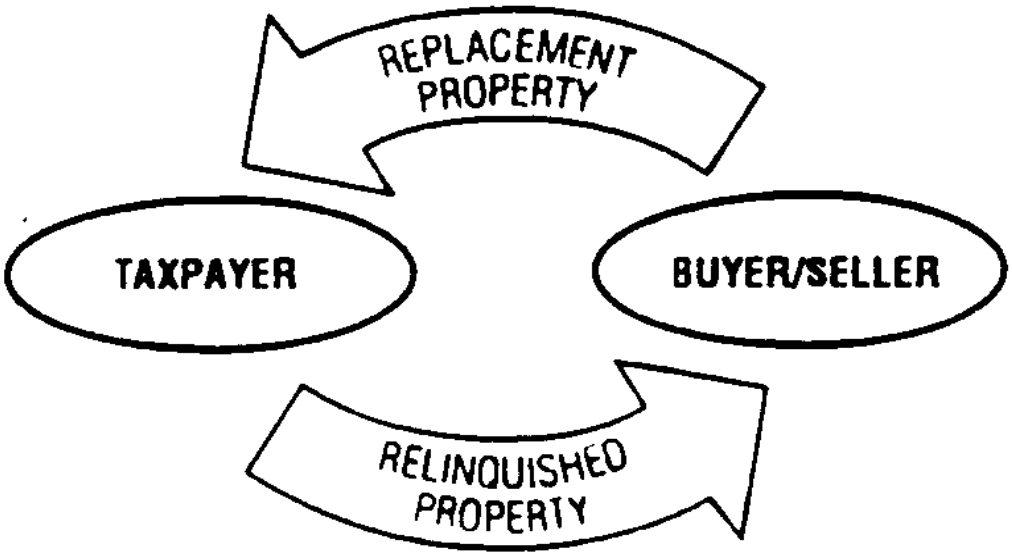
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§1.38 1. Two-Party Exchanges

In a two-party exchange, a taxpayer simply transfers the relinquished property to the seller of the replacement property, the seller transfers the replacement property to the taxpayer in exchange, and each retains the property received from the other. This type of exchange can occur either simultaneously or nonsimultaneously. If the exchange occurs nonsimultaneously, the time requirements of IRC §1031(a)(3) must be met. See §§4.16, 4.19.

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FIGURE 1. Two-Party Exchange



A two-party exchange can be deceptively simple. Although much of this book focuses on structuring transactions to ensure meeting the IRC §1031 requirements, the trap for the unwary in a two-party exchange lies in the fact that §1031 is nonelective. Taxpayers who attempt a sale transaction to recognize loss on disposition of relinquished property, or to achieve a new cost basis in the acquired property, may find themselves owning a new property with a carry-over basis or failing to achieve loss recognition. In several reported cases involving two-party exchanges, the IRS has attacked purported sales as disguised exchanges. See, *e.g., U.S. v Vardine* (2d Cir 1962) 305 F2d 60; *Jordan Marsh Co. v Commissioner* (2d Cir 1959) 269 F2d 453; *Century Elec. Co. v Commissioner* (8th Cir 1951) 192 F2d 155; *Leslie Co.* (1975) 64 TC 247, nonacq 1978-2 Cum Bull 3, aff'd (3d Cir 1976) 539 F2d 943; *Bennie D. Rutherford,* TC Memo 1978-505.

As a practical matter, actual two-party exchanges are rare because two independent parties seldom wish to acquire each other's property. Even if the seller of the replacement property is willing to acquire the taxpayer's relinquished property, the parties must agree on the value and terms of transfer for both properties rather than just one property.

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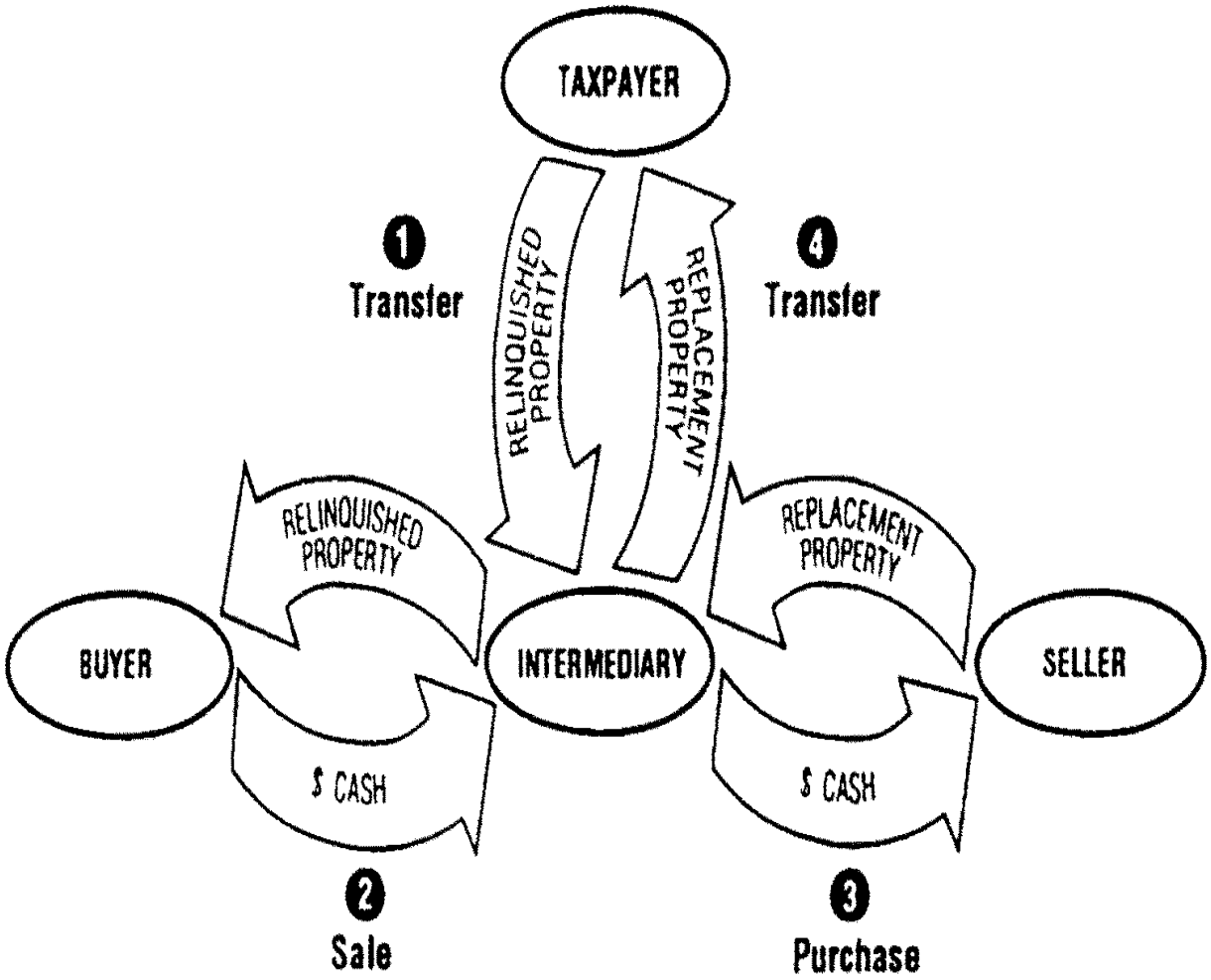
Source: Real Property/Real Property Exchanges/1 Introduction to Exchanges/§1.39 2. Multi-Party Exchanges Involving an Intermediary

§1.39 2. Multi-Party Exchanges Involving an Intermediary

Central to most modern like-kind exchanges is a party commonly known as the "intermediary." The intermediary acquires (or is deemed to acquire) the relinquished property from the taxpayer under an exchange agreement, conveys it to the buyer, and receives the net sale proceeds from the buyer. The intermediary grants an "exchange credit" to the taxpayer in the amount of the net proceeds. The intermediary then uses the net proceeds to purchase the replacement property from the seller and conveys it to the taxpayer. As will be discussed more fully in chapter 4, the intermediary need not obtain title to property to be treated as having participated in the exchange.

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FIGURE 2. Four-Party Exchange With Independent Intermediary



Why use an intermediary? To accomplish an exchange, a taxpayer must trade property with someone else and the taxpayer *must* avoid being in actual or constructive receipt of non-like-kind property. See §4.36. The intermediary acts as the taxpayer's exchange counterparty, the hub around which the exchange wheel spins, thus allowing relinquished property to be sold to a buyer and replacement property to be purchased from a seller, neither of whom needs to directly participate in an exchange.

Exchanges involving intermediaries were the subject of several exchange transactions that occurred before adoption

of the deferred exchange regulations in 1991. *Arthur E. Brauer* (1980) 74 TC 1134; *Earlene T. Barker* (1980) 74 TC 555; *Leslie Q. Coupe* (1969) 52 TC 394, acq in result 1970-2 Cum Bull xix; *J. H. Baird Publ'g Co.* (1962) 39 TC 608, acq 1963-2 Cum Bull 4; *Fred L. Fredericks,* TC Memo 1994-27; *Cary A. Everett,* TC Memo 1978-53; *Mercantile Trust Co.* (1935) 32 BTA 82.

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Source: Real Property/Real Property Exchanges/1 Introduction to Exchanges/§1.40 3. Multiple Party Exchanges Without Intermediaries: 'Round-Robins' and Other Three-Way Exchanges

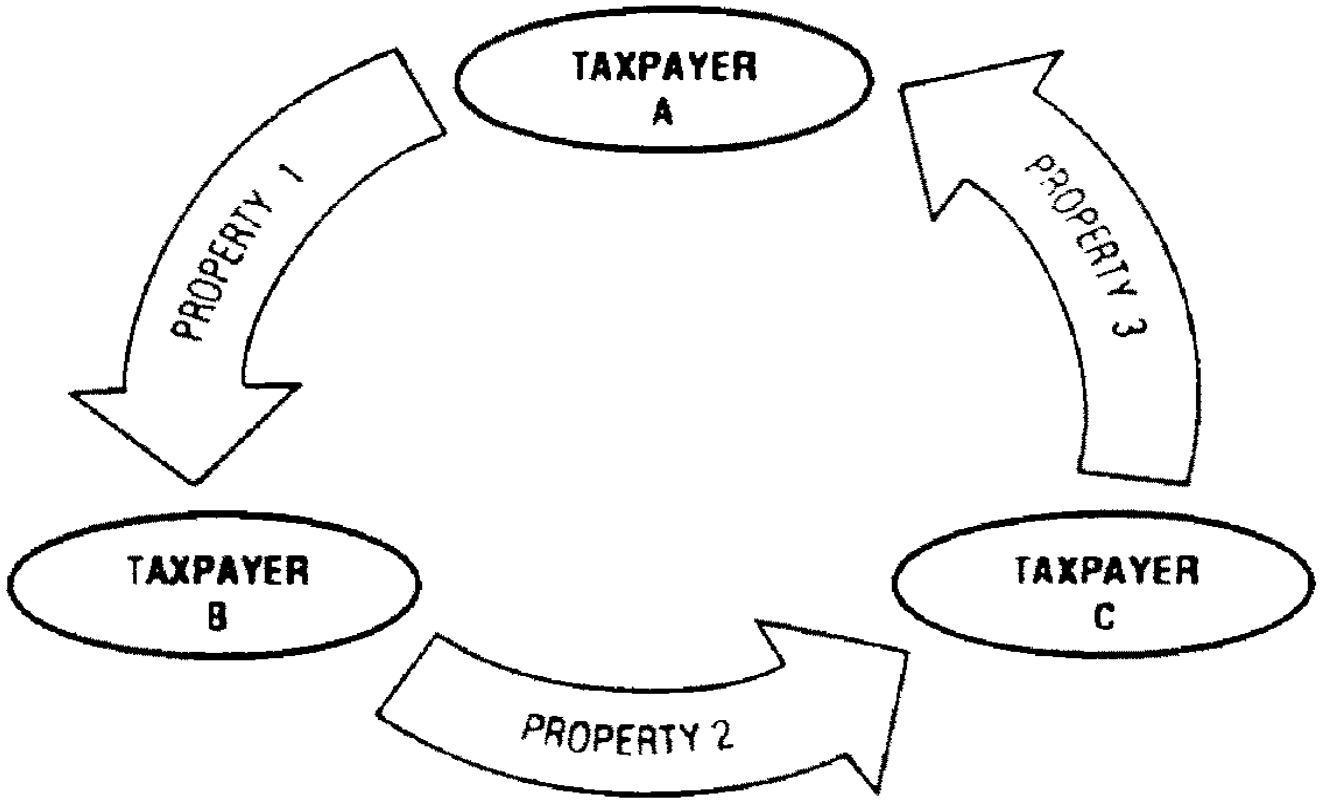
§1.40 3. Multiple Party Exchanges Without Intermediaries: "Round-Robins" and Other Three-Way Exchanges

In the absence of an intermediary and when there are more than two parties to the exchange, taxpayers have used at least three alternative methods to accomplish an exchange: either a "round-robin" or one of two variations of a three-way exchange.

In a true three-party exchange, the three parties transfer their respective relinquished properties in a "round-robin" in which no party exchanges directly for another's property. Instead, each party deeds directly to the ultimate recipient of the property as part of a mutually interdependent closing. Each party is contractually obligated to transfer his or her relinquished property to a party who is different from the party who transfers the replacement property. Round-robin exchanges eliminate the intermediary. See Rev Rul 57-244, 1957-1 Cum Bull 247. These exchanges are rare, however, because it is unusual to find three parties who all desire to exchange properties with one another on a simultaneous basis.

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FIGURE 3. Round-Robin Exchange

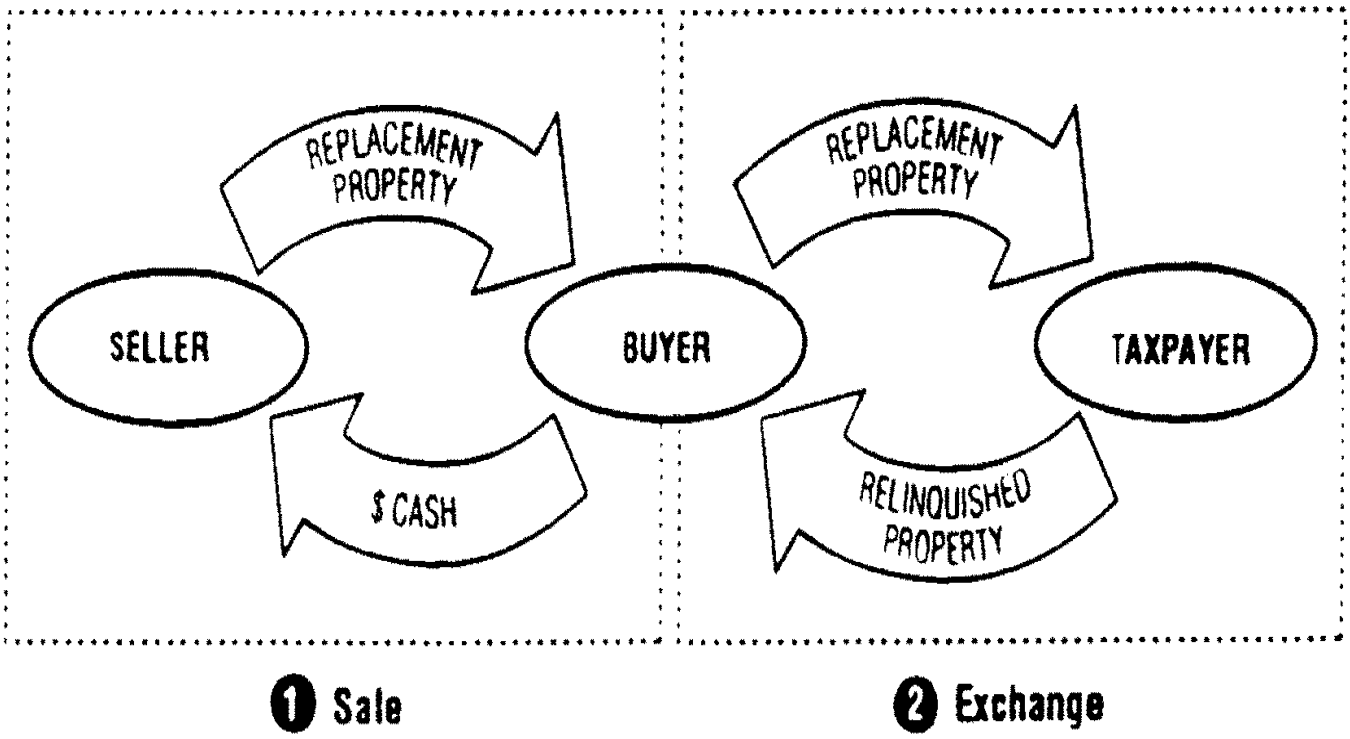


Before the advent of deferred exchanges, three-party exchanges were typically structured to use either the buyer of

the taxpayer's relinquished property or the seller of the taxpayer's replacement property as the intermediary to facilitate the exchange. In a "buyer-cooperating" exchange, the buyer of the relinquished property acted as the intermediary in the exchange by acquiring the replacement property from the seller and conveying it to the taxpayer in exchange for the relinquished property. This type of structure was involved in transactions discussed in *Starker v U.S.* (9th Cir 1979) 602 F2d 1341; *Coastal Terminals, Inc. v U.S.* (4th Cir 1963) 320 F2d 333; *Alderson v Commissioner* (9th Cir 1963) 317 F2d 790; *Hayden v U.S.* (D Wyo 1981) 82-2 USTC ¶9604, 50 AFTR2d 5570; *Fred S. Wagensen* (1980) 74 TC 653; *124 Front St., Inc.* (1975) 65 TC 6, nonacq 1976-2 Cum Bull 3; and *Hubert Rutland,* TC Memo 1977-8. See also Rev Rul 77-297, 1977-2 Cum Bull 304; Rev Rul 75-291, 1975-2 Cum Bull 332.

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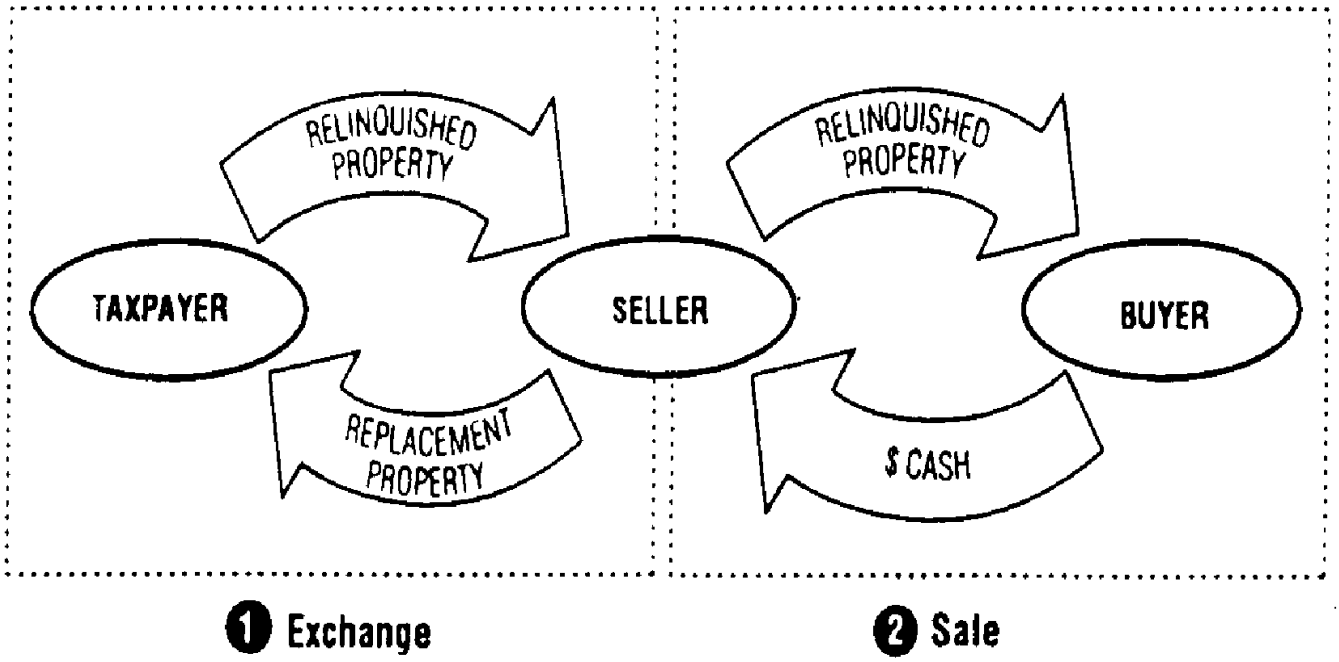
FIGURE 4. Type I Three-Party Exchange



In a "seller-cooperating" exchange, the taxpayer and the seller of the replacement property first exchange properties, and the seller then sells the taxpayer's relinquished property to the buyer of the relinquished property. This structure was used in transactions discussed in *Mays v Campbell* (ND Tex 1965) 246 F Supp 375; *Swaim v U.S.* (ND Tex 1979) 79-2 USTC ¶9462, 45 AFTR2d 1276, aff'd (5th Cir 1981) 651 F2d 1066; *Leo A. Woodbury* (1967) 49 TC 180, acq 1969-2 Cum Bull xxv; and *John M. Rogers* (1965) 44 TC 126, aff'd per curiam (9th Cir 1967) 377 F2d 534.

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FIGURE 5. Type II Three-Party Exchange



Under either variation, all parties end up in essentially the same position. The taxpayer receives the replacement property, the buyer receives the relinquished property, and the replacement property seller receives cash or other consideration. Before 1984 changes in the tax law codifying deferred exchanges were made (see §1.42), buyer-cooperating exchanges were probably the most common form of like-kind exchange of real estate. Since then, both the buyer-cooperating and the seller-cooperating forms have become rare, having been supplanted by the four-party transaction using an intermediary. See §1.39. It would be highly unusual for any attorney engaged to plan a like-kind exchange to use these now obsolete forms of transactions.

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§1.41 B. Timing of the Transactions

In addition to identifying the parties to a like-kind transaction, it is important to clearly understand the transactional timeframe anticipated by the participants. There may be instances in which all parties are prepared to convey their property immediately and others in which the taxpayer is ready to sell but the buyer is not ready to buy, or the buyer is ready to buy but the taxpayer is not ready to sell. Despite these various possibilities, like-kind exchange timeframes generally fall into one of three categories:

- Simultaneous, *e.g.,* all parties are ready to proceed (see §1.42);
- Deferred, *e.g.,* the taxpayer is ready to sell but the replacement property either has not been identified or needs to be constructed or the replacement property's owner is not ready to proceed (see chap 4); and
- Reverse, *e.g.,* the replacement property must be acquired before the taxpayer can dispose of the relinquished property (see chap 5).

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§1.42 1. Simultaneous Exchange

Except in the literal exchange of deeds, little guidance is available on what constitutes a "simultaneous" exchange. In some respects, the question of whether a transaction is a simultaneous exchange was made a historical anachronism by the Tax Reform Act of 1984 (TRA 1984) (Pub L 98-369, 98 Stat 494), which added IRC §1031(a)(3) to permit deferred exchanges, and was made even less relevant by the 1991 adoption of the final deferred exchange regulations, Reg §§1.1031(a)-1—1.1031(k)-1. Although simultaneous exchanges are theoretically possible in modern practice, the deferred exchange definition in Reg §1.1031(k)-1 ("an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the 'relinquished property') and subsequently receives property to be held either for productive use in a trade or business or for investment (the 'replacement property')") has the capacity to subsume the exception with the rule.

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§1.43 2. Deferred Exchange

As noted in §1.42, most like-kind exchanges fit the definition of deferred exchanges under IRC §1031(a)(3) and Reg §1.1031(k)-1. In a typical exchange, the taxpayer enters into a sale agreement with a buyer of the relinquished property and may or may not enter into a purchase agreement with the seller of the replacement property. Indeed, the taxpayer might not even identify the replacement property. Nevertheless, §1031(a)(3) permits the taxpayer to close with the buyer, *i.e.,* convey title to the relinquished property to the buyer, in anticipation of receipt of a replacement property. Moreover, Reg §1.1031(k)-1 provides detailed guidance on certain transactional parameters that, if followed, will permit the taxpayer to obtain like-kind exchange treatment if the replacement property is identified within 45 days after the taxpayer's transfer of the relinquished property and the replacement property is transferred to the taxpayer within 180 days after the transfer of the relinquished property. The means and methods of conducting a deferred exchange transaction are covered in depth in chapter 4.

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§1.44 3. Reverse Exchange

In some instances, the replacement property must come into the taxpayer's possession or control before the conveyance of the relinquished property. This situation is referred to as a "reverse exchange." There are two varieties of reverse exchanges:

- In a true reverse exchange, the replacement property is actually conveyed to the taxpayer before the taxpayer's conveyance of the relinquished property; and
- In a "parking" or "accommodation" reverse exchange, either the replacement property is temporarily "parked" with an accommodation party until the taxpayer is ready to sell the relinquished property or the accommodation party buys the replacement property and immediately exchanges it with the taxpayer for the relinquished property, holding the latter until it is sold.

See chap 5 for a complete discussion of these types of exchanges.

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§1.45 C. Assets Transferred and Received

Practitioners must also analyze the type of assets proposed to be exchanged. Practitioners must preliminarily ascertain whether the assets qualify for like-kind exchange treatment at all. In multiple asset exchanges, whether otherwise qualifying assets, *e.g.,* assets not explicitly excluded from like-kind exchange treatment under IRC §1031(a)(2), are of "like-kind" to replacement assets. If the exchange involves undeveloped land, for example, the attendant analysis is relatively simple; but if the transaction involves the exchange of businesses, the analysis can be quite complex.

As discussed more extensively in chap 2, the first litmus test to apply is the separation of real and personal property assets involved in the exchange. Many exchanges predominantly involving real estate still require consideration of the rules governing multiple assets because personal property is usually involved.

PRACTICE TIP: There is no de minimis rule applicable to the like-kind character of assets in an exchange under IRC §1031. Any transaction involving transfer or receipt of real and personal property will potentially be a multiple asset exchange.

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VI. ROLES OF ANCILLARY PARTIES TO THE EXCHANGE

A. Attorney

§1.46 1. Attorney's Role

The taxpayer may engage attorneys to perform transactional services and to provide tax advice in the exchange transaction. Transactional services include the following:

- Typical legal services associated with purchasing and selling property (*e.g.,* preparing purchase and sale agreements, escrow instructions, and listing agreements; negotiating contingency clauses and loan documents; assigning leases and other inchoate property rights; creating security documents; negotiating title insurance coverage; and counseling the client on environmental due diligence);
- Preparation or review of an exchange agreement; and
- Selection of an intermediary.

Tax services include the following:

- Advising the client on structuring and documenting the exchange;
- Analyzing the potential for partial gain recognition owing to receipt of non-like-kind property;
- Coordinating an installment sale with the exchange; and
- Otherwise minimizing the client's tax liability and exposure.

Just as real property attorneys should not perform tax-related services unless they are competent to do so, tax attorneys should not perform real property transactional services unless they are competent to handle them. Because most like-kind exchanges are fundamentally tax motivated, the danger of a real estate attorney providing erroneous tax advice is of particular concern. See also California Real Property Sales Transactions §§1.2-1.18 (4th ed Cal CEB 2007).

A client may request counsel's advice on the economic and business aspects of the transaction. The client may ask the attorney to help with the due diligence property inspections, investigate the financial qualifications of a party to the transaction, or assure the client of the economic soundness of the total venture. Because many of these tasks are outside the normal expertise of a real property or tax attorney, he or she should not agree to do so unless qualified for the task.

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§1.47 2. Attorney as Intermediary

If an attorney acts as an intermediary in a deferred exchange, owns the stock of a corporate intermediary, or is a partner or member in a partnership or limited liability company (LLC) acting as intermediary, the "safe harbor" of Reg §1.1031(k)-1(g)(4) for qualified intermediaries may be jeopardized. To meet the requirements for this safe harbor, the attorney or attorney-owned intermediary must not be a "disqualified person" within the meaning of Reg §1.1031(k)-1(k). See §4.65. The definition of disqualified person includes one who is the taxpayer's agent at the time of the transaction. An attorney who does not currently represent the taxpayer will still be a disqualified person if the attorney has acted as the taxpayer's attorney within the 2-year period ending on the transfer date of the first of the relinquished properties unless the only services rendered for the taxpayer related to the exchanges of property under IRC §1031. Reg §1.1031(k)-1(k)(2)(i).

The definition of disqualified person also covers any individual or entity that bears a proscribed relationship to an agent who is disqualified under Reg §1.1031(k)-1(k)(2). Reg §1.1031(k)-1(k)(4). The proscribed relationships are the familial and entity relationships described in IRC §§267(b) and 707(b), except that "10 percent" is substituted for "50 percent" wherever it appears. Reg §1.1031(k)-1(k)(4). See §4.66. Thus, if an attorney who has represented the taxpayer within the past 2 years owns more than 10 percent of the stock of the corporate intermediary, the exchange will not satisfy the qualified intermediary safe harbor of Reg §1.1031(k)-1(k)(4). See §4.67. The taxpayer should still qualify for the safe harbor, however, if the attorney acts as a director or an officer of a corporate intermediary without owning stock, because the corporate relationships described in either IRC §267(b) or §707(b) apply only to stock ownership, not to management. Reg §1.1031(k)-1(k)(5), Example 3.

If an attorney or attorney-owned corporation acts as an intermediary for a taxpayer and is classified as a "disqualified person" under Reg §1.1031(k)-1(k), the exchange may still qualify under IRC §1031 even though the safe harbor for qualified intermediaries is not satisfied. Substantial case law approves of the participation of an attorney or attorney-owned intermediary in a like-kind exchange. See *Biggs v Commissioner* (5th Cir 1980) 632 F2d 1171 (attorney-owned corporation acting as intermediary); *Leslie Q. Coupe* (1969) 52 TC 394, acq in result 1970-2 Cum Bull xix. A taxpayer is safer, however, using a qualified intermediary that meets the safe harbor requirements.

For further discussion of qualified intermediaries and disqualified persons, see chap 4.

PRACTICE TIP: In certain situations, an attorney who renders legal and tax advice in the exchange transaction may own or control the intermediary used in accomplishing the exchange. If the attorney is also providing legal services for the client, the attorney must disclose to the client any actual or potential conflict of interest resulting from owning or controlling the intermediary. When an actual or potential conflict of interest exists, the attorney should obtain the client's written consent before proceeding with structuring, coordinating, or documenting the exchange. See Cal Rules of Prof Cond 3-300.

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3. Attorney's Liability

§1.48 a. Identifying the Client

Exchanges are sometimes brought to the attorney by a real estate agent who represents the taxpayer. Frequently, the agent may have even agreed with the principal to pay the attorney fees for the exchange. Attorneys undertaking representation in a like-kind exchange are exposed to malpractice liability from each client in the exchange. Thus, the attorney must make it clear from the outset of the exchange whom the attorney represents: the taxpayer, the real estate agent, the seller of the replacement property, or the buyer of the relinquished property. The attorney usually represents the taxpayer, even if the taxpayer's real estate agent referred the transaction to the attorney and agreed to pay the attorney fees. In that situation, however, both the taxpayer and the agent should clearly understand whom the attorney represents.

If the attorney intends to represent more than one of these parties, the rules of professional conduct require the attorney to obtain each client's informed written consent before beginning representation because a potential conflict of interest may exist between the parties. See Cal Rules of Prof Cond 3-310. See also California Real Property Sales Transactions §§1.8-1.11 (4th ed Cal CEB 2007). If only one party will be represented, that fact should be disclosed in any correspondence with any other party and should be specified in the exchange agreement or in the engagement letter between the attorney and the client.

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§1.49 b. Liability for Tax Advice

Whether an attorney may be held liable for the tax consequences of a transaction in which the taxpayer fails to obtain like-kind exchange treatment is unclear. See *Holder v Home Sav. & Loan Ass'n* (1968) 267 CA2d 91, 72 CR 704 (recovery denied for misrepresentations by savings and loan association as to prospective tax liability because amount of damages was too speculative). Although the attorney does not guarantee the tax result, an ordinary standard of care requires that the attorney at least avoid the traps described in the statute and case law under which the taxpayer will clearly not qualify for like-kind treatment.

If exchanges are held by the courts to be within the province of specialists, an attorney who undertakes representation will be held to the standard of specialists. *Lucas v Hamm* (1961) 56 C2d 583, 15 CR 821; *Horne v Peckham* (1979) 97 CA3d 404, 158 CR 714, overruled on other grounds in *ITT Small Bus. Fin. Corp. v Niles* (1994) 9 C4th 245, 256, 36 CR2d 552. Because of the complex and often uncertain nature of the tax law in this area, however, the injured taxpayer may be unable to establish liability for professional malpractice even if the taxpayer fails to receive the desired like-kind treatment. Also, because the amount paid in a taxable transaction is deferred only in a qualifying transaction, the speculative nature of the damages for failing to obtain like-kind treatment may make establishing the amount of damages difficult (unless the taxpayer died shortly after the transaction but before the trial, and the step-up in basis under IRC §1014 would effectively eliminate any tax otherwise paid). Otherwise, the damages would be the income tax, interest, and penalties that the taxpayer is required to pay as a result of the disqualified exchange.

The attorney should inform the taxpayer of the time requirements under IRC §1031(a)(3), but it is the taxpayer's responsibility to satisfy these requirements. The attorney should not be responsible for a client's failure to identify replacement property within 45 days after the date on which the relinquished property is transferred as part of the exchange. Further, it should be the taxpayer's responsibility to acquire the replacement property within 180 days after the date on which the relinquished property is transferred as part of the exchange, unless in either situation the attorney is clearly responsible for the delay. As in all real property transactions, the attorney should not be responsible for the business risks associated with acquiring and disposing of real property.

Whether a taxpayer may claim taxes attributable to the loss of a tax benefit as an element of damages should turn on whether the tax benefit at issue is either a permanent benefit or a timing benefit. The tax benefit derived from a §1031 exchange is a timing benefit (*i.e.,* deferral, not avoidance, of tax liability). The taxes paid by plaintiffs, resulting from lost tax-timing benefits, are usually not recoverable as actual damages owing to a lack of proximate cause. Moreover, the uncertainties associated with tax-timing benefits may render the hypothetical lost deferral value far too speculative to constitute an element of recoverable damages. See Rich, *Financial Professionals' Liability to Clients for Lost Tax Benefits*, 80 Tax Notes 217 (July 13, 1998).

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§1.50 c. Tax Fraud

In *David Dobrich*, TC Memo 1997-477, aff'd (9th Cir 1999) 99-2 USTC ¶50,826, the taxpayers were convicted of fraud under IRC §6663(a) for providing false documents to the IRS in support of a like-kind exchange that failed to meet the 45-day replacement property identification requirement of IRC §1031(a)(3)(A). To support their contention that the property had been identified within the 45-day period, the taxpayers obtained from the attorney who facilitated the exchange a "sample" identification letter, which was backdated and written to describe the property that the taxpayer ultimately acquired.

The Tax Court found that the taxpayers had likely obtained the letter "to create a false impression that they had timely identified whatever property they acquired." Despite repeated advice from the attorney and other professionals involved with the transaction about the mechanics of the 45-day identification period, the taxpayers' backdated "sample" identification letter eventually found its way first into the hands of the taxpayers' accountants at the time the return reporting the putative like-kind exchange was being prepared, and later into the hands of a revenue agent conducting a field examination after the gain deferral was disallowed.

In defending the fraud, the taxpayers argued that they had, in fact, identified the replacement property within the 45-day period, presumably in an effort to persuade the court that the letter was not fraudulently backdated but was merely intended to be a memorandum of events that had transpired on the date of the letter. The Ninth Circuit found this contention "incredible" and affirmed the Tax Court's decision to find fraud under §6663(a). *Dobrich* should serve as a warning that forms and procedures matter in transactions. The practitioner should take care to exercise the duty to "reasonably ascertain the true facts and fully inform the [taxpayers] of the consequences." *Medieval Attractions,* TC Memo 1996-455.

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§1.51 4. Attorney Fees

In establishing the fee for representing one or more of the parties to a like-kind exchange, the attorney should consider the following:

- The time involved;
- The high degree of expertise required;
- The taxpayer's tax savings resulting from the exchange; and
- The attorney's malpractice exposure.

The representation may entail diverse functions, including counseling the client, undertaking tax research, giving tax and legal advice, structuring the exchange, and drafting the exchange agreement and escrow instructions. Fee arrangements should be resolved in advance so that the client clearly understands the basis of the fee, the time of payment, and the party or parties responsible for the fees. See Fee Agreement Forms Manual (2d ed Cal CEB 2007). See also California Real Property Sales Transactions §§1.19-1.21 (4th ed Cal CEB 2007).

An attorney acting as an intermediary, or an attorney-owned or controlled intermediary, should receive a separate fee for serving as the intermediary to separate the functions of performing legal services and acting as the intermediary. The attorney or attorney-owned intermediary may receive the interest earned on the net sales proceeds during the delay period of the deferred exchange in addition to or in lieu of other fees, but if large amounts are involved, the interest earned may be subject to the rules governing earnings on deferred exchange accounts designed to tax the exchange client. See discussion of these rules in §§4.57, 4.60-4.61.

Although the taxpayer may be entitled to receive the interest earned on such proceeds in a deferred exchange if the requirements of Reg §1.1031(k)-1(g)(5), (k)-1(h) are met, the taxpayer may obtain a better tax result by permitting the attorney or intermediary to retain the interest as all or part of the fee. Otherwise, the taxpayer will be required to pay tax on the interest income earned and pay the fee with after-tax dollars, which will increase the basis of only the replacement property. Rev Rul 72-456, 1972-2 Cum Bull 468. The taxpayer's ability to utilize this approach will also depend on whether rules governing taxation of exchange funds apply to the transaction. See §§3.62, 4.60.

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§1.52 B. Tax Specialist

If the attorney is not a tax specialist, the taxpayer should be encouraged to consult with a certified public accountant (CPA) or other tax law specialist before consummating a like-kind exchange. The CPA can verify the attorney's calculations of basis and any boot. In addition, the client's own CPA is usually more familiar with the client's overall tax position and objectives than the attorney and can better assist in evaluating whether a like-kind exchange is appropriate for the taxpayer.

If the accountant or an accountant-owned company wishes to participate as the intermediary in a deferred (nonsimultaneous) exchange, the requirements of Reg §1.1031(k)-1(k) should be reviewed to ensure that the accountant or accountant-owned intermediary is not a "disqualified person."

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§1.53 C. Real Estate Agent

Real estate agents are frequently involved in planning and structuring like-kind exchanges, but they rarely have the tax expertise and experience necessary to ensure that the requirements for like-kind exchange treatment are met. Accordingly, the agent's role should be focused on finding a buyer for the relinquished property and finding a replacement property acceptable to the taxpayer.

In California, buyers and sellers of real property often rely on real estate brokers and their agents for real property and tax advice, including advice on the nature and manner of structuring a like-kind exchange. Real estate brokers expose themselves to substantial liability by providing legal or tax advice. See, *e.g., Shapiro v Sutherland* (1998) 64 CA4th 1534, 1539 n6, 76 CR2d 101, citing *Easton v Strassburger* (1984) 152 CA3d 90, 199 CR 383. See also CC §§1102-1103.14, 2079-2079.24 (the latter apply only to real property sales, exchanges, or leases). Moreover, one who provides legal advice or drafts legal instruments or contracts for a paying client is engaging in the practice of law. *Biakanja v Irving* (1958) 49 C2d 647, 320 P2d 16; *People v Landlords Prof. Servs.* (1989) 215 CA3d 1599, 1604, 264 CR 548; *People v Sipper* (1943) 61 CA2d Supp 844, 142 P2d 960, overruled on other grounds in *Murgia v Municipal Court* (1975) 15 C3d 286, 301 n11, 124 CR 204. A nonattorney who negligently performs legal services for another may be held to the standard of a practicing attorney, at least if he or she knows that the client is relying on the nonattorney's services as a substitute for competent, professional services. Thus, a real estate agent who negligently provides legal or tax advice may be held to the standard of a practicing attorney or a tax professional. Agents may even be held to the standard of a tax specialist if they purport to be exchange specialists. See *Biakanja v Irving, supra*.

A real estate broker or an agent who finds a buyer for the relinquished property and helps negotiate the acquisition of suitable replacement property but does not advise the taxpayer to structure the transaction as an exchange should be able to avoid liability for failing to provide tax advice if the broker or agent did not lead the taxpayer to expect to receive such advice. In *Carleton v Tortosa* (1993) 14 CA4th 745, 17 CR2d 734, the agent incurred no liability for failing to advise the taxpayer on how to accomplish a like-kind exchange, because the listing agreement specifically advised the client to consult competent professionals for legal or tax advice, and no evidence was presented that the agent had undertaken such obligations.

Most real estate agents include exculpatory provisions in their listing and other agency agreements, advising their clients to seek competent legal and tax advice. Civil Code §2079.16 requires agents to use a specific form for this purpose in residential transactions. These exculpatory provisions will not shield an agent from liability if he or she actually provides legal or tax advice, recommends against hiring a professional, or refers the client to a professional whom the agent knew or should have known was incompetent for the task. See *Carleton v Tortosa, supra*; *Santos v Wing* (1961) 197 CA2d 678, 17 CR 457.

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Source: Real Property/Real Property Exchanges/1 Introduction to Exchanges/§1.54 D. Escrow Agent

§1.54 D. Escrow Agent

In many exchange transactions, escrow agents perform the relatively straightforward function of holding documents and funds for purposes of effecting the exchange. The escrow agents work with the brokers and attorneys representing the various parties in accomplishing these tasks. In some instances, however, escrow agents may complete the entire exchange transaction without the involvement of attorneys representing either party or even "in-house" legal counsel. Buyers, sellers, and real estate agents in Southern California often rely on an escrow officer (or the escrow company's affiliated exchange intermediary company) to structure the exchange.

Escrow agents sometimes attempt to structure an exchange transaction by using standard purchase and sale escrow instructions, one for the sale of the relinquished property and another for the purchase of the replacement property. These two transactions will not be considered to be an exchange even if the escrows close simultaneously. To qualify as an exchange, the two transactions must be contractually interdependent. *Joyce M. Allen,* TC Memo 1982-188; *Byron Wayne Meadows,* TC Memo 1981-417. Further, the exchange transaction must be properly documented to avoid the constructive receipt of funds. Without proper documentation, the taxpayer will be in constructive receipt of the sale proceeds as soon as they are received in escrow. See *Maxwell v U.S.* (SD Fla 1988) 88-2 USTC ¶9560, 62 AFTR2d 5406.

Escrow officers who attempt to structure or document exchange transactions risk substantial liability if the exchange is disqualified, an installment note is improperly handled, or other negative tax consequences result. Moreover, providing legal or tax advice may constitute the unauthorized practice of law. Bus & P C §6125. See *Farnham v State Bar* (1976) 17 C3d 605, 131 CR 661 (escrow holder practiced law); *People v Sipper* (1943) 61 CA2d Supp 844, 142 P2d 960, overruled on other grounds in *Murgia v Municipal Court* (1975) 15 C3d 286, 301 n11, 124 CR 204.

Although escrow instructions often include exculpatory provisions to shield escrow agents from liability for negligence if the transaction does not qualify as a proper IRC §1031 exchange, such provisions are generally not enforceable. *Akin v Business Title Corp.* (1968) 264 CA2d 153, 70 CR 287. A hold harmless or release of liability agreement, however, may protect the escrow agent from its own active negligence. In *Rooz v Kimmel* (1997) 55 CA4th 573, 64 CR2d 177, hold harmless provisions of an indemnity agreement effectively shielded a title company from any liability arising from its failure to timely record a deed of trust when it was clear that recordation was done only as an accommodation to the complainant and would not have been done at all in the absence of the indemnification and hold harmless agreement. The agreement clearly intended to release the title company from any liability.

A provision in the escrow instructions and exchange documents advising the taxpayer to seek tax advice from an attorney or accountant may diminish the escrow officer's liability (especially if the taxpayer specifically signs or initials the provision) but only if the officer's conduct is consistent with this advice. Merely stating in the escrow instructions and exchange documents that the taxpayer should seek tax advice from an attorney or accountant does not relieve an escrow company of liability. The company is likely to be liable if it has structured the transaction, prepared the exchange documents, and held itself out to the public to be competent to handle the entire exchange transaction.

In a deferred (nonsimultaneous) exchange, the taxpayer and the taxpayer's transferee (usually the buyer of the relinquished property or the intermediary) may instruct an escrow agent to hold the net sale proceeds in a qualified escrow account. This use of a qualified escrow account to secure the obligation of the taxpayer's transferee to transfer replacement property to the taxpayer is a "safe harbor" under Reg §1.1031(k)-1(g)(3). If the escrow agent who performs this function is a disqualified person as defined in Reg §1.1031(k)-1(k), the safe harbor for qualified escrow accounts will not be satisfied.

WARNING: The qualified escrow account safe harbor does not permit a taxpayer to cure an otherwise defective exchange; *e.g.,* the taxpayer cannot close a standard purchase and sale transaction and direct that the proceeds be delivered to the escrow agent to hold for purchase of replacement property. The purpose of a qualified escrow account is solely to secure the performance of the taxpayer's transferee (or intermediary) to transfer replacement property to the taxpayer. If the taxpayer's transferee has no obligation to purchase replacement property to transfer to the taxpayer to complete the exchange, the requirement under IRC §1031 will not be satisfied. See §4.51.

See §§4.49-4.52 for detailed discussion of the requirements and limits of the qualified escrow account safe harbor. On who are agents of taxpayer for purposes of determining status as a disqualified person, see §4.66. For form escrow instructions for deferred exchanges, see §§4.108, 4.111; for reverse exchanges, see §5.66.

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Requirements for Like-Kind Exchanges

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I. BASIC STATUTORY REQUIREMENTS

§2.1 A. Overview

The basic statutory requirements for a like-kind exchange of property are set forth in IRC §1031(a):

(a) Nonrecognition of gain or loss from exchanges solely in kind.

(1) *In general*. 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.

(2) *Exception*. This subsection shall not apply to any exchange of

(A) stock in trade or other property held primarily for sale,

(B) stocks, bonds, or notes,

(C) other securities or evidences of indebtedness or interest,

(D) interests in a partnership,

(E) certificates of trust or beneficial interests, or

(F) choses in action.

For purposes of this section, an interest in a partnership which has in effect a valid election under [IRC §]761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.

(3) *Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property.* For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if

(A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(B) such property is received after the earlier of

(i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

To summarize, the following are the basic requirements that apply:

- **Type of property requirement.** Only a transfer of property is subject to like-kind exchange treatment; provision of services is not. Neither the property relinquished nor the property received may be a type of property expressly excluded from the statute (see §§2.4-2.19).
- **Qualified use requirement.** Both the property relinquished and the property received in the exchange must be held by the taxpayer for productive use in a trade or business or for investment at the time of the exchange (see §§2.20-2.39).
- Like-kind requirement. The property received in the exchange transaction must be of like-kind to the relinquished property (see §§2.40-2.50).
- **Exchange requirement.** The transaction must be an exchange of relinquished property for replacement property, not a sale of the relinquished property followed or preceded by a purchase of another property (see §§2.51-2.69).
- **Time requirement.** If the exchange is nonsimultaneous, the replacement property must be (a) identified no later than 45

days after the date on which the relinquished property is transferred and (b) received by the taxpayer on or before the earlier of (1) 180 days after the date on which the taxpayer transfers the relinquished property or (2) the due date, including any allowable extensions, for the taxpayer's tax return for the taxable year in which the relinquished property is transferred. See chap 4 for discussion of the rules for nonsimultaneous exchanges.

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B. Eligible Taxpayers

§2.2 1. Corporations Filing Consolidated Returns: Intercompany Transfers

Internal Revenue Code §1031 does not apply to intercompany transactions. Reg §1.1502-80(f). Corporate members of a consolidated group will look to the intercompany transaction rules of IRC §1502 and Reg §1.1502-13, rather than §1031, for the treatment of intercompany exchanges of property.

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§2.3 2. All Other Taxpayers

Internal Revenue Code §1031 applies to individuals, corporations, partnerships, and trusts and to domestic transactions of nonresident taxpayers. IRC §1031(a)(2).

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II. TYPE OF PROPERTY REQUIREMENT

§2.4 A. Basic Rule

Under the basic rule of IRC §1031(a), a taxpayer will not recognize gain or loss from an exchange of property that the taxpayer holds either for productive use in a trade or business or for investment, for like-kind property that the taxpayer also holds either for productive use in a trade or business, or for investment. The rule applies to real and personal property. Exchanges involving certain types of property, however, are expressly excluded from nonrecognition treatment under IRC §1031(a)(2). See §2.6.

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§2.5 B. Services Not Eligible

Internal Revenue Code §1031 does not apply to an exchange of services or any transfer not considered a transfer of property. §1031(a)(1)-(2).

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§2.6 C. Excluded Property

For an exchange to qualify under IRC §1031, neither the property relinquished nor the replacement property received may be a proscribed type of property. The following are specifically excluded by IRC §1031(a)(2):

- Inventory and other property held primarily for sale (see §§2.7-2.10).
- Stocks and other securities and evidences of interest (see §2.11);
- Bonds, notes, and other evidence of indebtedness (see §2.12);
- Partnership interests (see §§2.13-2.14);
- Certificates of trust or beneficial interests (see §§2.15-2.17); and
- Choses in action (see §2.18).

Congress initially added several of these exclusions to prevent taxpayers from completing exchanges of appreciated stocks and bonds for other securities. See H Rep No. 1432, 67th Cong, 4th Sess (1923), reprinted in 1939-1 (pt 2) Cum Bull 554, discussed in §1.4. In addition, notes and securities were excluded because they were considered to be equivalent to money. See H Rep No. 1432 at 564. See also *Jordan Marsh Co. v Commissioner* (2d Cir 1959) 269 F2d 453.

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§2.7 1. Stock in Trade

Internal Revenue Code §1031(a) specifically excludes exchanges of property held as stock in trade. IRC §1031(a)(2)(A). Stock in trade is property that would properly be included in inventory or property held for sale to customers in the ordinary course of the taxpayer's trade or business. IRC §1221(a)(1).

Real property held for sale to customers in the ordinary course of a trade or business is commonly referred to as "dealer property." Gain from the sale of dealer property is taxed as ordinary income. IRC §1221(a)(2); *Margolis v Commissioner* (9th Cir 1964) 337 F2d 1001. Dealer status is determined with respect to each particular property. *Crosswhite v U.S.* (D Or 1977) 438 F Supp 368. Even if a taxpayer is in the business of buying and selling real property, the taxpayer may hold some real property for investment purposes. *Neal T. Baker Enters.,* TC Memo 1998-302; *Loren F. Paullus,* TC Memo 1996-419; *Planned Communities, Inc.,* TC Memo 1980-555.

A taxpayer who is a dealer has the burden of showing that the property relinquished in the exchange was held for productive use in a trade or business or for investment and not primarily for sale to customers. *Margolis v Commissioner* (9th Cir 1964) 337 F2d 1001, 1004. This is a question of fact. *Commissioner v Tri-S Corp.* (10th Cir 1968) 400 F2d 862. The following are among the factors to be considered:

- The holding period of the property in question;
- The nature of the taxpayer's business;
- The construction of improvements and extent of subdivision activity undertaken on the property;
- Whether the property had income-producing potential;
- The number and frequency of real property sales by the taxpayer; and
- The percentage of taxpayer's income derived from real property sales.

For instance, in *Loren F. Paullus,* TC Memo 1996-419, a taxpayer was found to have relinquished property held for investment rather than sale because its corporate owner consistently reported its business activity as a resort operator rather than as a land developer, engaged in relatively few purchases and sales, held the property over 4 years, and exchanged it for other resort property. See *Biedenharn Realty Co. v U.S.* (5th Cir 1976) 526 F2d 409; *U.S. v Winthrop* (5th Cir 1969) 417 F2d 905; *Margolis v Commissioner, supra; Stanley H. Klarkowski,* TC Memo 1965-328, aff'd on other grounds (7th Cir 1967) 385 F2d 398. See Reg §1.1237-1 for special rules on the effect of subdivision and selling activities on the determination of whether the taxpayer holds the property primarily for sale to customers.

A taxpayer who is not in the business of buying and selling real property may still be treated as a dealer if he or she enters into a joint venture with a dealer regarding the taxpayer's property. This problem is likely to arise when a taxpayer is required by the buyer of the relinquished property to undertake subdivision activities or other work in preparation for the buyer's development of the property. The taxpayer may be considered to be a joint venturer with the buyer by virtue of his or her activities, and dealer status may be imputed to the taxpayer. See Reg §1.1237-1(c).

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§2.8 2. Other Property Held Primarily for Sale

An exchange will not qualify under IRC §1031 if, at the time of the exchange, the taxpayer holds either the relinquished property or the replacement property primarily for sale, even though the taxpayer is not holding the property for sale to customers in the ordinary course of the taxpayer's business. IRC §1031(a)(2)(A). This exception is broader than the one proscribing exchanges of inventory or stock in trade and includes any property held by the taxpayer primarily for sale, regardless of whether the taxpayer is regarded as being in the business of offering the property for sale to customers. See *Ethel Black* (1960) 35 TC 90; *Land Dynamics,* TC Memo 1978-259; *George M. Bernard,* TC Memo 1967-176; *Stanley H. Klarkowski,* TC Memo 1965-328, aff'd on other grounds (7th Cir 1967) 385 F2d 398. "Primarily" means "of first importance" or "principally." *Malat v Riddell* (1966) 383 US 569, 16 L Ed 2d 102, 86 S Ct 1030.

The difference between property held primarily for sale and property held for trade or business or for investment is not clearly defined. Because this distinction can establish whether an exchange qualifies under IRC §1031(a), disagreements in this area often arise between taxpayers and the Internal Revenue Service. In determining whether property has been held primarily for sale, the courts consider the facts surrounding the exchange, the taxpayer's use of relinquished property, and the primary purpose for which replacement property is acquired. *George M. Bernard, supra*. See also *Margolis v Commissioner* (9th Cir 1964) 337 F2d 1001, 1005 (relinquished property was held for investment because it had income-producing potential, was offered by the taxpayer for lease but never for sale, was held for a significant period of time, and was exchanged for other commercially zoned property that was later leased out rather than sold).

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§2.9 a. Property Relinquished in Exchange

The mere fact that property is held as a capital asset does not ensure that the taxpayer will be entitled to exchange it under IRC §1031. Rev Rul *74-7*, 1974-1 Cum Bull 198 (foreign currency reconverted to United States dollars does not qualify for like-kind exchange treatment, because foreign currency is not property held for productive use in trade or business or for investment even when taxpayer is not a dealer in foreign currency). Similarly, the mere fact that an owner grants an option to purchase the property does not characterize the property as being held primarily for sale. *Cary A. Everett,* TC Memo 1978-53. The taxpayer may even enter into a binding contract to sell the property without eliminating the ability to restructure the transaction as a like-kind exchange. See *Alderson v Commissioner* (9th Cir 1963) 317 F2d 790. The contract should provide, however, that the buyer will cooperate with the taxpayer in structuring the transaction as an exchange at the taxpayer's request. See §6.13 for sample clauses. The contract may still provide for a straight sale if an exchange cannot be made. See, *e.g., Carlton v U.S.* (5th Cir 1967) 385 F2d 238, 239.

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§2.10 b. Property Acquired in Exchange

The taxpayer's intent at the time he or she acquires the replacement property dictates whether the property is held primarily for sale. See *Ethel Black* (1960) 35 TC 90, 95. See also §2.23 for discussion of *Dollie H. Click* (1982) 78 TC 225 and *Fred S. Wagensen* (1980) 74 TC 653. Even seemingly insignificant activity by the taxpayer, such as obtaining a short-term title insurance binder for the replacement property, may indicate an intent to resell the property.

An exchange does not qualify if, before completing the exchange, the taxpayer has already committed to sell the replacement property to another purchaser. *Regals Realty Co. v Commissioner* (2d Cir 1942) 127 F2d 931 (at a single meeting, taxpayer's board of directors authorized exchange and "sale" of replacement property to newly formed corporation for stock); *Brooks Griffin* (1967) 49 TC 253 (replacement property sold simultaneously with exchange); *George M. Bernard,* TC Memo 1967-176 (before agreeing to exchange, taxpayer instructed broker to find buyer for replacement property; broker located buyer 2 weeks after exchange).

On the effect of a brief holding period, see §2.26. On the effect of a taxpayer's acquisition of property from a related entity shortly before exchanging it, see §2.30. On the effect of a taxpayer's transfer of replacement property to a related entity shortly after the exchange, see §2.31.

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§2.11 3. Stocks, Securities, and Evidences of Interest

A taxpayer may own an equity interest in a corporation represented by stock, securities, or some other evidences of interest. *U.S. v Evans* (9th Cir 1967) 375 F2d 730. Although exchanges of stocks are excluded from like-kind exchange treatment by IRC §1031(a)(2)(B), they may nevertheless avoid gain or loss recognition if the exchange either complies with IRC §1036(a) or is accomplished as part of a plan of reorganization under IRC §354. Exchanges of other securities and "evidences of indebtedness or interest" are excluded by IRC §1031(a)(2)(C), although exchanges of securities may also fall within the scope of IRC §354.

In 2008, subsection (i) was added to IRC §1031, which provides that the restriction on exchanges of "stock" contained in §1031(a)(2)(B) does not include shares of mutual ditch, reservoir, or irrigation companies (as defined in IRC §501(c)(12)(A)). In order to qualify, the stock must be recognized as real property or an interest in real property within the state it is located. Pub L 110-246, §15342, 122 Stat 1651.

In the context of IRC §1031 and real property, the most important aspect of the IRC §1031(a)(2)(C) exclusion is whether tenancy-in-common (TIC) interests should be treated as securities for §1031 purposes. The history of the exclusion and the current content of the Internal Revenue Code suggest that TIC interests should not be regarded as securities for federal tax law purposes. The exclusion originated in former §112(b)(1) of the Internal Revenue Code of 1939, and the Code today continues to refer to the general concept that securities are monetary instruments akin to capital stock rather than direct interests in real property or other tangible assets. The owner of a security may have an equity interest in an entity that, in turn, has a direct interest in real property or other tangible assets, but the owner holds an intangible monetary asset rather than a direct ownership interest in the property owned by the corporation. This construction should distinguish a security for tax purposes from TIC interests, which for all purposes are direct ownership interests in real property or some other tangible asset. It is significant that nowhere in any of the uses of the term "securities" in the Internal Revenue Code does a direct interest in real estate, such as a TIC interest, appear to be included as a "security." See, *e.g.,* IRC §§351(e)(1)(B), 368(a)(2)(F)(vii), 402(e)(4)(E)(i), 409(*l*)(1), 475(c)(2), 851(b)(2); Reg §1.165-5(a). When the concept of an interest regulated by federal securities laws is addressed in the Internal Revenue Code, there is a specific cross-reference. See, *e.g.,* IRC §§368(a)(2)(F)(vii)(IV), 731(c)(2)(B)(i)(II), 851(b)(2), 1246(b)(2)(A), 1296(e)(1)(A).

There is very little case law on this topic, perhaps because the exchanges of stock and securities have generally been regarded as subject to the corporate reorganization rules of IRC §§362-368. *Frederick R. Horne* (1945) 5 TC 250 held that a coffee-and-sugar-exchange seat was held not to be a stock or other security, although the IRS's position is that IRC §1031(a)(2)(C) excludes from like-kind exchange treatment all types of equity interests in financial enterprises other than exchanges of direct ownership of the underlying property. See Rev Rul 78-135, 1978-1 Cum Bull 256.

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§2.12 4. Bonds, Notes, Debt Securities, and Other Evidence of Indebtedness

"Stock" is a type of securities that represents an ownership interest in a corporation that is excluded from like-kind exchange treatment. Similarly, debt instruments such as bonds, notes, and debt securities are also excluded from like-kind exchange treatment by IRC §1031(a)(2)(B). The debt exclusion is intended to be all-inclusive of exchanges of other evidence of indebtedness, *e.g.,* debt instruments other than bonds or notes are also excluded from like-kind exchange treatment by IRC §1031(a)(2)(C). For example, gain or loss will be recognized in an exchange of a real property mortgage for a consolidated farm loan bond or in an exchange of Treasury bonds maturing in different years. Reg §1.1031(a)-1(d).

Losses on exchanges of mortgage portfolios were recognized in *U.S. v Centennial Sav. Bank* (1991) 499 US 573, 113 L Ed 2d 608, 111 S Ct 1512, and in *Cottage Sav. Ass'n v Commissioner* (1991) 499 US 554, 113 L Ed 2d 589, 111 S Ct 1503. In determining that a sale or disposition had occurred for purposes of IRC §1001(a), however, the Supreme Court focused on material differences in the composition of the exchanged portfolios and did not address IRC §1031(a)(2).

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5. Partnership Interests

§2.13 a. General Exclusion of Interests in Partnership

Although partnerships themselves may undertake like-kind exchanges of partnership property, exchanges of partnership interests are excluded from like-kind exchange treatment. See IRC §1031(a)(2)(D). When adding IRC §1031(a)(2)(D) to the Internal Revenue Code in the Tax Reform Act of 1984 (TRA 1984) (Pub L 98-369, 98 Stat 494), Congress indicated that the exclusion was intended to apply only to exchanges of interests in *different* partnerships. H Rep No. 432, 98th Cong, 2d Sess (1984), reprinted in 1984 US Code Cong & Ad News 697, 896. In 1991, however, Reg §1.1031(a)-1(a)(1) was promulgated, providing that IRC §1031(a) does not apply to *any* exchange of interests in a partnership, regardless of whether the exchanged interests are general or limited partnership interests or are interests in the same partnerships or different ones.

The Internal Revenue Service has made it clear that other sections of the Internal Revenue Code that might allow nonrecognition of gain or loss in an exchange of partnership interests are not affected by Reg §1.1031(a)-1(a)(1). See the supplementary information preceding the deferred-exchange regulations, reprinted in TD 8346, 1991-1 Cum Bull 150.

EXAMPLE: The IRS has ruled that, under Subchapter K of the Internal Revenue Code, the conversion of a general partnership interest to a limited partnership interest in the same partnership is not taxable. See Rev Rul 84-52, 1984-1 Cum Bull 157. See also Rev Rul 95-37, 1995-1 Cum Bull 130 (same income tax consequences for conversion of a domestic partnership interest into an interest in a domestic limited liability company).

The IRS is likely to contend that an interest in a joint venture is an interest in a partnership subject to the limitations of IRC §1031(a)(2)(D). Interests in a joint venture are governed by partnership law in California. See *Zeiback v Nasser* (1938) 12 C2d 1, 12, 82 P2d 375; *Gherman v Colburn* (1977) 72 CA3d 544, 557, 140 CR 330. See also 9 Witkin, Summary of California Law, *Partnership* §§9-14 (10th ed 2005).

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§2.14 b. Status of Tenancy-in-Common Interests

A number of taxpayers and promoters have, since the mid-1990s, been exploring means by which group ownership of real estate can be structured to qualify co-ownership interests as relinquished or replacement property for purposes of IRC §1031(a)(1) despite §1031(a)(2)(D)'s prohibition against tax-free receipt or transfer of partnership interests. These structures involve use of tenancy-in-common (TIC) interests, which are intended to permit owners of the TIC interests to treat themselves as direct owners of the underlying real property. However, the exclusion of partnership interests from nonrecognition treatment will create problems for a taxpayer who holds an undivided interest in a fee as a tenant in common if the IRS contends that such a taxpayer is a partner and that an exchange of the interest is excluded from like-kind exchange treatment. A "partnership" for federal tax purposes is defined in IRC §§761(a) and 7701(a)(2) to include a syndicate, group, pool, joint venture, or another unincorporated organization that is not a corporation, a trust, or an estate and through or by means of which any business, financial operation, or venture is carried on. Under Reg §1.761-1(a), which directs the reader to the controlling regulations under Reg §§301.7701-1—301.7701-2 that define the term "partnership," mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a partnership. Tenants in common may be partners, however, if they actively carry on a trade, business, financial operation, or venture and divide the profits. For example, a partnership exists if co-owners of an apartment building lease space and provide services to the occupants either directly or through an agent. Reg §1.761-1(a). On the distinctions between a tenancy in common and a partnership, see *Estate of Aaron Levine* (1979) 72 TC 780, aff'd (2d Cir 1980) 634 F2d 12; *Madison Gas & Elec. Co.* (1979) 72 TC 521, aff'd (7th Cir 1980) 633 F2d 512; *Almy Gilford,* TC Memo 1952-175, aff'd (2d Cir 1953) 201 F2d 735; IRS Letter Ruling 8330093.

Members of an unincorporated organization, such as the tenant-in-common owners of real property, may elect out of treatment as a partnership under Subchapter K of the Internal Revenue Code (IRC §§701-777) if (IRC §761(a))

- the organization is used for investment purposes only and not for the active conduct of a business; and
- the income of the members of the organization may be adequately calculated without computation of partnership taxable income.

If the election is made, a member's interest is treated as an interest in each of the assets of the organization, rather than as an interest in a partnership, for purposes of IRC §1031(a). IRC §1031(a)(2). However, the qualifications for exclusion from Subchapter K as an "investment partnership" are so narrow that few cotenancies and partnerships can qualify. See 1 McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners §3.05[1] (3d ed 1997). There does not appear to be any express prohibition, however, against revising an existing partnership or cotenancy structure to comply with the IRC §761(a) requirements. On qualifying for the election, see Weller, *1990 Legislation Offers Expanded Possibilities for Exchange of Real Estate Partnership Interests,* 9 Real Est Tax Dig 29 (Feb. 1991).

In response to the growing phenomenon of syndicated tenancy-in-common programs, in 2002 the IRS issued Rev Proc 2002-22, 2002-1 Cum Bull 733, to provide guidelines for obtaining a private ruling on whether a tenant-in-common interest held by a taxpayer will *not* be characterized as a partnership interest for federal income tax purposes. Weller & Sacon, *Real Estate Fractional Interests Programs and Rev. Proc. 2002-22: Birth of an Industry?,* 5 Journal of Passthrough Entities (May-June 2002).

See chap 7 for a more detailed discussion of Rev Proc 2002-22 and the use of TIC co-ownership arrangements, as well as the issues created by IRC §1031(a)(2)(D) when a partnership wishes to dispose of its property and its partners have differing inclinations to undertake like-kind exchanges of their respective shares of the partnership property equity.

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§2.14A c. Exception for Acquisitions of All Interests in Partnership

One exception from the general rule that interests in a partnership are excluded property for purposes of IRC §1031 involves the acquisition of all interests in a partnership not already owned by the taxpayer. In Rev Rul 99-5, 1999-1 Cum Bull 434, the IRS determined that purchase of a partial interest in a single-owner limited liability company (LLC) formerly treated as a disregarded entity should be regarded as purchase of a corresponding partial interest in the assets held by the entity followed by a contribution of that partial interest to a newly formed partnership. In Rev Rul 99-6, 1999-1 Cum Bull 432, the IRS determined that one person's acquisition of all interests in an LLC classified as a partnership should be regarded as acquisition of a share of the assets of the entity proportionate to the interest acquired. This principle, based on the holding in *McCauslen v Commissioner* (1966) 45 TC 588, applies to a third party's acquisition of the interests of all members of such an LLC or to an existing LLC member's acquisition of the interests of all other members' interests in the LLC.

Because these acquisitions are regarded as asset purchases, not purchases of partnership interests, it makes sense to treat them as outside the exclusion established by IRC §1031(a)(2)(D) with respect to replacement property acquisition. This conclusion has been confirmed by the IRS in two letter rulings dealing with both deferred and reverse exchanges. See IRS Letter Rulings 200807005 and 200909008. However, when the purchase is of a partial interest in an existing disregarded entity, elimination of the IRC §1031(a)(2)(D) taint does not eliminate the risk that the deemed immediate contribution of the asset into a newly formed partnership will fail the "qualified use" requirement of §1031. For discussion of this "swap and drop" issue, see §2.31.

The same principle does not apply to a seller of interests in a partnership or an LLC regarded as a partnership when the seller wishes to treat the property sold as relinquished property under §1031. In other words, even when a buyer of an LLC interest may be treated as acquiring underlying assets as qualifying replacement property, the seller is still regarded as selling a partnership interest that will not be eligible for deferral under §1031. See chap 7 for discussion of approaches taken by sellers.

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6. Certificates of Trust or Beneficial Interests

§2.15 a. Trust Interests

Exchanges of "certificates of trust or beneficial interests" are expressly disqualified from like-kind exchange treatment by IRC §1031(a)(2)(E). No published cases have explored the limits of this category, but it is presumably intended to cover beneficiaries' rights under inter vivos and testamentary trust instruments. See Rev Rul 92-105, 1992-2 Cum Bull 204. This exclusion should also apply to exchanges of ownership interests in a business organization formed as a Massachusetts business trust, at least to the extent that such ownership rights are not otherwise considered to fall within the exclusion of exchanges of stock under IRC §1031(a)(2)(B) (see §2.11).

In Rev Rul 92-105, the IRS stated that a beneficial interest in an Illinois land trust is real property that can be exchanged for other real property in a qualifying IRC §1031 exchange. The Revenue Ruling states that the same is true of beneficial interests in similar land trust arrangements authorized under the laws of states such as California, Florida, Hawaii, Indiana, North Dakota, and Virginia. The Ruling also states that it applies to trust arrangements with the following characteristics:

- The trustee has title to real property;
- The beneficiary or a designee of the beneficiary has the exclusive right to direct or control the trustee in dealing with this title; and
- The beneficiary has the exclusive control of the management of the property, the exclusive right to the earnings and proceeds, and the obligation to pay any taxes and liabilities relating to the property.

In Rev Rul 2004-86, 2004-33 Int Rev Bull 191, the IRS determined that the interest of a grantor in a grantor trust is treated the same as the ownership of the underlying property held by the trust. Before this ruling it was unknown whether, for purposes of completing an exchange, an interest in a grantor trust would be treated the same as an interest in the property owned by the trust. It is important to note that, under the facts of the ruling, the trustee had extremely limited discretionary powers and could not vary the investments of the trust. These limitations on the trustee's powers were critical to the IRS's conclusion that the arrangement was not classified as a business entity, which would have led to a different result for purposes of completing an exchange. See §7.43A.

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b. Rights in Executory Real Property Sales Contracts

§2.16 (1) Exchanges of Buyer's Interest

In *Starker v U.S.* (9th Cir 1979) 602 F2d 1341, the court held that the buyer's rights under an executory real property purchase contract were like in kind to a fee interest for purposes of IRC §1031. The purchase contract in *Starker* provided that legal title would not pass to the buyer until the original seller's life interest expired; meanwhile, the buyer would have the right of possession subject to certain restrictions. Examining these rights, the court concluded that in substance the taxpayer had received at least the rights of a long-term lessee plus equitable fee title subject to conditions precedent. Going beyond the unusual facts of the case, however, the court explained that because title to real property, like the contract right to purchase real property, is merely a bundle of potential causes of action, the contract right to assume the rights of ownership should not be treated any differently from the rights of ownership themselves. 602 F2d at 1355.

Because the rules of equity view the holder of contractual purchase rights as the property owner, an argument can be made that these contractual rights qualify for like-kind exchange treatment just as a fee or long-term leasehold estate qualifies for such treatment. The argument is strongest and most compelling for rights under an installment land sale contract. The buyer under such a contract is entitled to possession of the property while paying the purchase price in installments before transfer of legal title. *Tucker v Lassen Sav. & Loan Ass'n* (1974) 12 C3d 629, 116 CR 633. Because the "rights created in the property determine the character of the property owned" for purposes of IRC §1031 (*William Fleming* (1955) 24 TC 818, 824, aff'd in part and rev'd in part on other grounds (5th Cir 1957) 241 F2d 78, rev'd on other grounds (1958) 356 US 260, 2 L Ed 2d 743, 78 S Ct 691), the vendee with both equitable ownership and the right of possession should be considered the owner of the property for purposes of IRC §1031(a), not merely the holder of an excluded "beneficial interest" under IRC §1031(a)(2)(E).

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§2.17 (2) Exchanges of Seller's Interest

In contrast to the buyer, the seller under an executory real property contract retains only a limited interest in the property. Under the equitable conversion doctrine, the seller holds only an equitable lien on the property for the unpaid balance of the purchase price. Although the seller retains legal title, he or she is viewed as holding it in trust for the buyer. *Estate of Dwyer* (1911) 159 C 664, 675, 115 P 235; *Mamula v McCulloch* (1969) 275 CA2d 184, 193, 79 CR 571. The seller's interest under an installment land sale contract is similar to that of a beneficiary under a promissory note secured by a mortgage or deed of trust, the exchange of which is excluded from the like-kind exchange provisions of IRC §1031 under IRC §1031(a)(2)(B) (see §2.12). See 1 Miller & Starr, California Real Estate §2.12 (3d ed 2000). Accordingly, the seller's interest under an installment land sale contract should be excluded from like-kind exchange treatment, either as a beneficial interest under IRC §1031(a)(2)(E) or as evidence of indebtedness under IRC §1031(a)(2)(C).

The doctrine of equitable conversion might also be applied in a deferred exchange to support the position that a taxpayer has complied with the 180-day period mandated by IRC §1031(a)(3)(B) when he or she receives assignment of a specifically enforceable contract to acquire the replacement property within the 180-day period. See §§4.16, 4.29. See also *Biggs v Commissioner* (5th Cir 1980) 632 F2d 1171; *Starker v U.S.* (9th Cir 1979) 602 F2d 1341. No taxpayer, however, has successfully asserted this position in any reported court decision or IRS pronouncement.

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§2.18 7. Choses in Action

Internal Revenue Code §1031(a)(2)(F) excludes an exchange of a chose in action from like-kind exchange treatment. Courts rely on state law for the definition of a chose in action. *Estate of Rollin E. Meyer* (1972) 58 TC 311, nonacq 1975-2 Cum Bull 3, aff'd per curiam (9th Cir 1974) 503 F2d 556. In California, a chose in action is a right to recover money or other personal property by a judicial proceeding. CC §953.

The IRS has argued unsuccessfully that a contract right to purchase real property is a proscribed chose in action. See *Starker v U.S.* (9th Cir 1979) 602 F2d 1341, discussed in §4.7. In *Estate of Rollin E. Meyer, supra,* the IRS argued that a partnership interest is a chose in action under California law, based on two cases that dealt with the characterization of a deceased partner's interest and the rights of the deceased partner's personal representative to an accounting and a cash liquidation. The court declined to hold, however, that the partnership interest of a living partner is a chose in action. See §§2.13-2.14 for discussion of partnership interests.

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8. "Tax-Exempt Use" Property Subject to a Lease

§2.18A a. "Tax-Exempt Use Loss" Restrictions

Internal Revenue Code §470 was enacted as part of the American Jobs Creation Act of 2004 (Pub L 108-357, 118 Stat 1418) as a legislative response to so-called "sale-in, lease-out" (SILO) tax shelter transactions. SILO transactions typically involve nominal transfer of a publicly owned property to a taxable entity able to utilize depreciation deductions or treat the property as replacement property in a like-kind exchange. The property is then leased back to the public user for an extended period, together with the grant of an option to reacquire the property. As part of the legislative attempt to restrict use of SILOs, IRC §470(a) provides that a "tax-exempt use loss" for any taxable year will not be allowed.

"Tax-exempt use loss" is the amount, for any taxable year, by which the sum of the aggregate deductions (other than interest) directly allocable to "tax-exempt use property," and the aggregate deductions for interest properly allocable to such property, exceeds the aggregate income from such property. IRC §470(c)(1). Any tax-exempt use loss with respect to tax-exempt use property that is disallowed for a taxable year is treated as a deduction with respect to such property in the next taxable year. IRC §470(b). If a taxpayer subsequently disposes of its entire interest in tax-exempt use property, the taxpayer generally should be able to deduct previously disallowed deductions and losses. IRC §470(e)(2).

However, IRC §470 does not act solely as a loss deferral provision. Relinquished property that is tax-exempt use property subject to certain types of leases entered into before March 13, 2004, and replacement property that is tax-exempt use property subject to certain types of leases are excluded from like-kind exchange treatment. IRC §470(e)(4)(A).

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§2.18B b. "Tax-Exempt Use Property" Defined

Internal Revenue Code §470(c)(2) defines the term "tax-exempt use property" by reference to the cost recovery rules of IRC §168(h), with certain modifications and additions. For example, IRC §470(c)(2) adds certain specified intangible property (*e.g.,* IRC §197 intangibles) to the universe of property covered.

Section 168(h)(1) provides a general definition of "tax-exempt use property" that relates to tangible property that is leased to a tax-exempt entity. Tax-exempt use property does not include property that is predominately used by the tax-exempt entity (directly or through a partnership in which such entity is a partner) in an unrelated trade or business, the income of which is subject to tax under IRC §511. IRC §168(h)(1)(D).

Section 168(h)(6) contains a special rule that has the effect of treating as tax-exempt use property any property of a partnership that includes tax exempt partners when the partnership's profit and loss allocations are not "qualified allocations." If property is owned by a partnership that has both a tax-exempt entity and a person who is not a tax-exempt entity as partners, and any allocation of partnership items to the tax-exempt entity is not a qualified allocation, then an amount equal to such tax-exempt entity's proportionate share of such property is treated as tax-exempt use property. IRC §168(h)(6)(A).

As a result of IRC §470's initial incorporation of IRC §168(h)(6) through a cross-reference, many partnerships were affected that merely had a tax-exempt entity partner and were not involved in "sale-in, lease-out" transactions. To remedy this problem and limit the scope of IRC §470 to transactions considered abusive, in 2007 Congress amended IRC §470(c)(2) by adding IRC §470(c)(2)(B), providing that "tax-exempt use property" does not include property owned by a partnership that was deemed tax exempt "solely by reason of §168(h)(6)." Tax Technical Corrections Act of 2007 (Pub L 110-172, §7(c)(1), 121 Stat 2473.

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Source: Real Property/Real Property Exchanges/2 Requirements for Like-Kind Exchanges/§2.18C c. 'Tax-Exempt Use Property' Qualifying as Relinquished or Replacement Property

§2.18C c. "Tax-Exempt Use Property" Qualifying as Relinquished or Replacement Property

Under IRC §470(e)(4)(A), leased property that is considered tax-exempt use property may still qualify as relinquished or replacement property if the lease meets the four following requirements:

- The lessee may not prepay its lease obligations (including purchase options) in an amount that exceeds 20 percent of the taxpayer's adjusted basis in the leased property at the time the lease is entered into. IRC §470(d)(1). For this purpose, basis is not adjusted downward by reason of the taxpayer's like-kind exchange. IRC §470(e)(4)(B).

- The taxpayer must have an unconditional at-risk equity investment in the property of 20 percent of its basis and maintain this investment throughout the life of the lease, and at all times during the lease term the fair market value of the property at the end of the lease term must be expected to be equal to at least 20 percent of the taxpayer's basis. This requirement does not apply to lease terms of 5 years or less. IRC §470(d)(2). Again, basis for testing the sufficiency of investments is not reduced as a result of an IRC §1031 exchange.

- The lessee may not assume more than a minimal risk of loss. For this purpose, the lessee assumes more than a minimal risk of loss if the taxpayer is protected from either (1) any portion of the loss that would occur if the fair market value of the leased property were 25 percent less than the leased property's reasonably expected fair market value at the time the lease is terminated, or (2) an aggregate loss that is greater than 50 percent of the loss that would occur if the fair market value of the leased property were zero at lease termination. This requirement does not apply to lease terms of 5 years or less. IRC §470(d)(3).

- The lessee may not have an option to purchase the leased property for any stated purchase price other than the fair market value of the property as determined at the time of the exercise of the option. This requirement does not apply to property with a class life (as defined in IRC §168(i)(1)) of 7 years or less, or any fixed-wing aircraft or ships. IRC §470(d)(4).

Although it's not entirely clear, it also appears that if all or a portion of property is tax-exempt use property solely by virtue of IRC §168(h)(6)(A) but is not subject to a lease, then the property would not be excluded from qualifying as relinquished or replacement property under IRC §470(e)(4).

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§2.18D d. Application of IRC §470

Internal Revenue Code §470(c)(2) has generated much consternation among taxpayers and their advisors. IRS Notice 2007-4, 2007-1 Cum Bull 260, extends relief previously provided to partnerships in IRS Notice 2006-2, 2006-1 Cum Bull 278, and IRS Notice 2005-29, 2005-1 Cum Bull 796. Under IRS Notice 2007-4, for tax years beginning before January 1, 2007, the IRS will not apply IRC §470(a) to disallow losses associated with property that is treated as tax-exempt use property solely as a result of the application of IRC §168(h)(6). However, Notice 2007-4 does not provide relief for taxpayers exchanging tax-exempt use property. Notice 2007-4 does not change the characterization of relinquished or replacement property as tax-exempt use property. Rather, it simply states that the IRS will not disallow reporting of losses associated with certain tax-exempt use property.

PRACTICE TIP: Section 470 now requires taxpayers and their advisors to determine whether relinquished or potential replacement property is tax-exempt use property subject to a lease that does not meet certain statutory exceptions and is therefore property that is excluded from like-kind exchange eligibility. When selecting replacement property, a careful examination should be made of the property's prior and current leases to determine whether they result in a property being deemed tax exempt use property. Application of IRC §470(c)(2), unless the provision is narrowed via future amendment, will also require additional review by partnership taxpayers that have tax-exempt partners.

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§2.19 D. Mortgaged Property With Zero or Negative Equity

Instances may arise in which a taxpayer has zero or "negative" equity in real property, *e.g.,* when the fair market value of the property is less than the debt secured by the property. Under the general tax law principles articulated in *Commissioner v Tufts* (1983) 461 US 300, 307, 75 L Ed 2d 863, 103 S Ct 1826, the taxpayer would nonetheless realize "phantom" gain that is taxable, but not economic gain, on the disposition of the property. The disposition may take the form of a foreclosure sale, a deed in lieu of foreclosure, or a sale to a third party. In any event, a taxpayer may wish to obtain the benefit of deferral of gain under IRC §1031 on the disposition of the property.

No legislative, regulatory, or other rule requires (1) the relinquished property to have a fair market value in excess of indebtedness secured by that property or (2) the taxpayer to have equity in the relinquished property at the time of the exchange. Further, there is no requirement that indebtedness be secured by the property involved in the exchange. See §3.9.

EXAMPLE: Assume that a taxpayer purchases an apartment building for $5 million by paying $1 million in cash and borrowing $4 million as a secured nonrecourse obligation. If the value of the property declines to $4 million, the mortgage on the property is still $4 million, and the adjusted basis of the property is $3,500,000, then a sale, an abandonment, a foreclosure, or a deed in lieu of foreclosure would result in a taxable gain of $500,000 to the taxpayer ($4 million sales price minus $3,500,000 adjusted basis).

Once the exchange has been completed, the taxpayer should not be deprived of the benefits of tax deferral under §1031 if the transferee subsequently loses the relinquished property through a foreclosure, because the transferee assumed all the benefits and burdens of ownership of the relinquished property. The tax consequences to the taxpayer are affected only by the subsequent disposition of the replacement property.

A taxpayer who seeks to defer gain under IRC §1031 on the disposition of property with a value and basis less than the mortgage amount faces two challenges. First, there is the practical problem of acquiring the replacement property when little or no cash is available from the disposition of the relinquished property. Second, issues arise in a multiparty exchange scenario about the mechanics of a transaction involving a qualified intermediary (the QI), the lender, a third party seller of the replacement property and, perhaps, a third party buyer of the relinquished property. The principal question is whether or not there was a transfer of property to the QI when the lender forecloses or takes title by a deed in lieu of foreclosure. To obtain §1031 coverage, the taxpayer should consider whether to structure the transaction such that the QI obtains legal title and the lender obtains title from the QI. The QI can then obtain replacement property to transfer to the taxpayer. If the lender or the lender's designee at auction obtains title directly from the taxpayer, the taxpayer's subsequent acquisition of property could be regarded as a separate and independent transaction and not as an exchange of the foreclosed property for the subsequently acquired property.

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§2.20 III. QUALIFIED USE REQUIREMENT

Under IRC §1031(a), the property relinquished and the property received in a like-kind exchange must each be held by the respective taxpayer for productive use in a trade or business or for investment. Property held for productive use in a trade or business may be exchanged for property held for investment, and vice versa. Reg §1.1031(a)-1(a). Another way of looking at this requirement is in the negative: Neither relinquished nor replacement property in the exchange may be used for personal purposes (*e.g.,* a personal residence; see §2.38) or held or acquired primarily for sale (see §§2.7-2.10). See IRC §1031(a); Reg §1.1031(a)-1(a). The required use of property in §1031(a) is often referred to as "qualified use."

The qualified use requirement applies only to the taxpayer. The property relinquished by the taxpayer need not be held by its new owner for productive use in a trade or business or for investment. Similarly, the property acquired by the taxpayer in the exchange need not have been held by its seller for such a purpose. See *Barker v U.S.* (CD Ill 1987) 668 F Supp 1199 (taxpayer acquired restaurant from farmers who had acquired it for sole purpose of transferring it to taxpayer in an exchange); Rev Rul 75-292, 1975-2 Cum Bull 333 (taxpayer exchanged real property with owner of corporation, who immediately contributed it to his corporation for stock); Rev Rul 75-291, 1975-2 Cum Bull 332 (taxpayer acquired replacement property from someone who had acquired and developed it for sole purpose of transferring it to taxpayer in an exchange).

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§2.21 A. "For Productive Use in Trade or Business"

The phrase "property held for productive use in a trade or business" in IRC §1031(a)(1) is not defined in the Internal Revenue Code or the regulations. The United States Supreme Court in *Commissioner v Groetzinger* (1987) 480 US 23, 94 L Ed 2d 25, 107 S Ct 980, pointed out that the phrase "trade or business" is common in the code and appears in over 50 sections and 800 subsections. "Despite this, the Code has never contained a definition of the words 'trade or business' for general application, and no regulation has been issued expounding its meaning for all purposes." 480 US at 27, 94 L Ed 2d at 32. *Groetzinger* held that "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit." 480 US at 35, 94 L Ed 2d at 37.

Thus, a taxpayer may not obtain like-kind exchange treatment when the exchange property is used in connection with an activity in which the taxpayer engages either sporadically or without a profit motive. Although this activity cannot be sporadic or without profit motive, it is unclear whether the property itself need be actively or continuously used. Occasional or infrequent use will not cause property to fail to be regarded as used in a trade or business under IRC §§167(a)(1) and 1231(a)-(b). See *Sears Oil Co. v Commissioner* (2d Cir 1966) 359 F2d 191; *Carter-Colton Cigar Co.* (1947) 9 TC 219 (interpreting former IRC §117, the predecessor to IRC §1231). Section 1031(a)(1), however, requires that qualifying property be held for "productive" use in the taxpayer's trade or business. This requirement might imply that the property must be actively used in the business to qualify under that section, although there is no case law that explores the distinction between property held for productive use and property merely used in a trade or business. Regulation §1.167(a)-8 provides that, for purposes of IRC §167, "retirement" means the permanent withdrawal of property from productive use in the trade or business, which suggests that the IRS might regard property that a taxpayer treats as scrap or abandoned business property under §167 as ineligible for §1031 treatment because it is not held for "productive" use.

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§2.22 B. "For Investment"

Property that is not actively used in a trade or business can still qualify to be exchanged in a like-kind exchange under IRC §1031(a) if the property is "held for investment" and not specifically excluded by IRC §1031(a)(2). The IRS and the taxpayer often disagree over whether the taxpayer has held property for investment purposes or primarily for sale. The difference is often unclear, but the distinction is vital because property held primarily for sale is excluded from like-kind exchange treatment by IRC §1031(a)(2). See §2.8.

Although the Internal Revenue Code and the regulations do not define "property held for investment" for purposes of IRC §1031(a), the regulations provide some guidance. Regulation §1.1031(a)-1(b) specifies that unproductive real property held by a nondealer taxpayer for future use or future realization of the appreciation is held for investment and not primarily for sale. Thus, it appears that the term "investment" includes the passive holding of property with the expectation that it will appreciate in value. Generally, taxpayers who rent or attempt to rent real property to tenants at fair market rental value should satisfy the "hold for investment" requirement (*John C. Dewey,* TC Memo 1993-645), and intermittent personal use (*e.g.,* less than 10 days per year) incidental to an investment purpose does not disqualify the use. IRS Letter Ruling 8103117. The extent of allowable personal use for vacation properties has recently received considerable attention and is the subject of a Revenue Procedure safe harbor promulgated in 2008. See discussion in §2.39.

There is an explicit mutuality of identity of investment property between IRC §163 and §469. Investment property is defined in IRC §163(d)(5)(A)(i) by reference to IRC §469(e)(1)(A)(ii)(II). It is also reasonable to expect consistent treatment of property regarded as held for investment under IRC §1031(a) and the treatment of the same property for purposes of §163 regarding investment interest and §469 regarding passive income or loss characterization. Thus, if gain or loss from the disposition of property which would not be treated as income from a passive activity because the property is held for investment under IRC §469(e)(1)(A)(ii)(II), then the same property should be treated as held for investment under IRC §1031(a). For example, the apartment unit owned by the taxpayers in *Kevin Seits,* TC Memo 1994-522 was held to be investment property, the gain on sale of which was not passive income under IRC §469(e)(1) as the taxpayers contended, because the unit was neither rented to tenants nor advertised as available for rent. The taxpayers' attempt to absorb the gain on disposition with passive losses from other activities failed, therefore, but the implication is that the taxpayers would have been able to defer gain had they engaged in an exchange of the apartment in a transaction that otherwise complied with IRC §1031(a).

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C. Holding Requirement

§2.23 1. Taxpayer's Qualified Use Determined as of Time of Exchange

The taxpayer's purpose in holding the relinquished property and the replacement property is determined as of the time of the exchange. *Fred S. Wagensen* (1980) 74 TC 653; *Stanley H. Klarkowski,* TC Memo 1965-328, aff'd on other grounds (7th Cir 1967) 385 F2d 398; Rev Rul 57-244, 1957-1 Cum Bull 247. Whether the relinquished property and the replacement property are held for a qualified use is a question of fact. *Gulfstream Land & Dev. Corp.* (1979) 71 TC 587; *John C. Dewey,* TC Memo 1993-645; *Cary A. Everett,* TC Memo 1978-53; *George M. Bernard,* TC Memo 1967-176. The taxpayer has the burden of proof on this issue. *Dollie H. Click* (1982) 78 TC 225; *Land Dynamics,* TC Memo 1978-259.

PRACTICE TIP: A subsequent intervening event that occurs immediately after the exchange and that causes the taxpayer to offer the replacement property for sale instead of continuing to hold the property for investment or productive use in a trade or business should not affect the characterization of the taxpayer's purpose at the time of the exchange. A taxpayer who owns a rental property too small to operate remotely through a property management company might suddenly and unexpectedly be transferred to a remote location and should not be excluded from IRC §1031 coverage. Nor should a taxpayer who immediately on receipt of replacement property receives an unsolicited purchase offer that is too good to refuse.

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§2.24 2. Taxpayer's Purpose May Change During Holding Period

A taxpayer's purpose may be changed during the period in which the property is held. Compare Rev Rul 57-244, 1957-1 Cum Bull 247 (property originally purchased by taxpayer to build personal residence changed to property held for investment), and *Fred S. Wagensen* (1980) 74 TC 653 (ranch acquired in exchange and, nine months later, transferred as a gift to taxpayer's children was held for productive use in taxpayer's ranching business) with *Dollie H. Click* (1982) 78 TC 225 (residential property acquired in exchange and, seven months later, transferred as a gift to taxpayer's children was acquired and held for purpose of making gift, not for investment). See also *Brooks Griffin* (1967) 49 TC 253; *Ethel Black* (1960) 35 TC 90; *Paul Serdar,* TC Memo 1986-504 n13; IRS Letter Rulings 8915012, 8429039.

The IRS successfully challenged a developer's attempt to transform the purpose of its real estate holdings from building and selling single-family homes to owning properties for investment. See *Neal T. Baker Enters.,* TC Memo 1998-302. The court held that the taxpayer's original business purpose—to subdivide land and build and sell single-family homes—showed that the taxpayer held the property "primarily for sale." The court noted that the IRC §1031 exclusion for property held primarily for sale does not include the words (found in IRC §1221) "to customers in the ordinary course of his trade or business"; thus, the court did not have to decide whether the selling activity was in the ordinary course of the taxpayer's trade or business. Further, the court reviewed the taxpayer's tax returns to determine whether the taxpayer had changed its intent from developing to investing, and found that the taxpayer had not. The taxpayer treated the real estate as "work in progress" and "construction in progress" on its income tax return and stated that its principal business activity was "real estate subdivider and developer."

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§2.25 3. Courts and IRS Disagree on Effect of Taxpayer's Acquiring Property Solely to Exchange It

The courts and the IRS disagree about whether a taxpayer who acquires property solely for the purpose of transferring it in a like-kind exchange satisfies the qualified use requirement. The IRS has taken the position that nonrecognition treatment under IRC §1031(a) is not available if the property relinquished in the exchange was acquired only for the purpose of making the exchange. See Rev Rul 75-291, 1975-2 Cum Bull 332. See also Rev Rul 77-337, 1977-2 Cum Bull 305; Rev Rul 77-297, 1977-2 Cum Bull 304. In contrast, the Ninth Circuit Court of Appeals has held that a taxpayer may defer gain on exchanging property that was acquired and held solely for purposes of the exchange. In *Bolker v Commissioner* (9th Cir 1985) 760 F2d 1039, 1045, the court announced a liberal standard for meeting the qualified use requirement, holding that if a taxpayer owns property that he or she does not intend to liquidate or to use for personal pursuits, the taxpayer is holding that property for a qualified use.

The taxpayer in *Bolker v Commissioner, supra,* liquidated his wholly owned corporation, receiving a distribution of the corporation's real property in redemption of his stock in a transaction qualifying for nonrecognition treatment under former IRC §333. On the same day, the taxpayer entered into a contract with a bank to exchange the real property for like-kind property. The exchange was consummated three months later. The Tax Court reasoned that, if the corporate liquidation and the exchange viewed separately were each "tax free," in combination they should be tax free as long as the taxpayer's investment remained unliquidated and thereby followed the continuity-of-investment principle underlying IRC §1031(a) (see §1.7). *Joseph R. Bolker* (1983) 81 TC 782, 805, aff'd (9th Cir 1985) 760 F2d 1039.

The Ninth Circuit affirmed the Tax Court decision on different grounds, holding that it was not sufficient for the taxpayer simply to satisfy the continuity-of-investment test of IRC §1031(a). The taxpayer must actually hold the property for a qualified use. *Bolker v Commissioner* (9th Cir 1985) 760 F2d 1039, 1044. The court ruled, however, that the taxpayer could satisfy the "holding" requirement by owning the property and the "for productive use in trade or business or for investment" requirement by showing the lack of intent either to liquidate the investment or to use it for personal pursuits. 760 F2d at 1045.

The court held that Rev Rul 77-337 did not apply to the facts in this case, because the taxpayer had planned to acquire the land before he formed the intent to exchange it and owned it for three months before the exchange occurred. 760 F2d at 1043. The court did not explain how these factual differences affect the outcome in light of (a) the rule that the taxpayer's intent in holding the property must be determined as of the time of the exchange, and (b) the fact that the taxpayer was contractually bound to exchange the property during the entire 3-month period of ownership. See also *Barker v U.S.* (CD Ill 1987) 668 F Supp 1199 (following Rev Rul 77-297 and distinguishing *Bolker v Commissioner, supra,* for same reasons that *Bolker* court distinguished Rev Rul 77-337).

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§2.26 4. Length of Holding Period Affects Characterization of Qualified Use

One factor used in determining whether property was held for productive use in a trade or business or for investment is the length of time that the taxpayer holds it. Although IRC §1031(a) does not specify a minimum holding period, the IRS takes the position that, if the relinquished property was acquired immediately before the exchange or if the replacement property is disposed of immediately after the exchange, the taxpayer held the property primarily to dispose of it rather than for productive use in a trade or business or for investment. The courts take a more liberal approach, viewing time as only one factor in determining a taxpayer's intent in holding property.

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§2.27 a. Property Relinquished in Exchange

The IRS has ruled that property relinquished in the exchange is not held for productive use in a trade or business or for investment if the taxpayer purchases it immediately before the exchange for the sole purpose of transferring it in the exchange. Rev Rul 77-297, 1977-2 Cum Bull 304. See also Rev Rul 77-337, 1977-2 Cum Bull 305 (property acquired in a corporate liquidation immediately before it is relinquished in an exchange is not held for business or investment purposes). Presumably, the IRS's position would be the same for a taxpayer who acquires the relinquished property through a partnership distribution or a gift immediately before the exchange.

The courts are more flexible in deciding that a taxpayer has held property for the appropriate purpose despite owning it only briefly before the exchange. See, *e.g., Joseph R. Bolker* (1983) 81 TC 782, aff'd (9th Cir 1985) 760 F2d 1039 (taxpayer relinquished property in exchange after 3 months); *124 Front St., Inc.* (1975) 65 TC 6, nonacq 1976-2 Cum Bull 3 (taxpayer relinquished property in exchange after 6 months); *Bennie D. Rutherford,* TC Memo 1978-505 (taxpayer relinquished property in exchange immediately on acquiring it); *Allegheny County Auto Mart, Inc.* (1953) 12 CCH TCM 427, P-H TCM ¶53,140, aff'd (3d Cir 1953) 208 F2d 693 (taxpayer relinquished property in exchange after 5 days). See also *Fred S. Wagensen* (1980) 74 TC 653, 660 (dictum that taxpayer's receipt of relinquished property by a gift, followed immediately by an exchange, qualified); *Estate of Rollin E. Meyer* (1972) 58 TC 311, 316 n2, nonacq 1975-2 Cum Bull 3, aff'd per curiam (9th Cir 1974) 503 F2d 556 (dissent's comment that majority holding would require approval of exchange by corporation immediately after acquisition of relinquished property through contribution from one of its shareholders). But see *Regals Realty Co. v Commissioner* (2d Cir 1942) 127 F2d 931 (taxpayer's intention to hold replacement property just long enough to reduce taxes was not sufficient).

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§2.28 b. Property Acquired in Exchange

The IRS typically takes the position that a taxpayer who disposes of replacement property shortly after the exchange has not held the property for productive use in a trade or business or for investment. See, *e.g., Fred S. Wagensen* (1980) 74 TC 653 (IRS unsuccessfully argued that rancher who transferred ranchland to his children as a gift 9 months after acquiring it in exchange had not held it for productive use in ranch business); *Ethel Black* (1960) 35 TC 90 (IRS unsuccessfully argued that taxpayer who sold replacement property 8 months after exchange had acquired it primarily for sale); Rev Rul 75-292, 1975-2 Cum Bull 333 (nonrecognition of gain under IRC §1031 is not available to taxpayer who contributes replacement property to corporation immediately after completing exchange). But see Rev Rul 57-244, 1957-1 Cum Bull 247 (exchange approved even though taxpayer sold replacement property after exchange).

The IRS prevailed in asserting this position in *George M. Bernard,* TC Memo 1967-176, in which a prearranged sale of replacement property shortly after its acquisition in an exchange resulted in disallowance of the exchange.

WARNING: There is no safe holding period for the replacement property that will automatically qualify it as having been held for productive use in a trade or business or for investment. Even replacement property that is held for a significant period after the exchange may still be considered property held primarily for sale. See, *e.g., Stanley H. Klarkowski,* TC Memo 1965-328, aff'd on other grounds (7th Cir 1967) 385 F2d 398 (replacement property held for 6 years after its acquisition). Many experts believe, however, that a 2-year holding period should be sufficient, absent clear evidence of disqualified use immediately following acquisition of a property.

PRACTICE TIP: The cases described in this section reflect the courts' acceptance of various holding periods, illustrating the importance of the taxpayer's credibility and the total circumstantial evidence presented by the taxpayer. The shorter the period during which the taxpayer holds the property before or after an exchange, the stronger the facts and circumstances the taxpayer must show to prove the proper intent. Any change in intent to hold for a qualifying purpose should be well documented.

The IRS has determined that the termination of a private testamentary trust, and subsequent distribution to a limited liability company (LLC) taxed as a partnership held by its beneficiaries, will not preclude the replacement property from being considered held for use in a productive trade or business or for investment under §1031. IRS Letter Ruling 200521002.

The letter ruling points to two facts in arriving at its conclusion: (1) the testamentary trust had a fixed date of termination that would occur regardless of condemnation and subsequent purchase of replacement property, and (2) the purchase of the replacement property and subsequent disposition to the beneficiaries was not part of a prearranged plan by the trustee, but rather a result dictated by the date fixed by the decedent. The IRS concluded that the replacement property purchase by the trust was independent of the trust pending termination causing the distribution to occur and should not preclude the taxpayer from representing replacement property purchased from being considered held for use in a productive trade or business or for investment under §1031.

The IRS made a similar determination based on similar facts in IRS Letter Ruling 200651030. The fact that two of the properties held by the trust were subject to contracts of disposition at the time of the termination did not change the outcome. The letter points to the same two factors cited by IRS Letter Ruling 200521002. Here, the IRS concluded that the trust's termination should not preclude the LLC from exchanging the property it received as a result of the termination.

See §§2.31-2.32 for discussion of when a taxpayer's investment may be found to be continuous and unliquidated even though the taxpayer held property only briefly before transferring it to, or after acquiring it from, a partnership or corporation.

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§2.29 5. Change in Form of Investment Complicates Characterization of Qualified Use

The qualified use requirement can become an issue when a taxpayer who is planning a like-kind exchange wishes to change the form of the investment at or about the time the exchange transaction occurs. This sometimes happens when a taxpayer owns an interest in property as a partner of a partnership or member of a limited liability company and wishes to separate himself or herself from the other partners or members in the ownership of the replacement property. In other situations, the taxpayer simply desires to hold the replacement property in a different form of entity or ownership than that in which the relinquished property was held, *e.g.,* to change from individual ownership to entity or trust ownership. Such transactions are complicated by the fact that exchanges of partnership interests and corporate shares are excluded from nonrecognition treatment by IRC §1031(a)(2). See §2.13.

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§2.30 a. Relinquished Property Acquired From Related Partnership or Corporation

If a taxpayer receives a distribution of property from a related partnership or corporation and then exchanges it for like-kind property, the IRS might challenge the exchange on the ground that the relinquished property was not held for productive business use or for investment. The IRS has ruled that a shopping center, received as the only asset from the liquidation of a taxpayer's wholly owned corporation and immediately exchanged for like-kind property held by a third party, was not held by the taxpayer for productive use in a trade or business or for investment; the corporation's productive use of the shopping center before liquidation could not be attributed to the taxpayer. Rev Rul 77-337, 1977-2 Cum Bull 305. Presumably, the IRS's position would be the same for a taxpayer who acquires property in a partnership distribution immediately before exchanging it for like-kind property.

The courts are more flexible than is the IRS in finding that the qualified use requirement has been satisfied even though the taxpayer exchanged the property promptly after acquiring it from a related entity. Compare *Joseph R. Bolker* (1983) 81 TC 782, aff'd (9th Cir 1985) 760 F2d 1039 (see §2.25), and *Miles H. Mason,* TC Memo 1988-273, aff'd without published opinion (11th Cir 1989) 880 F2d 420 (exchange qualified when taxpayer acquired real property in IRC §731 distribution of partnership assets and exchanged it with former partner for like-kind property), with *Crenshaw v Commissioner* (5th Cir 1971) 450 F2d 472 (intricate transaction purporting to be liquidation of partnership interest followed by exchange of real property held to be in substance a sale of partnership interest).

WARNING: Transactions involving a taxpayer's exchange of property acquired from a related partnership are particularly vulnerable to attack under the step-transaction and substance-over-form doctrines. See, *e.g., Crenshaw v Commissioner, supra*. For discussion of these doctrines, see IRS Letter Ruling 9645005.

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§2.31 b. Replacement Property Contributed to Related Partnership or Corporation

If, immediately or shortly after a like-kind exchange, the taxpayer contributes the replacement property to a partnership or corporation, the IRS may contend that the taxpayer did not hold the property for productive use in a trade or business or for investment as required by IRC §1031(a)(1). See Rev Rul 75-292, 1975-2 Cum Bull 333 (holding requirement is not satisfied if taxpayer immediately transfers replacement real property to newly formed corporation); *Norman J. Magneson* (1983) 81 TC 767, 769, aff'd (9th Cir 1985) 753 F2d 1490 (IRS argued unsuccessfully that taxpayer did not hold replacement property for productive business use or for investment, because taxpayer immediately contributed property to limited partnership for general partner's interest). On appeal, the Ninth Circuit agreed with the Tax Court that the taxpayer was not required to recognize the gain on the exchange.

In *Magneson v Commissioner* (9th Cir 1985) 753 F2d 1490, the Ninth Circuit applied a continuity-of-investment analysis in concluding that the taxpayer had complied with IRC §1031(a). The court examined whether the taxpayer's contribution of the tenant-in-common interest in real property to the partnership in return for a general partner's interest was a liquidation of the taxpayer's old investment or a continuation of the investment in modified form. The court held that a taxpayer's investment is continued unliquidated if the relationship to the property under applicable state law is such that the taxpayer's control of the property is not significantly altered by the transaction. The court found that the rights of possession and control of real property vested in an investor holding a tenant-in-common interest are so similar to those of an investor holding an interest as a general partner that the change from one to the other was a continuation of the same investment in a modified form, rather than a liquidation. 753 F2d at 1495.

The court distinguished Rev Rul 75-292, in which the IRS ruled that a taxpayer who transferred real property received in an exchange transaction to a corporation in return for shares was no longer the holder of the real property. Contrasting the legal relationships and rights of ownership and control of a corporate shareholder with those of a general partner, the court concluded that the shareholder relinquishes ownership and control of the property, but the general partner retains both. 753 F2d at 1493.

Although the Ninth Circuit accepted the continuity-of-investment test, it recognized that the transaction must also meet the technical "holding" requirement of IRC §1031(a). The court concluded, however, that §1031(a) does not require the taxpayer to continue to hold the acquired property in the exact form of ownership in which it was acquired. The court ruled as follows (753 F2d at 1497):

So long as, as in this case, the taxpayers continue to own the property and to hold it for investment, a change in the mechanism of ownership which does not significantly affect the amount of control or the nature of the underlying investment does not preclude nonrecognition under section 1031(a).

In 1984, Congress amended IRC §1031(a) to exclude exchanges of partnership interests from nonrecognition treatment under IRC §1031(a). See IRC §1031(a)(2)(D), discussed in §2.13.

In *Bonny B. Maloney* (1989) 93 TC 89, the taxpayer was a corporation that acquired real property in a like-kind exchange and then distributed the property to its shareholders one month later in an IRC §333 liquidation of the corporation. In upholding the exchange, the Tax Court noted that the facts in *Maloney* were merely a variant of those in *Magneson v Commissioner, supra:* Both cases involved an exchange of like-kind properties followed by a tax-free change in the form of ownership. In *Maloney,* however, the Tax Court appears to have ignored the fact that the Ninth Circuit in *Magneson* made a point of distinguishing the rights of possession and control of a shareholder from those of a general partner. For further analysis of *Maloney* and *Magneson,* see Cuff, *1031 Exchanges Involving Partnerships and LLC's: Some Observations on an ABA Report,* 28 J Real Est Tax'n 203 (Spring 2001). The IRS approved an exchange when the technical termination of a limited liability company under IRC §708(b)(1)(B) resulted in a postexchange transfer of replacement property. This result was based, in part, on the fact that the termination of the trust—which had been the limited liability company's owner at the time of the exchange—legally mandated the termination of the limited liability company. See IRS Letter Ruling 200812012.

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§2.32 c. Contributions To, Receipt From, and Other Uses of Disregarded Entities

Single-member domestic limited liability companies and certain wholly owned S corporations and REIT subsidiaries are ignored as separate entities for federal income tax purposes under Reg §301.7701-3. No election under the tax code is required to achieve this "disregarded" status. As long as the single-owner domestic entity does not elect to be classified as an association taxable as a corporation, it will not be regarded as an entity separate from its owner. Reg §301.7701-3(b)(1)(ii). Internal Revenue Service Letter Ruling 9807013 treats as transparent for federal income tax purposes certain legal entities that have only one equity owner. If the exchanger, therefore, must (*e.g.,* because of lender's requirements) take title to replacement property in a legal entity, or if the exchanger wants personal liability protection, use of a single-member limited liability company (LLC), in which the exchanger is the sole member, as the party acquiring the replacement property will not invalidate the exchange for federal income tax purposes. See also IRS Letter Rulings 200131014 and 200732012.

NOTE: When the qualified intermediary is itself a single-member LLC holding title to the replacement property, the IRS has ruled that acquisition of the LLC interest by the taxpayer instead of a direct deed of the replacement property will be treated as receipt of the replacement property for IRC §1031 purposes. IRS Letter Ruling 200118023.

All states now permit formation of single-member LLCs. On LLCs generally, see the Beverly-Killea Limited Liability Company Act (Corp C §§17000-17655). See also Forming and Operating California Limited Liability Companies (2d ed Cal CEB 2007).

States with a state income tax must conform the state income tax law treatment of single-member LLCs to permit "tax transparency" to the same extent as that available under federal tax law (but query whether taxpayers can elect, as they can under federal tax law, to have their single-member LLC *not* taxed as a separate entity). Under Rev Proc 2002-69, 2002-2 Cum Bull 831, spouses who hold their interests in an LLC as community property under the laws of a state, foreign country, or U.S. possession may treat the LLC as a "disregarded entity" for federal income tax purposes. This permits those married couples who are eligible to claim that their assets are community property to exchange from co-ownership in another form (usually direct ownership, as community property) to indirect ownership through an LLC of which they are the sole members. Because that LLC will be disregarded for federal income tax purposes, such spouses will be treated as directly acquiring replacement property. By implication, married couples who cannot, or do not, elect to treat their assets as community property (either because under the applicable state or foreign law such treatment is not available or for other reasons) will not obtain the same treatment when they exchange from direct co-ownership to indirect ownership in a jointly held LLC, even if they are the sole owners of all membership interests in the LLC.

Because the IRS considers a single-member LLC as transparent for federal income tax purposes, it will treat the transfer of the single member's LLC ownership interest as the transfer of the LLC's assets. For example, if a single-member LLC holds real property and elects not to be taxed as a separate entity, the single member's interest can be transferred in a like-kind exchange, and the character and nature of the property that is analyzed to ascertain if it is "like-kind" is the LLC asset, not the membership interest.

The IRS has allowed use of a two-member LLC to receive replacement property when one member holds all economic interests in the entity. In IRS Letter Ruling 199911033, the LLC had been formed at a lender's request. The second member was a controlled corporation with no economic interest in the LLC. The IRS concluded that the arrangement was not a partnership for income tax purposes, and thus the LLC would be (1) treated as having a single owner and (2) disregarded as an entity separate from the taxpayer.

NOTE: The IRS has concluded that the transfer of replacement property to an LLC *wholly owned* by the taxpayer will not violate the qualified use requirement. See IRS Letter Ruling 200131014.

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§2.33 d. Midstream or Postexchange Corporate Reorganizations

Corporate reorganizations that occur during or after the exchange transaction generally do not pose a problem for like-kind exchange treatment under IRC §1031. For example, in IRS Letter Ruling 9850001, after an exchange between a taxpayer (a wholly owned subsidiary of a United States company that was a subsidiary of a foreign corporation) and a limited liability company (LLC) owned by the taxpayer (LLC1), the taxpayer merged into its United States holding company parent and the taxpayer ceased to be a separate legal entity. The U.S. holding company then merged with another U.S. operating subsidiary of the foreign corporation. The IRS stated that the exchange was valid and that the taxpayer/owner's subsequent transfer of the membership interest in LLC1 to another LLC, also owned by the subsidiary, did not adversely affect the exchange under §1031.

See also IRS Letter Rulings 9751012 and 200012064, in which the IRS validated an exchange consummated as part of a corporate reorganization. The use of a single-member LLC as the owner of the replacement property was also approved. The IRS reached a similar conclusion when it approved the use of a qualified chapter S subsidiary or single-member LLC to receive replacement property in a IRC §1033 nonrecognition transaction. IRS Letter Ruling 199909054.

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§2.34 6. Change in Economic Arrangements Before or After Exchange

Like-kind exchange treatment under IRC §1031 can be jeopardized by changes in the taxpayer's economic arrangements that occur before or after the exchange transaction. Examples of these changes include the following:

- Leasing the relinquished property to a third party before the exchange (see §2.35);
- Granting a third party an option to purchase or exchange the relinquished property (see §2.36); and
- Granting or obtaining "puts," "calls," or similar options on the replacement property (see §2.37).

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§2.35 a. Leasing Relinquished Property to Third Party Before Exchange

The taxpayer should be permitted to lease the relinquished property to a third party in anticipation of an exchange without jeopardizing like-kind exchange treatment under IRC §1031. The primary issue is whether the benefits and burdens of ownership are deemed to have shifted to the lessee under the lease, resulting in a disposition of the relinquished property before conveyance of title. See §§2.16, 4.16, 4.32.

The attorney should ensure that the risk of loss has not shifted to the lessee under the lease; such a transfer might constitute a transfer of equitable ownership, regardless of legal title. The taxpayer should continue to pay any mortgage payment, claim any depreciation or cost recovery deductions on the relinquished property, and retain insurance on the property until disposition, although the lessee may pay the insurance premiums. See Rev Rul 69-93, 1969-1 Cum Bull 139. The fact that the lessee pays rent, insurance, property taxes, and maintenance costs under a triple net lease should not affect the result, but a bargain purchase option at the end of the lease term may convert the lease to a sale. Furthermore, the taxpayer may receive option consideration in the form of cash before commencement of the exchange, and the proceeds will not be treated as boot as long as the taxpayer deposits all the option consideration with a qualified intermediary before the exchange and none of the option consideration is received by the taxpayer at the completion of the exchange. But if the taxpayer either retains the option consideration or receives all or a portion of the consideration at completion of the exchange, then the consideration retained or received will be treated as boot for purposes of the exchange. *Delbert C. Sowerby,* TC Memo 1984-21. See also *Frank Lyon Co. v U.S.* (1978) 435 US 561, 55 L Ed 2d 550, 98 S Ct 1291, rev'g (8th Cir 1976) 536 F2d 746.

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§2.36 b. Relinquished Property Sale Option

If the taxpayer grants a third party an option to purchase or exchange the relinquished property, the granting of the option should not jeopardize the exchange. In Rev Rul 84-121, 1984-2 Cum Bull 168, the IRS ruled that the taxpayer properly completed an IRC §1031 exchange even though he had previously granted an option to a third party to acquire the relinquished property. Furthermore, the taxpayer may receive option consideration in cash before the exchange commences, and the proceeds will not be treated as boot if the taxpayer deposits all the option consideration with a qualified intermediary before the exchange and none of the option consideration is received by taxpayer at the completion of the exchange. But if the taxpayer either retains the option consideration or receives all or a portion of the consideration at the completion of the exchange, then the consideration retained or received will be treated as boot for purposes of the exchange.

In *Cary A. Everett,* TC Memo 1978-53, the taxpayer granted an option to sell his property. When the optionee was not able to exercise the option, it was canceled and the taxpayer exchanged his property with a third party that owned property desired by the taxpayer. The third party then sold the relinquished property to the former optionee for cash. The IRS contended that the option had converted the relinquished property to property held primarily for sale; the fact that the relinquished property was ultimately purchased by the former holder of the option made the transaction equivalent to a sale by the taxpayer and reinvestment of the proceeds in the replacement property. In upholding the exchange, the Tax Court noted that not only was the option never exercised but it was canceled before the taxpayer exchanged the relinquished property for the replacement property. See also Rev Rul 84-121, 1984-2 Cum Bull 168.

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§2.37 c. Replacement Property "Puts" and "Calls"

If a taxpayer transfers the replacement property soon after receiving it in the exchange, the IRS could assert that the taxpayer did not have the requisite intent to hold the property for business or investment purposes. On one hand, if the taxpayer holds a "put" relating to the replacement property (which requires a third party, usually the seller of the replacement property, to reacquire the replacement property), the IRS is likely to question the exchange. On the other hand, a "call" option held by the seller of the replacement property (giving the seller the right, but not the obligation, to buy the property) would be less likely to cause the IRS to challenge the transaction's validity as an exchange because the taxpayer would not control whether the seller would reacquire the replacement property unless the call option price was so favorable to the holder that the option was likely or certain to be exercised. However, the IRS could still raise the issue of whether the taxpayer satisfied the qualified use test if the taxpayer granted someone the right to purchase property immediately after its acquisition by the taxpayer. See *George M. Bernard,* TC Memo 1967-176.

In any event, the longer the taxpayer holds the replacement property, the less likely it is that the IRS could successfully argue that the taxpayer did not intend to hold the replacement property for sale or use in a trade or business.

See §2.36 for discussion of options on relinquished property.

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Source: Real Property/Real Property Exchanges/2 Requirements for Like-Kind Exchanges/§2.38 D. Personal Residences

§2.38 D. Personal Residences

Exchanges of personal residences are excluded by implication from nonrecognition treatment under IRC §1031 because personal residences are not held for productive use in a trade or business or for investment. Rev Rul 59-229, 1959-2 Cum Bull 180; *Starker v U.S.* (9th Cir 1979) 602 F2d 1341. Under current law, the first $250,000 of gain ($500,000 if the taxpayer is a married couple filing a joint return) is excluded from gross income on the sale or exchange of property owned and used by a taxpayer as its principal residence for 2 of the previous 5 years, as long as the taxpayer consummates only one such sale or exchange in any 2-year period. IRC §121. The 2-year rule does not apply to sales or exchanges of personal residences occurring before May 7, 1997. IRC §121(b)(3)(B).

IRC §121 was amended in 2009 to limit its availability when property is used for "nonqualified use" before its use as a principal residence. IRC §121(b)(4)[5]. Similarly, taxpayers who purchase replacement property pursuant to IRC §1031 and subsequently convert it into a personal residence will not qualify for an IRC §121 tax exclusion during the 5-year period following the deferred exchange acquisition date. IRC §121(d)(11). Taxpayers can take advantage of §121 more than once, but no more often than once every 2 years, and there is no longer any minimum age requirement before taxpayers can use this provision. An otherwise qualifying taxpayer who fails to satisfy the 2-year ownership and use requirements may exclude an amount equal to a prorated fraction of the $250,000 ($500,000 if married and filing a joint return) exclusion amount. An exchange transaction may qualify partially under §121 and partially under §1031.

EXAMPLE: Taxpayer *A* buys a property for $210,000. The property consists of two separate dwelling units (within the meaning of Reg §1.121-1(e)(2)), a house and a guesthouse. From 2004 until 2009, *A* uses the house as *A*'s principal residence and uses the guesthouse as an office in *A*'s trade or business. On the basis of the square footage of the respective parts of the property, *A* allocates 2/3 of the basis of the property to the house and 1/3 to the guesthouse. From 2004 to 2009, *A* claims depreciation deductions of $30,000 for the business use. In 2006, *A* exchanges the entire property for a residence and a separate property that *A* intends to use as an office. The total fair market value of *A*'s replacement properties is $360,000. The fair market value of the replacement residence is $240,000 and the fair market value of the replacement business property is $120,000, which is equal to the fair market value of the relinquished business property. *A* realizes gain of $180,000 on the exchange.

Under §121, *A* may exclude the $100,000 gain allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000) because *A* meets the ownership and use requirements for that portion of the property. Because the guesthouse is business property separate from the dwelling unit, *A* may not exclude the gain allocable to the guesthouse. Reg §1.121-1(e). However, because the fair market value of the replacement business property is equal to the fair market value of the relinquished business property and *A* receives no boot, *A* may defer the remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis, which is 1/3 of $210,000 basis, or $70,000, adjusted by $30,000 depreciation) under §1031.

In an exchange qualifying partially under IRC §1031 and partially under IRC §1031, the allocation of value between the two types of properties becomes the crucial issue. In *Sayre v U.S.* (SD W Va 1958) 163 F Supp 495, the court held that any reasonable allocation would be permissible. As a result, whenever relinquished property is composed of both a personal residence and property held for productive use in a trade or business or for investment, the taxpayer should explore which of the various methods of allocation of value would be most beneficial, given the nature and character of the property to be received in the exchange.

In circumstances where a taxpayer has used a property consecutively or concurrently as a home and a business (*e.g.*, rental residence), a taxpayer may benefit from both the home-sale exclusion under IRC §121 and the like-kind deferral under IRC §1031. Rev Proc 2005-14, 2005-7 Int Rev Bull 528 In order to obtain the benefit of both code sections the property exchanged must satisfy the requirements of both IRC §§121 and 1031.

The prospect of a taxpayer obtaining the benefit of both IRC §§121 and 1031 gives rise to the question of when and how boot is taken into account. On this question the IRS has taken a taxpayer-favorable position in Rev Proc 2005-14. Boot is only taken into account to the extent boot exceeds the gain excluded under §121 with respect to the relinquished business property. See §§3.12-3.32A for further discussion of boot.

EXAMPLE: Taxpayer *B* is an unmarried individual and the property or portion of the property has been used in the taxpayer's trade or business or held for investment within the meaning of §1031(a) as well as used as a principal residence as required under §121. *B* buys a house for $210,000 that *B* uses as *B*'s principal residence from 2003 to 2007. From 2007 until 2009, *B* rents the house to tenants and claims depreciation deductions of $20,000. In 2009, *B* exchanges the house for $10,000 cash plus a

townhouse with a fair market value of $460,000 that *B* intends to rent to tenants. *B* realizes gain of $280,000 on the exchange.

B's exchange of a principal residence that *B* rents for less than 3 years for a townhouse intended for rental plus cash satisfies the requirements of both §§121 and 1031. Section 121 does not require the property to be the taxpayer's principal residence on the sale or exchange date. Because *B* owns and uses the house as *B*'s principal residence for at least 2 years during the 5-year period prior to the exchange, *B* may exclude gain under §121. Because the house is investment property at the time of the exchange, *B* may defer gain under §1031.

Under Rev Proc 2005-14, §4.02(1), *B* applies §121 to exclude $250,000 of the $280,000 gain before applying the nonrecognition rules of §1031. *B* may defer the remaining gain of $30,000, including the $20,000 gain attributable to depreciation, under §1031. Although *B* received $10,000 cash (boot) in the exchange, *B* is not required to recognize gain because the boot is taken into account for the purposes of §1031(b) only to the extent that boot exceeds the amount of excluded gain.

Amount realized		$470,000
Less:	Adjusted basis	$190,000
	Realized gain	$280,000
Less:	Gain excluded under §121	$250,000
	Gain to be deferred	$30,000

B's basis in the replacement property is $430,000, which is equal to the basis of the relinquished property at the time of the exchange ($190,000) increased by the gain excluded under §121 ($250,000), and reduced by the cash *B* receives.

See Rev Proc 2005-14 for an example of a single-dwelling-unit mixed-use property exchange qualifying under both IRC §§121 and 1031.

In light of Rev Proc 2005-14, it is no longer necessary for taxpayers to consider whether it would be more advantageous to have the transaction qualify entirely under IRC §1031 rather than under IRC §121. This is because it will always be advantageous to use the §121 exclusion to the extent available, even when planning to use §1031 is prudent and gains exceed the limits of $250,000 or $500,000 set by §121. In such cases, conversion of a residence to a business property should be considered.

No published cases have evaluated the conversion of a personal residence to business or investment property for purposes of IRC §1031. A taxpayer is clearly permitted, however, to deduct an otherwise nondeductible loss on the sale of a personal residence that, before its sale, was rented or otherwise appropriated to income-producing purposes and is used for such purposes up to the time of its sale. Reg §1.165-9(b). The most critical factors in determining whether such a conversion has occurred focus on the reality of the leasing transaction, the length of the term, and whether a fair market rental is charged. See *Andrew F. McBride, Jr.* (1968) 50 TC 1; *Sweet v U.S.* (ND Cal 1968) 68-2 USTC ¶9656, 23 AFTR2d 448; *Paul H. Rechnitzer,* TC Memo 1967-55. For cases in which the taxpayer did not take enough steps to accomplish the conversion, see *Harry C. Welch,* TC Memo 1964-42; *Charles A. Foehl, Jr.,* TC Memo 1961-93; *Stanley G. Paffrath,* TC Memo 1961-71.

The success of this tactic depends on the following:

- The length of the rental term;
- The length of time the house was used as a residence before rental;
- Whether all personal use of the house was permanently abandoned;
- The character of the house (recreational or otherwise);
- The existence of offers to sell or rent;
- The amount of rent; and
- The absence of a prearranged exchange.

EXAMPLE: In *Bolaris v Commissioner* (9th Cir 1985) 776 F2d 1428, the Ninth Circuit held that taxpayers who had rented out their old residence at fair market value on a month-to-month basis while attempting to sell it were entitled to (1) take depreciation and expense deductions attributable to the period of the rental under IRC §§167 and 212, and (2) defer tax on the gain under former IRC §1034 once the house sold. To qualify as property held for production of income under §§167 and 212, the taxpayers must have engaged in the rental activity with the primary purpose of making a profit. The court held that this profit motive was shown by factors such as the fair market rental. How far a taxpayer can go in arranging such a transaction to qualify

as a like-kind exchange under IRC §1031 is not clear.

In *Bundren v Commissioner* (10th Cir 2002) 32 Fed Appx 527 (unpublished opinion), the taxpayers disputed the determination of its carryover basis in the relinquished property. The relinquished property had previously been used as the taxpayers' personal residence and was then converted to rental property. At the time of conversion, the adjusted cost basis was greater than the fair market value of the property. The Tax Court (TC Memo 2001-2) held that IRC §165 limited the taxpayers' carryover basis to adjusted cost basis, *but not more than* the property's fair market value at the time of conversion. The 10th Circuit affirmed the Tax Court decision.

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§2.39 E. Vacation Homes

Vacation homes may qualify as investment property for purposes of IRC §1031(a). The broad definition of "investment" in Reg §1.1031(a)-1(b) includes holding unproductive real property for future appreciation. Under this definition, a vacation home may be found to be investment property when the taxpayer's primary reason for holding the property is investment and when personal use of the property is minimal.

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§2.39A 1. *Moore v Commissioner*

In *Moore v Commissioner,* TC Memo 2007-134, the Tax Court denied IRC §1031 treatment on an exchange of vacation properties that it deemed were not held primarily for trade or business or for investment by the taxpayers.

The facts in *Moore* are illustrative of a fairly common scenario associated with vacation properties. The taxpayers purchased lakefront real property and used it 2 or 3 weekends a month during the summers. They made various improvements to the property but never advertised the property for sale and never rented or attempted to rent it to others. They did not claim deductions for investment interest or for maintenance and repair costs. Subsequently, they sold the property and purchased another, continuing the same pattern of use. Again, they improved the property and although they did claim deductions for investment interest, they did not claim deductions for maintenance or other expenses associated with the property. They never rented or attempted to rent the property.

The Moores asserted that one of their principal reasons for holding both properties was the investment potential of these assets. The Tax Court dismissed this rationale, holding that in order to qualify for §1031 treatment on the exchange of these properties, the Moores had to prove that they held both *primarily* for investment. This is the critical holding in the case. The court specifically held that it was not sufficient to show that expectation of appreciation in value was one of the motives for holding the property, but that investment must be the principal or primary intent. The court concluded that on the basis of the Moores' use of the homes, the lack of rental activity, and their failure to hold the homes primarily for sale at a profit, they did not hold the homes primarily for investment. Accordingly, §1031 treatment was denied.

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§2.39B 2. Safe Harbor for Exchanges of Dwelling Units (Rev Proc 2008-16)

In February 2008 the IRS issued Rev Proc 2008-16, 2008-10 Int Rev Bull 1. Revenue Procedure 2008-16 was issued, at least in part, in response to a report by the Treasury Inspector General for Tax Administration (TIGTA) that found that the current guidance on exchanging vacation homes was complex and unclear. Dept. of the Treasury Reference No. 2007-30-172. TIGTA urged the IRS to issue clear rules on exchanges of vacation and second homes.

Revenue Procedure 2008-16 provides a safe harbor, effective for exchanges occurring on or after March 10, 2008, under which the IRS will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under IRC §1031. Under Rev Proc 2008-16, a "dwelling unit" is real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including sleeping space, bathroom, and cooking facilities. Rev Proc 2008-16, §3.02.

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Source: Real Property/Real Property Exchanges/2 Requirements for Like-Kind Exchanges/§2.39C a. Must Be Held for Productive Use in a Trade or Business or for Investment

§2.39C a. Must Be Held for Productive Use in a Trade or Business or for Investment

A dwelling unit sold as relinquished property qualifies as held for productive use in a trade or business or for investment under IRC §1031 if (Rev Proc 2008-16, §4.02(1))

- it is owned by the taxpayer for at least 24 months immediately before the exchange; and
- in each of the two 12-month periods immediately preceding the start of the exchange,
- the taxpayer rents the property to another person at a fair rental for 14 days or more; and
- the taxpayer's personal use of the property does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the property is rented at a fair rental.

Similarly, a dwelling unit acquired as replacement property in an exchange qualifies as held for productive use in a trade or business or for investment under §1031 if

- it is owned by the taxpayer for at least 24 months immediately after the exchange; and
- in each of the two 12-month periods immediately after the exchange (Rev Proc 2008-16, §4.02(2)),
- the taxpayer rents the property to another person at a fair rental for 14 days or more; and
- the taxpayer's personal use of the property 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 a fair rental.

Fair rental is determined on the basis of all of the facts and circumstances that exist when the rental agreement is entered into and all rights and obligations of the parties to the rental agreement are taken into account. Rev Proc 2008-16, §4.04.

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§2.39D b. Personal Use Standards

To determine what constitutes a taxpayer's "personal use" of a property, Rev Proc 2008-16 incorporates the personal use standards of IRC §280A(d)(2), under which a taxpayer is deemed to have used a dwelling unit for personal purposes that are charged against the 14-day or 10 percent of rental day limit (see §2.39C) if used by any of the following (Rev Proc 2008-16, §4.03):

- The taxpayer or any other person who has an interest in such unit (including a tenant in common) or by any member of the family of the taxpayer or such other person;
- Any individual who uses the unit under an arrangement that enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of such other unit); or
- Any individual if rented for less than a fair market value rental.

Consistent with these rules, a taxpayer may rent the dwelling unit to a family member if the family member uses it as a principal residence (and not a vacation home) and the family member pays fair market rent. See Prop Reg §1.280A-1(e)(6). The taxpayer may also use the property for repairs and annual maintenance consistent with IRC §280A(d)(2). See Prop Regs §1.280A-1(e)(6).

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§2.39E c. Timing Rules

In order to qualify for the safe harbor for property being sold, a taxpayer must rent out the property in each of the 2 years before an exchange and during that period engage in limited personal use. In order to avoid potential IRS challenge with respect to vacation property being acquired in an exchange, the taxpayer must rent out that property and also limit personal use in each of the 2 years after the exchange. However, there is clearly no requirement that both sides of an exchange satisfy these requirements. A taxpayer can exchange a vacation property for an office, commercial, or other type of rental property that is like-kind and satisfies the qualified use test, or vice versa.

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§2.39F 3. Exchanges of Vacation Homes Outside Safe Harbor

Revenue Procedure 2008-16 (see §§2.39A-2.39E) is a safe harbor. It does not establish substantive law nor does it affect any requirement of IRC §1031 other than the question of whether personal use of a residence prevents it from being deemed to be held primarily for use in a trade or business or for investment for purposes of §1031(a).

However, Rev Proc 2008-16 does not contain exculpatory language, as does other similar guidance, that specifically states that taxpayers may enter into exchanges of dwelling units that fall outside the safe harbor. For example, Rev Proc 2000-37, 2000-2 Cum Bull 308, covering reverse exchanges, specifically states that the IRS recognizes that reverse exchanges can be completed outside the safe harbor. Rev Proc 2000-37 §3.02. See §5.25.

Nevertheless, it should be possible for an exchange of a vacation property that does not satisfy all requirements of the safe harbor to still meet the statutory requirements under §1031.

EXAMPLE: In *Paul Serdar*, TC Memo 1986-504, the taxpayer allowed his son's family to reside, at below-market rent, in the replacement property received in an exchange. The IRS contended that the taxpayer did not hold the replacement property with the proper intent for purposes of IRC §1031. In dictum supporting the taxpayer, the court noted that property acquired both to provide a residence for relatives and for investment qualifies if the primary motive is investment, which is a question of fact. See TC Memo 1986-504 at n13.

Other statutes may assist a taxpayer's argument that an exchange of vacation property meets the statutory requirements even if the exchange falls outside of the safe harbor. See §§2.39G-2.39I.

PRACTICE TIP: Conservative taxpayers desiring to exchange an interest in a vacation home under IRC §1031 outside of the safe harbor established by Rev Proc 2008-16 should rent the property to unrelated third parties under a written agreement, with little or no personal use, for at least 12 months before exchanging the property. Taxpayers and their advisors should also take care to document periods of business versus personal use.

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§2.39G a. IRC §280A (Deduction for Certain Expenses)

Revenue Procedure 2008-16 adopts a number of concepts found in IRC §280A. Section 280A governs the deductibility of expenses and depreciation other than mortgage interest and real estate taxes associated with vacation or second home properties when there is both personal use and some rental income. Section 280A(a) provides that a taxpayer may not deduct certain expenses associated with business property with respect to a dwelling unit used as a "residence" by the taxpayer during the taxable year. However, §280A is not an absolute bar to deductions. Section 280A(c) allows deductions to be taken to offset gross rental income, and §280A(e) provides for an allocation of deductible items between rental and nonrental periods. Section 280A(d) provides that a taxpayer uses a dwelling unit as a residence if the taxpayer uses the unit for personal purposes for a number of days that exceeds the greater of 14 days or 10 percent of the number of days during the year for which such dwelling unit is rented for fair market value. This is the same standard applied by Rev Proc 2008-16.

Personal use for less than these minimums may be a strong indication that property is held for trade or business or investment purposes, even when the taxpayer does not rent out the property during the 2-year period before or after the exchange. Accordingly, a taxpayer may be able to exchange unproductive real estate that was subject to minimal personal use even though that property would not meet the criteria of the Rev Proc 2008-16 safe harbor.

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§2.39H b. IRC §165 (Deductions for Certain Losses) and §163(h) (Deduction for Certain Interest)

If IRC §280A does not apply to determine whether a vacation home is held for investment, §165 or §163(h) may be relevant. Section 165 allows a taxpayer to claim a deduction for losses that were not compensated by insurance or otherwise. The general rule under §165 is that losses may be deducted if the transaction was entered into for a profit. Personal use may not bar this treatment. However, a taxpayer would still need to satisfy the test established in *Moore v Commissioner,* TC Memo 2007-134 of "principal" or "primary" intent to hold for investment in making an IRC §165 argument. See §2.39A.

Another relevant provision may be IRC §163(h), which limits "personal interest" deductions. The following are expressly excluded:

(A) interest paid or accrued on indebtedness properly allocable to a trade or business …,

(B) any investment interest …,

(D) any qualified residence interest.

A possible implication of this provision is that debt whose deduction is barred by IRC §163(h) is associated with property not held for trade or business or investment purposes. The definition of "qualified residence" carries over from the IRC §280A definition of "residence," with the exception that the 14-day minimum use rule does not apply if no rental income is generated from a property. Prior tax reporting of property subject to §163(h) limits could prejudice qualification of that property as §1031 exchange relinquished property.

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§2.39I c. IRC §183 (Hobby Loss Rules)

IRC §183 hobby loss rules also may be relevant, although §183 is technically trumped by IRC §280A (see §280A(f)(3)). The long history of court analysis of use of property for personal versus business purposes may be relevant to analysis of property for vacation home personal use versus business use.

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§2.40 IV. LIKE-KIND PROPERTY REQUIREMENT

Nonrecognition treatment under IRC §1031 is available only in connection with an exchange of property. The words "of like-kind" and "like-kind" refer to the nature or character of the property, not to its grade or quality. Reg §1.1031(a)-1(b). One kind or class of property may not be exchanged for property of a different kind or class. Reg §1.1031(a)-1(b). The receipt of money or other non-like-kind property will not disqualify the transaction from like-kind exchange treatment under §1031. Gain realized by the taxpayer on disposition of the relinquished property will be recognized, however, in an amount not greater than the sum of the money and the fair market value of the other non-like-kind property received. IRC §1031(b). See §3.6.

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§2.41 A. Real Property

With few exceptions, an interest in real property is considered to be like in kind to any other interest in real property, regardless of the presence or absence of improvements or the type of improvements. See §§2.42-2.46. Whether the property is improved or unimproved is not material for purposes of IRC §1031, because that fact relates only to the grade or quality of the property and not to its kind or class. Reg §1.1031(a)-1(b).

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§2.42 1. Real Property Exchanges Considered to Be of Like-Kind

The following types of real property exchanges are considered to be of like-kind:

- City real property for a ranch or farm. See Reg §1.1031(a)-1(c); *Hubert Rutland,* TC Memo 1977-8.
- A leasehold with 30 years or more to run for a fee. See Reg §1.1031(a)-1(c). See also §2.44.
- Rental income property (house and land) for farmland and improvements but not farm machinery. See Rev Rul 72-151, 1972-1 Cum Bull 225.
- Improved real property for unimproved real property. See Reg §1.1031(a)-1(b)-(c); *Earlene T. Barker* (1980) 74 TC 555. See §2.45 for further discussion of improvements.
- An exchange among cotenants of two or more parcels of real property so that each ends up with sole ownership of one of the parcels. See Rev Rul 79-44, 1979-1 Cum Bull 265; Rev Rul 73-476, 1973-2 Cum Bull 300; IRS Letter Ruling 9525038. See also IRS Letter Ruling 9609016. The attorney should take care, however, in evaluating exchanges of property held in cotenancy because the interests exchanged may be treated as partnership interests, precluding nonrecognition treatment. See *M.H.S. Co.,* TC Memo 1976-165, aff'd per curiam (6th Cir 1978) 575 F2d 1177. See also §2.14.
- A 50-percent tenant-in-common interest in old-growth timberlands for a 100-percent interest in half of such timberlands. See IRS Letter Ruling 199926045. See also IRS Letter Ruling 199945046.
- A fee for a fee subject to an unexercised option. See *Boise Cascade Corp.,* TC Memo 1974-315. See also *Cary A. Everett,* TC Memo 1978-53.
- A fee for the contractual right to purchase real property or equitable fee title subject to conditions precedent. See *Biggs v Commissioner* (5th Cir 1980) 632 F2d 1171; *Starker v U.S.* (9th Cir 1979) 602 F2d 1341.
- A remainder interest in one property for a remainder interest in another property. See Rev Rul 78-4, 1978-1 Cum Bull 256.
- A remainder interest in one property for a life estate in another property when the life tenant has a life expectancy of at least 30 years. See Rev Rul 72-601, 1972-2 Cum Bull 467.
- An agricultural conservation easement in perpetuity in a farm, found to be real property under state law, for a fee simple interest in real property. See IRS Letter Ruling 9232030. See also IRS Letter Ruling 200201007 and companion IRS Letter Rulings 200203033 and 200203042.
- Agricultural conservation easements over two farms for fee simple title in a different farm. See IRS Letter Ruling 9851039.
- A perpetual conservation easement encumbering real property for a fee simple interest in either farm land, ranch land, or commercial real property. See IRS Letter Ruling 9601046 (the conservation easement in question was granted by the taxpayer to the federal government over real property the taxpayer had held for many years for productive use in the business of cattle grazing and duck hunting).
- A scenic conservation easement, found to be real property under state law, for a fee simple interest in timberland, farmland, or ranch land. See IRS Letter Ruling 9621012.
- Raw land acquired by taxpayers for future use as a mobilehome park, on which taxpayers operated sand mining business under a nontransferable mining permit, for land and buildings. See *Larry L. Beeler,* TC Memo 1997-73.
- Transferable development rights associated with real property for a fee interest in real property. IRS Letter Rulings 200805012, 200901020.
- A utility easement for another utility easement. See IRS Letter Ruling 9814019.

- Replacement property for involuntarily converted outdoor advertising displays, which the taxpayer elected to treat as real property under an IRC §1033(g)(3)(C) election. See IRS Letter Ruling 200041027.

- An exchange of FCC radio licenses for FCC television licenses. See IRS Letter Ruling 200035005.

- Standing timber to be severed by the buyer, found to be a transfer of real property under state law, for a fee interest in land. *D. G. Smalley* (2001) 116 TC 450.

- The conversion of a stock cooperative into a condominium. See IRS Letter Rulings 200137032 and 200631012.

- An exchange of FCC spectrum rights licenses in two bandwidths for similar licenses in which one of the bandwidths differs. See IRS Letter Ruling 200532008.

- An exchange of old growth timber for reproductive timber. See IRS Letter Ruling 200541037.

- Coal supply contracts for a fee interest in a gold mine. See *Peabody Natural Resources Co.* (2006) 126 TC 261. For discussion of supply contracts, see §2.46B.

- An exchange of a perpetual stewardship easement for fee interest in real property. IRS Letter Rulings 200649028, 200651018, and 200651025.

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§2.43 2. Real Property Exchanges Not Considered to Be of Like-Kind

The following types of real property exchanges are *not* considered to be of like-kind:

- Real property located in the United States for real property located outside the United States. See IRC §1031(h)(1). IRS regulations now treat real property located in the U.S. Virgin Islands, Guam, and the Northern Mariana Islands as like-kind to real property located in the United States. Reg §1.935-1T(c)(ii)(E); TD 9194, 2005-1 Cum Bull 1016.

- A remainder interest in one property for a life estate in another property, when the taxpayer has a life expectancy of less than 30 years. See Rev Rul 72-601, 1972-2 Cum Bull 467.

- A fee for a leasehold of fewer than 30 years. See Reg §1.1031(a)-1(c); Rev Rul 72-601. For further discussion of leaseholds, see §2.44.

- Improvements without land. See §2.45.

- Lease-in/Lease-out transactions that lack economic substance and are merely offsetting legal obligations. See IRS Field Service Advice 200205023.

- Certain types of water rights for fee simple interests in real estate. In *Wiechens v U.S.* (D Ariz 2002) 228 F Supp 2d 1080, the district court determined that limitations on the priority, quantity, and duration of the water rights caused their nature and character to be materially dissimilar from a fee interest in real property, even though there was a remaining term of 40 years under the water rights contract. The taxpayers' argument that water rights were analogous to a leasehold estate of more than 30 years did not persuade the court.

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§2.44 3. Leasehold Interests

An exchange of fee title for a leasehold with a remaining term of 30 years or more, or vice versa, is an exchange of like-kind property. Reg §1.1031(a)-1(c). See also IRS Letter Ruling 200842019. This is true even if the taxpayer who acquires the leasehold as replacement property is the landlord who already owns the remainder interest in the property and acquires the leasehold by purchasing it from his or her own tenant. Rev Rul 68-394, 1968-2 Cum Bull 338. See also *Boise Cascade Corp.,* TC Memo 1974-315.

NOTE: All leases in this case predated the exchange transaction. If a lease is created solely to facilitate an exchange, the IRS may challenge a landlord's acquisition of the tenant's interest (resulting in merger of the leasehold interest into the fee interest) on step-transaction grounds.

Unexercised option periods are included in meeting the 30-year requirement. Rev Rul 78-72, 1978-1 Cum Bull 258 (involving involuntary conversion under IRC §1033 but applying like-kind standards of IRC §1031). See also *Century Elec. Co. v Commissioner* (8th Cir 1951) 192 F2d 155. A leasehold of less than 30 years is not like in kind to a fee (Reg §1.1031(a)-1(c); Rev Rul 72-601, 1972-2 Cum Bull 467), but it is like-kind to a lease of more than 30 years. Rev Rul 78-72, 1978-1 Cum Bull 258.

A leasehold of an entire 20-story building with more than 30 years to run is like in kind to a sublease of five floors in the same property of equal duration. Rev Rul 76-301, 1976-2 Cum Bull 241. See also *Carl E. Koch* (1978) 71 TC 54, acq 1979-2 Cum Bull 2 (fee interest subject to 99-year lease exchanged for other real property); IRS Letter Ruling 9224008 (lessor's reversionary interest is real property that may be exchanged for other real property in qualified IRC §1031 exchange, even if lessor retains its interest as lessor under 47-year lease on relinquished property).

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§2.45 4. Improvements

The IRS has often taken the position that buildings and other real property improvements are not like in kind to a fee or other interests in land. See Rev Rul 76-391, 1976-2 Cum Bull 243 (unimproved farmland and commercial building are not of like kind); Rev Rul 76-390, 1976-2 Cum Bull 243 (motel built on land already owned by taxpayer is not like-kind replacement property for mobilehome park); Rev Rul 67-255, 1967-2 Cum Bull 270 (storm drains, water systems, and roads constructed on land already owned by taxpayer are not like-kind replacement property for unimproved land). See also *Bloomington Coca-Cola Bottling Co. v Commissioner* (7th Cir 1951) 189 F2d 14 (exchange did not qualify under IRC §1031 when taxpayer exchanged bottling plant and underlying land to building contractor that had constructed bottling plant on other land owned by taxpayer). But see *Davis v U.S.* (D Haw 1976) 411 F Supp 964, aff'd on other grounds (9th Cir 1979) 589 F2d 446. This issue has come under increasing scrutiny in light of the increased use of "reverse" exchanges following issuance of Rev Proc 2000-37, 2000-2 Cum Bull 308. See chap 5.

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§2.46 5. Natural Resources

Generally, mineral rights are considered to be like in kind to estates in real property. For example:

- A tenant in common interest in oil deposits in place is like in kind to a fee interest in improved real property (Rev Rul 68-331, 1968-1 Cum Bull 352);
- An overriding royalty interest in minerals is like in kind to a city lot (*Commissioner v Crichton* (5th Cir 1941) 122 F2d 181); and
- An interest in overriding oil and gas royalties is like in kind to unimproved real property (Rev Rul 72-117, 1972-1 Cum Bull 226).

When the mineral right is limited in duration or amount, however, authorities are less likely to view it as like in kind to fee interests or other mineral rights. In *William Fleming* (1955) 24 TC 818, aff'd in part and rev'd in part on other grounds (5th Cir 1957) 241 F2d 78, rev'd on other grounds (1958) 356 US 260, 2 L Ed 2d 743, 78 S Ct 691, the Tax Court held that an exchange of overriding royalties from oil and gas leases for a fee estate in ranch land was not an exchange of like-kind property, because the overriding royalties were a limited mineral interest that would expire when a definite sum of money had been realized from it. The United States Supreme Court upheld this position, finding that the characteristics of the royalty rights in that case made them a different class of property. In *Midfield Oil Co.* (1939) 39 BTA 1154, the Board of Tax Appeals ruled that an exchange of an oil payment for an overriding oil and gas royalty reserved from the same lease was not a like-kind exchange, because the oil payment was limited and would terminate after a specified amount of proceeds had been received.

An exchange of land for perpetual water rights is an exchange of like-kind property if the water rights constitute real property under state law. Rev Rul 55-749, 1955-2 Cum Bull 295. IRS Letter Ruling 200404044. An exchange of wetland "mitigation credits" granted to a landowner also qualifies as property eligible for like-kind exchange treatment. IRS Letter Ruling 9612009.

In general, timber rights are like in kind to other timber rights (*Cary A. Everett,* TC Memo 1978-53), and timberland is like in kind to other timberland (Rev Rul 72-515, 1972-2 Cum Bull 466). When an agreement to cut and remove standing timber is an agreement for sale of goods only and not an interest in real estate under state law, however, the right to cut standing timber is not like in kind to a fee interest. *Oregon Lumber Co.* (1953) 20 TC 192. When the conveyance of standing timber to be severed by the buyer is a transfer of real property under state law, the interest conveyed is like kind to a fee interest in land. *D. G. Smalley* (2001) 116 TC 450.

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§2.46A 6. Government Quotas and Price Support Programs

In 2004 Congress enacted the Fair and Equitable Tobacco Reform Act of 2004 as Title VI of the American Jobs Creation Act of 2004 (Pub L 108-357, 118 Stat 1418) (the "Tobacco Reform Act"). As a result, holders of tobacco quotas became eligible for tobacco tax quota payments. Payments made to a taxpayer pursuant to the Tobacco Reform Act qualify for tax deferral by entering into a like-kind IRC §1031 exchange. IRS Notice 2005-57, 2005-32 Int Rev Bull 267.

WARNING: The date a taxpayer enters into a contract with the United States Department of Agriculture (USDA) for receipt of payment under the Tobacco Reform Act is the date on which the quota is transferred for purposes of §1031. A taxpayer who intends to defer any gain as a result of a transfer of a tobacco quota to the USDA must enter into an exchange agreement with a Qualified Intermediary in advance of executing an agreement with the USDA. IRS Notice 2005-57. See §4.18 for transitional relief.

Notice 2005-57 does not provide guidance regarding what types of property or intangible assets are considered like kind to a tax quota.

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§2.46B 7. Supply Contracts

In *Peabody Natural Resources Co.* (2006) 126 TC 261, the Tax Court held that a coal mining property subject to operating supply contracts was like-kind to gold mining property. Despite deciding that the supply contracts were considered real property under New Mexico law, the Tax Court concluded that this was not dispositive in determining whether their presence created boot in the taxpayer's exchange. Relying primarily on the decision in *Carl E. Koch* (1978) 71 TC 54, acq 1979-2 Cum Bull 2 (fee interest subject to 99-year lease exchanged for other real property), the Tax Court concluded that the supply contracts, despite their significant value, were simply a burden on the underlying fee ownership of the real property to which they were appurtenant and did not constitute non-like-kind assets separate and apart from the fee interests for purposes of IRC §1031. Thus the exchange of the gold mining property free of such appurtenances for the coal mining property subject to the appurtenances was still deemed an exchange of like-kind property under the test of nature or character versus "grade or quality" found in Reg §1.1031(a)-1(b).

WARNING: Despite the fact that the Tax Court ultimately reached a taxpayer-favorable result, *Peabody* serves as a reminder to undertake a thorough analysis of whether properties are like kind when dealing with the exchange of a fee interest in real estate with any other type of interest in real property, even when such an interest is considered real property under applicable state law.

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B. Personal Property

§2.47 1. Not Like in Kind to Real Estate

Personal property is not like in kind to real property. *Oregon Lumber Co.* (1953) 20 TC 192; *M.H.S. Co.,* TC Memo 1976-165, aff'd per curiam (6th Cir 1978) 575 F2d 1177. Whether property is real property or personal property is determined by state law. *Aquilino v U.S.* (1960) 363 US 509, 4 L Ed 2d 1365, 80 S Ct 1277; *Commissioner v Crichton* (5th Cir 1941) 122 F2d 181. In California, the determination is based on mobility. See CC §657. Real property consists of land; things that are affixed, incidental, or appurtenant to land; and things that are immovable by law. CC §658. Personal property consists of everything else. CC §663.

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2. Personal Property Like-Kind Principles

§2.48 a. Generally

Ascertaining whether personal property is like-kind to other personal property requires a narrow focus, with close attention being paid to where the property is used (see IRC §1031(h)(2)) and how it is used (see Rev Rul 82-166, 1982-2 Cum Bull 190).

Personal property used predominantly in the United States is not "like kind" to personal property used predominantly outside the United States. IRC §1031(h)(2)(A). The "predominant use" is determined on the basis of the use of such property for the 2-year period ending on the date of relinquishment (when applied to the relinquished property) and the 2-year period beginning on the date of acquisition (when applied to the replacement property). If either property is held for less than 2 years, then the requisite holding period is the period of time that the relinquished property was held by the person relinquishing it and the period of time the replacement property is held by the person acquiring it, except when the exchange is structured to avoid the purpose of IRC §1031(h).

Property described in any subparagraph of IRC §168(g)(4) is treated as property used predominantly in the United States. This includes aircraft, vessels, motor vehicles, and other property operating between the United States and locations outside of the United States, certain satellites in earth-orbit launched from the United States, and marine telephone cables connecting the United States and locations outside of the United States.

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§2.49 b. IRS Like-Class Guidelines

The IRS has published guidelines for determining whether personal property exchanges involve like-kind property. Reg §1.1031(a)-2. The regulations distinguish between the following types of property:

- Depreciable tangible personal property (DTPP) held for productive use in a trade or business or for investment (Reg §1.1031(a)-2(b)); and
- Other personal property (OPP), including intangible and nondepreciable personal property (Reg §1.1031(a)-2(c)).

DTPP can be exchanged for other DTPP of either a "like class" or a like kind (Reg §1.1031(a)-2(b)(1)); OPP can be exchanged only for OPP of a like kind (Reg §1.1031(a)-2(c)).

In TD 9202, 2005-24 Int Rev Bull 1213, the IRS issued final regulations, generally effective August 12, 2004, replacing the use of Division D of the Standard Industrial Classification Manual (1987) with the product classes listed in the North American Industrial Classification System published by the Executive Office of the President, Office of Management and Budget, and available at the website shown in the Directory. In defining DTPP of a like class, Reg §1.1031(a)-2(b)(2) refers to 13 general asset classes (*e.g.,* office furniture, airplanes, information systems, automobiles) and, the product classes listed in Sectors 31 through 33 of the North American Industrial Classification System.

Detailed discussion of these regulations is beyond the scope of this book. Attorneys must become familiar with the rules, however, because any exchange of real property that also involves personal property (*e.g.,* an apartment house with refrigerators, washers, and dryers, or a hotel with associated furniture and equipment) requires their application.

The regulations provide little guidance for determining whether OPP is like in kind to other OPP. With respect to intangible personal property, the determination depends on the nature or character of the rights involved and the nature or character of the underlying property to which the intangible personal property relates. Reg §1.1031(a)-2(c)(1). Regulation §1.1031(a)-2(c)(2) further specifies that goodwill associated with one business is not like in kind to goodwill associated with a different business. Livestock of different sexes are specifically defined not to be of like kind. IRC §1031(e); Reg §1.1031(e)-1.

In IRS Letter Ruling 200224004, the IRS held that a holder of an FCC license had a property right solely in the "assigned frequency of the electromagnetic spectrum," not in the ability to affiliate the licensed broadcast operation with a broadcast network.

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§2.49A c. Intellectual Property

Internal Revenue Service Letter Ruling 200602034 addressed the exchanges of a broad array of intellectual properties, including patents, unregistered intellectual property, trademarks, and trade names. The IRS examined the intellectual property at issue using the two-prong test of Treas Reg §1.1031(a)-2(c)(1). However, the IRS applied the special rules regarding the like-kind characterization of intangible personal property in a manner much stricter than any previously issued guidance.

Letter Ruling 200602034 examined the patents by determining whether (1) a patent was present on both sides of the exchange and (2) the underlying properties had the same North American Industrial Classification System (NAICS) code (or were otherwise like-kind). Similarly, the IRS examined whether (1) the unregistered intellectual property at issue was of the type protected by law (Uniform Trade Secrets Act, Economic Espionage Act of 1996, or common law) and (2) the underlying properties had the same NAICS code (or were otherwise like-kind). The ruling ultimately addressed whether the transaction involved an exchange of domestic and foreign intangibles, which is not recognizable under IRC §1031(h)(2). In finding that one property was used predominantly domestically while the other was used predominantly outside the country, the IRS determined that the exchange did not meet the requirements of §1031.

For a more complete discussion of Letter Ruling 200602034, see Alton & Weller, *New IRS Ruling Unveils Restrictive Approach to Like Kind Exchanges of Intangibles,* 104 J Tax 208 (Apr. 2006).

In a ruling that involved exchanges of newspapers, the IRS concluded that newspaper mastheads, advertising accounts, and subscriber accounts were not like-kind property under §1031. In Field Attorney Advice 20074401F, the IRS conceded that these types of assets would be classified as intangibles separate from goodwill and going concern value under IRC §197. The ruling also recognized that under *Newark Morning Ledger Co. v United States* (1993) 507 US 546, such assets had a depreciable life that could be ascertained. However, the IRS concluded that mastheads, advertising accounts, and subscriber accounts were not eligible for like-kind exchange treatment under IRC §1031 because they are "so closely related to, if not a part of, the newspapers' goodwill and going concern value." These items were thereby excluded under Reg §1.1031(a)-2(c)(1) (see §2.49).

In a rather surprising but welcome turnabout, the IRS announced in 2009 that it has reversed its earlier conclusion that trademarks, tradenames, and other types of "customer based intangibles" such as mastheads and advertiser and subscriber accounts are automatically excluded from §1031 as varieties of goodwill. See Chief Counsel Memorandum 200911006. The IRS determined that the analysis in *Newark Morning Ledger Co.* should apply in determining whether intangibles constitute goodwill or going concern under Reg §1.1031(a)-2(c)(1). Henceforth, such types of OPP may be analyzed to determine whether they can be separately described and valued from goodwill. If so, they are not excluded from §1031 treatment.

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§2.50 C. Businesses

Exchanges of business are exchanges of the multiple assets that comprise such businesses and are generally covered by regulations addressing exchanges that consist of multiple properties. Reg §1.1031(j)-1(a). An exchange is considered to be an exchange of multiple properties if the properties exchanged can be separated into more than one exchange group. An exchange group consists of at least one relinquished property and one replacement property that are either like-kind or within the same general asset or product class. Reg §1.1031(j)-1(b)(2)(i). The amount of gain recognized on the properties relinquished and the basis of the properties that replace them is then determined by reference to the exchange groups. Doing so avoids the necessity of computing gain and tracking basis asset by asset in a multiple property exchange. Multiple property exchanges are discussed in greater detail in chapter 3.

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V. EXCHANGE REQUIREMENT

§2.51 A. Sale Versus Exchange

For a transaction to qualify for the nonrecognition of gain or loss under IRC §1031, the property relinquished must be exchanged for the property received. A sale of the relinquished property and a reinvestment of the proceeds in the replacement property will not qualify as an exchange under §1031. *Carlton v U.S.* (5th Cir 1967) 385 F2d 238; *John M. Rogers* (1965) 44 TC 126, aff'd per curiam (9th Cir 1967) 377 F2d 534.

The drafters of the Revenue Act of 1921 (Pub L 67-98, §202(c), 42 Stat 227) originally contemplated two-party exchange transactions, in which the parties simply barter their respective properties without exchanging money (see §1.38), and the "true" three-party exchange, in which the properties are traded round robin (see §1.40). See H Rep No. 704, 73d Cong, 2d Sess (1934), reprinted in 1939-1 (pt 2) Cum Bull 554, 564.

An exchange, rather than a sale, is accomplished in a barter transaction because the taxpayer receives the replacement property in consideration for the transfer of the relinquished property. The essence of an exchange is the transfer of property between owners; the mark of a sale is the receipt of cash for the property. *Carlton v U.S., supra; Swaim v U.S.* (ND Tex 1979) 79-2 USTC ¶9462, 45 AFTR2d 1276, aff'd (5th Cir 1981) 651 F2d 1066; *Hubert Rutland,* TC Memo 1977-8.

Many transactions have the characteristics of both a sale and an exchange and can be manipulated to look like either one. If a taxpayer disposes of the relinquished property solely to obtain a loss deduction or a higher basis in the replacement property and structures the transaction as a sale, the IRS may contend that the transaction constitutes an exchange. Rev Rul 55-77, 1955-1 Cum Bull 339 (sale of property under a partition action, purchased by cotenants); *Jordan Marsh Co. v Commissioner* (2d Cir 1959) 269 F2d 453 (sale and leaseback for more than 30 years); *Century Elec. Co. v Commissioner* (8th Cir 1951) 192 F2d 155 (sale and leaseback for 95 years); *Leslie Co.* (1975) 64 TC 247, nonacq 1978-2 Cum Bull 3, aff'd (3d Cir 1976) 539 F2d 943 (sale of real property and leaseback for 30 years); *Frederick R. Horne* (1945) 5 TC 250 (sale of seat on coffee and sugar exchange and purchase of seat on same exchange); *Bennie D. Rutherford,* TC Memo 1978-505 (exchange of cattle for offspring of those cattle); *James Godine, Jr.,* TC Memo 1977-393 (sale of real property and purchase of other real property); *Joseph J. Vidmar* (1952) 11 CCH TCM 854, P-H TCM ¶52,248 (exchange of old automobile for new automobile).

When the taxpayer attempts to qualify for the nonrecognition benefits of IRC §1031 but fails to observe the formalities of an exchange, the IRS may argue that the transaction constitutes a sale and reinvestment. See *Maxwell v U.S.* (SD Fla 1988) 88-2 USTC ¶9560, 62 AFTR2d 5406; *Garbis S. Bezdjian,* TC Memo 1987-140, aff'd (9th Cir 1988) 845 F2d 217; *Byron Wayne Meadows,* TC Memo 1981-417. The issue is not simply form versus substance, because frequently the substance of the transaction may be characterized in different ways. See §1.9.

EXAMPLE: In a three-party exchange in which the buyer of the relinquished property first acquires the replacement property and then exchanges it with the taxpayer for the relinquished property, the transaction may be characterized as a sale and reinvestment because the source of the purchase price for the replacement property is funds intended for purchase of the relinquished property. The transaction may also be characterized as an exchange, however, because the taxpayer starts with one property and ends up with a different but like-kind property, without constructively or actually receiving cash.

The rule that a sale and reinvestment will not qualify under IRC §1031 is so well established that the few exceptions to it are easily overlooked. If state law precludes an actual exchange, a sale and reinvestment may qualify for nonrecognition treatment. Rev Rul 57-469, 1957-2 Cum Bull 521 (state law prohibited guardian's exchange of ward's property). See also Rev Rul 55-77 (property held in cotenancy by six persons was purchased by five of the persons in a court-ordered partition sale, a transaction held to be nontaxable).

Further, some transactions are not classified as sales or exchanges, but as mere realignments of property interest. In IRS Letter Rulings 200303023, 200328034, 200411022, and 200411023, the IRS determined that partitioning a contiguous tract of jointly owned real property into separate parcels was not a sale or an exchange for purposes of IRC §1001. In an exchange of property, each party to the exchange gives up a property interest in return for a new or additional property interest. The IRS, citing Rev Rul 56-437, 1956-2 Cum Bull 507, noted that in a partition the parties do not acquire a new or additional interest. Therefore, the partition of jointly owned property is not a sale or other disposition, but merely the severance of joint ownership. The result is that a partition of a contiguous tract of jointly owned real property into separate parcels will not qualify as an exchange under IRC §1031.

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§2.52 B. Continued Viability of Exchange Requirement After 1984

Although the exchange requirement continues to be incorporated into the language of IRC §1031(a), the rise of nonsimultaneous exchanges since adoption of IRC §1031(a)(3) in 1984 and the availability of a safe harbor for reverse exchanges following issuance of Rev Proc 2000-37, 2000-2 Cum Bull 308, make this requirement far less important than was previously true. Deferred exchanges under IRC §1031(a)(3) and the deferred exchange regulations make it possible to satisfy the exchange requirement in almost any sale transaction. See chap 4. Use of so-called parking arrangements makes it possible to satisfy the exchange requirement in many reverse exchange scenarios. See chap 5. The main continued applicability of the exchange requirement relates to the mandatory application of §1031(a) to (1) two-party simultaneous exchanges, because in those situations neither gain nor loss can be recognized regardless of the parties' desire for such recognition, (2) instances in which the taxpayer seeks to avoid phantom income on the disposition of property secured by debt in an amount exceeding both basis and fair market value (see §2.19), and (3) situations when a taxpayer would like to change its qualified intermediary in the middle of an exchange. See §4.53.

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C. Tests Used to Distinguish Sale From Exchange

§2.53 1. Receipt-of-Boot Test

The primary focus in ascertaining whether a transaction is a sale and reinvestment or an exchange is on whether the taxpayer actually or constructively receives non-like-kind property (*i.e.,* boot, generally cash) in the transaction. Even if the taxpayer does not *actually* receive boot, the exchange will not qualify for nonrecognition treatment if the taxpayer is considered to have *constructively* received boot before acquiring the replacement property. For these purposes:

- A taxpayer is in constructive receipt of money at the time the money is (a) credited to the taxpayer's account, (b) set apart by the taxpayer, or (c) otherwise made available so that the taxpayer may draw on it at any time or after giving notice of the intention to draw on it. Reg §§1.451-2, 1.1031(k)-1(f)(2).

- A taxpayer is not in constructive receipt, however, if the taxpayer's control of the money's receipt is subject to substantial limitations or restrictions, until those limitations or restrictions lapse, expire, or are waived. Reg §§1.451-2, 1.1031(k)-1(f)(2).

See also Reg §1.1031(k)-1(j)(3), Example 4; Rev Rul 77-297, 1977-2 Cum Bull 204.

PRACTICE TIP: Because almost all modern exchanges are structured as deferred (nonsimultaneous) exchanges, the analysis of constructive receipt typically occurs in the context of those transactions. The IRS has issued regulations providing four "safe harbors" for deferred exchanges, under which the taxpayer is deemed not to be in actual or constructive receipt of money or other property for purposes of IRC §1031. See Reg §1.1031(k)-1(g). The safe harbors include permissible security or guaranty arrangements (Reg §1.1031(k)-1(g)(2)), qualified intermediaries (Reg §1.1031(k)-1(g)(4)), qualified escrow accounts and qualified trusts (Reg §1.1031(k)-1(g)(3)), and the effect of a taxpayer's right or potential right to receive interest growth factor on proceeds from sale of a relinquished property (Reg §1.1031(k)-1(g)(5)). See §§4.36-4.69.

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§2.54 2. Contractual-Interdependence Test

In the past, when determining whether to characterize a transaction as a sale and reinvestment of the proceeds or an exchange, courts often focused on the presence or absence of contractual provisions making the sale of the relinquished property and purchase of the replacement property mutually dependent. In light of modern deferred exchange practice, courts now rarely use the contractual-interdependence test. Attorneys, however, should be familiar with this test because published cases applying it are still cited to support various propositions.

The contractual-interdependence test basically involves two requirements:

- The disposition of the relinquished property must be contractually contingent on the taxpayer's acquisition of the replacement property. *Halpern v U.S.* (ND Ga 1968) 286 F Supp 255, 258; *Swaim v U.S.* (ND Tex 1979) 79-2 USTC ¶9462, 45 AFTR2d 1276, aff'd (5th Cir 1981) 651 F2d 1066; *Joyce M. Allen,* TC Memo 1982-188. See also *Redwing Carriers, Inc. v Tomlinson* (5th Cir 1968) 399 F2d 652, 659; *C. Bean Lumber Transp. v U.S.* (WD Ark 1999) 68 F Supp 2d 1055, 1060, distinguishing *Redwing*.

- A reciprocal transfer of properties must occur (*i.e.,* the taxpayer must receive the replacement property from the transferee of the relinquished property). *Carlton v U.S.* (5th Cir 1967) 385 F2d 238; *Swaim v U.S., supra*; *Garbis S. Bezdjian,* TC Memo 1987-140, aff'd (9th Cir 1988) 845 F2d 217. See also *Halpern v U.S.* (ND Ga 1968) 286 F Supp 255, 257.

The transfer of the relinquished property and acquisition of the replacement property need not be simultaneous. If the disposition of the relinquished property is completed first, however, the proceeds must be placed beyond the taxpayer's control and earmarked for the acquisition of the replacement property. If the taxpayer has access to the proceeds and can use them for other purposes, the acquisition of the replacement property is not contractually contingent on the disposition of the relinquished property. *Carlton v U.S., supra; Swaim v U.S., supra*.

It is not enough that the parties execute documents making the disposition of the relinquished property contractually dependent on the acquisition of the replacement property. To satisfy the contractual-interdependence test, the parties must follow through and complete the transaction in the form of an exchange of properties. This principle is illustrated by *Carlton v U.S., supra*.

In *Carlton,* the taxpayer executed a contract with the buyer of the relinquished property (General), giving General an option to acquire the relinquished property at a stated price and giving the taxpayer the choice of receiving cash or replacement property selected by the taxpayer and purchased by General. At all times, the taxpayer intended to complete the transaction as an exchange under IRC §1031. The taxpayer located the replacement properties, and General executed agreements to purchase them. Instead of acquiring the replacement properties and transferring them to the taxpayer, however, General assigned the contractual rights to purchase the replacement properties to the taxpayer and paid the purchase price of the relinquished property to the taxpayer on the same day. That day and the next day, the taxpayer acquired the replacement properties, using the cash proceeds from the relinquished property. The court held that the transaction constituted a sale and reinvestment, rather than an exchange, because

- General never acquired legal title to the replacement properties or became obligated on the notes or mortgages involved in their acquisition; and

- General did not pay for the replacement property, because the money that the taxpayer received from General was not earmarked by General for use in purchasing the target properties and could have been used by the taxpayer for other purposes.

The court reasoned as follows (385 F2d at 242):

[W]hile elaborate plans were laid to exchange property, the substance of the transaction was that the [taxpayers] received cash for the deed to their ranch property and not another parcel of land.

Compared with the integrated-plan test (see §2.55), the contractual-interdependence test places less emphasis on the taxpayer's intent and more emphasis on the details of documentation and implementation of the transaction. The taxpayer's intent to accomplish an exchange cannot overcome deficient procedures. See, *e.g., Carlton v U.S., supra*; *Maxwell v U.S.* (SD Fla 1988) 88-2 USTC ¶9560, 62 AFTR2d 5406; *Swaim v U.S., supra; Garbis S. Bezdjian,* TC Memo 1987-140, aff'd (9th Cir 1988) 845 F2d 217. See §1.3.

Because of the difficulty of meeting each of its requirements, the contractual-interdependence test has been urged by the

Commissioner and resisted by the taxpayer in virtually all published multiple party exchange cases. See, *e.g., Biggs v Commissioner* (5th Cir 1980) 632 F2d 1171; *Redwing Carriers, Inc. v Tomlinson, supra; Carlton v U.S., supra; Arthur E. Brauer* (1980) 74 TC 1134; *Earlene T. Barker* (1980) 74 TC 555. In recent years, courts have moved away from this test toward the more lenient integrated-plan test, discussed in §2.56. Moreover, with the Treasury Department's 1991 adoption of regulations governing deferred exchanges, and the release of Rev Proc 2000-37, 2000-2 Cum Bull 308, applicable to reverse exchanges, the importance of both tests has diminished. See Reg §1.1031(k)-1, discussed in chap 4. The contractual-interdependence and integrated-plan tests are still useful, however, in evaluating exchanges that do not qualify for the "safe harbors" in the regulations. See §4.38.

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§2.55 3. Integrated-Plan Test

In analyzing whether a transaction is a sale and reinvestment or an exchange, courts have recently favored the integrated-plan test, which considers whether disposition of the relinquished property and acquisition of the replacement property are mutually related parts of an overall plan. Although the test requires that the taxpayer enter into a written agreement describing the various steps of the exchange transaction, it does not require contractual interdependence. In applying the integrated-plan test, courts have referred to the relatedness requirement in several ways:

- The transfers being made in consideration of one another (see *Orville E. Christensen,* TC Memo 1996-254, aff'd without published opinion sub nom *Christensen v Commissioner* (9th Cir 1998) 142 F3d 442; *Arthur E. Brauer* (1980) 74 TC 1134; *Boise Cascade Corp.,* TC Memo 1974-315);

- The transfers being reciprocal (see *Leslie Co.* (1975) 64 TC 247, nonacq 1978-2 Cum Bull 3, aff'd (3d Cir 1976) 539 F2d 943; *J. H. Baird Publ'g Co.* (1962) 39 TC 608, acq 1963-2 Cum Bull 4; *James Godine, Jr.,* TC Memo 1977-393); and

- The transfers being mutually dependent (see *Biggs v Commissioner* (5th Cir 1980) 632 F2d 1171; *Crenshaw v Commissioner* (5th Cir 1971) 450 F2d 472; *J. H. Baird Publ'g Co., supra*).

Because the court's focus under the integrated-plan test is on the plan, the taxpayer's intent is more important than how each step of the exchange transaction is executed and the exact form of the transaction. Cash may be deposited into escrow by another party to the exchange for the taxpayer's benefit as long as the taxpayer cannot freely withdraw it for his or her own use. Rev Rul 77-297, 1977-2 Cum Bull 304; *Arthur E. Brauer, supra*.

In *Chad A. Lincoln,* TC Memo 1998-421, the Tax Court held that a cash sale of a taxpayer's rental property (Pacific Grove Property) was not a like-kind exchange even though the taxpayer used the cash received to improve another rental property (Big Sur Property). There was no evidence that the parties agreed to participate in an exchange and the taxpayer did not claim that the transaction was a like-kind exchange until after the sale of the Pacific Grove Property, nearly 1 year after buying the Big Sur Property. Furthermore, the cash received on the Pacific Grove sale was not earmarked to effect an exchange, but was available to the taxpayer, without restrictions, for any purpose.

Carried to its extreme, the integrated-plan test may be used to characterize virtually any sale and reinvestment as an exchange. Indeed, the only apparent distinction advanced by the courts most liberally applying this test is that the taxpayer must not be in actual or constructive receipt of cash. See, *e.g., Biggs v Commissioner, supra*. Because its requirements are so easy to satisfy, the integrated-plan test has been urged by taxpayers and resisted by the IRS in multiple party exchange cases. See *Biggs v Commissioner, supra*; *Alderson v Commissioner* (9th Cir 1963) 317 F2d 790; *Arthur E. Brauer, supra*; *J. H. Baird Publishing Co., supra*. Use of the test has been advanced by the IRS and opposed by the taxpayer, however, when the taxpayer seeks sale rather than exchange treatment. See Rev Rul 60-43, 1960-1 Cum Bull 687; *Bell Lines, Inc. v Commissioner* (4th Cir 1973) 480 F2d 710; *Jordan Marsh Co. v Commissioner* (2d Cir 1959) 269 F2d 453; *Century Elec. Co. v Commissioner* (8th Cir 1951) 192 F2d 155; *Leslie Co., supra*; *Frederick R. Horne* (1945) 5 TC 250.

Judicial decisions have frequently applied the integrated-plan test, regardless of whether the taxpayer or the Commissioner recommends its use. See *Starker v U.S.* (9th Cir 1979) 602 F2d 1341; *Coastal Terminals, Inc. v U.S.* (4th Cir 1963) 320 F2d 333; *Alderson v Commissioner, supra*. In multiparty exchanges, the Tax Court has wholeheartedly embraced the test. See *Arthur E. Brauer, supra*; *Franklin B. Biggs* (1978) 69 TC 905, aff'd (5th Cir 1980) 632 F2d 1171; *J. H. Baird Publ'g Co., supra; Fred L. Fredericks,* TC Memo 1994-27; *Allegheny County Auto Mart, Inc.* (1953) 12 CCH TCM 427, P-H TCM ¶53,140, aff'd (3d Cir 1953) 208 F2d 693.

The courts have allowed taxpayers great latitude in structuring exchanges under the integrated-plan test. See §§2.58-2.60. If a taxpayer intends an exchange and ultimately ends up with like-kind property rather than cash, the courts frequently disregard the intermediate steps and find that the transaction, taken as a whole, is an exchange. Despite this latitude, conservative tax planning calls for adherence to the form of an exchange to preserve the desired tax result.

PRACTICE TIP: Like the contractual-interdependence test, the integrated-plan test is rendered unnecessary in many cases by regulations governing deferred exchanges. See chap 4. Both tests are still useful, however, in evaluating exchanges that do not qualify for the regulatory "safe harbors." See §4.38.

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§2.56 D. Sale-Leaseback Transactions as Unintended Exchanges

Some sale-leaseback transactions are undertaken to enable the taxpayer to recognize a tax loss on the sale of relinquished property while retaining use of the property. The IRS has attempted to characterize such transactions as exchanges to prevent the recognition of loss.

In *Century Elec. Co. v Commissioner* (8th Cir 1951) 192 F2d 155, the taxpayer sold its foundry property to a college and simultaneously entered into a 95-year leaseback of the property. The court noted that the foundry property was held both before and after the "sale" for productive use in, and was necessary to the continued operation of, the taxpayer's business. The taxpayer's fee interest in the foundry property before the "sale" was like in kind to its leasehold interest in the foundry property after the transaction. Thus, the court held that the transaction was an exchange, and the taxpayer could not recognize a loss.

A contrary result was reached in *Jordan Marsh Co. v Commissioner* (2d Cir 1959) 269 F2d 453. In that case, the taxpayer sold the building in which it operated a department store and entered into leases with the buyers for 30 years and three days, with options to renew. The court distinguished *Century Elec. Co. v Commissioner, supra,* on the ground that, in that case, there was no finding that the property was sold for its fair market value or that it was leased back for its fair rental value. By contrast, the *Jordan Marsh* court found that the property was sold for its fair market value and leased back for its fair rental value. The court observed that Congress's primary purpose in enacting IRC §1031 was to eliminate the inequity of forcing a taxpayer to recognize a paper gain (or permitting a taxpayer to recognize a paper loss) that was still tied up in a continuing investment of the same type. The court concluded that this purpose would not be served in this case. By unconditionally conveying the fee to a stranger in an arm's-length transaction, the taxpayer had done more than merely change the form of ownership; it had closed out a losing venture. Because the taxpayer had liquidated its investment for $2,300,000 in cash (the full value of the fee) and had undertaken a liability to make annual payments of rent, the court held that the transaction was a sale and leaseback rather than an exchange. See also *Crowley, Milner & Co.* (1981) 76 TC 1030, aff'd (6th Cir 1982) 689 F2d 635; *Leslie Co.* (1975) 64 TC 247, nonacq 1978-2 Cum Bull 3, aff'd (3d Cir 1976) 539 F2d 943; *City Investing Co.* (1962) 38 TC 1.

A different problem arises when a taxpayer conveys a leasehold interest for a term exceeding 30 years and receives as replacement property the fee interest in the same or other real property. In such a case, even though the leasehold interest conveyed and the real property received may be like-kind property (see §2.41), the value of the real property received may be treated as an advance rental payment, includable in the taxpayer's gross income in the taxable year of receipt. Rev Rul 66-209, 1966-2 Cum Bull 299.

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E. Permitted Preexchange and Postexchange Activities

§2.57 1. Transaction Begun as Sale of Relinquished Property Under Purchase and Sale Agreement

A transaction begun as a sale under a purchase and sale agreement may be changed to an exchange by a specific amendment of the purchase and sale agreement or by conduct of the parties that is inconsistent with a sale. Rev Rul 77-297, 1977-2 Cum Bull 304; Rev Rul 61-119, 1961-1 Cum Bull 395; *Alderson v Commissioner* (9th Cir 1963) 317 F2d 790; *Arthur E. Brauer* (1980) 74 TC 1134; *Leslie Q. Coupe* (1969) 52 TC 394, acq in result 1970-2 Cum Bull xix; *Hubert Rutland,* TC Memo 1977-8; *Antone Borchard,* TC Memo 1965-297. See also Reg §1.1031(k)-1(g)(4)(v) (applicable to qualified intermediaries). The transformation of the transaction from a sale to an exchange, however, must occur before there is "substantial implementation" of the sale. *Estate of Alexander S. Bowers* (1990) 94 TC 582; *Leslie Q. Coupe, supra; Fred L. Fredericks,* TC Memo 1994-27; *Hubert Rutland, supra*.

In *Estate of Alexander S. Bowers, supra,* the taxpayer, before his death, undertook to sell his interest in an oil and gas lease for $2 million and received an earnest money deposit of $400,000. In an entirely separate transaction several months later, the taxpayer entered into an agreement to purchase a farm for $1,070,000. The taxpayer did not dispute that the agreement to sell the oil and gas lease (structured as a cash sale) and the agreement to purchase the farm (structured as a cash purchase) were unrelated. Both transactions were completed in 1982. On his 1982 federal income tax return, the taxpayer reported a net loss from operation of the farm of more than $130,000. In February 1983, the taxpayer prepared and executed various documents designed to restructure these two transactions into the form of an exchange. Not surprisingly, the Tax Court found that no exchange of properties had occurred. Instead, the court held that the taxpayer had sold his oil and gas lease for cash and had purchased the farm for cash. The court found that there had been "substantial implementation" of the purchase of the farm before the taxpayer attempted to recast the sale of the lease and the purchase of the farm in the mold of an exchange.

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§2.58 2. Taxpayer's Permitted Actions

As courts increasingly use the integrated-plan test, transactions expressly designed to accomplish an exchange are generally found to satisfy the requirements of IRC §1031. Under this test, the exchange may be structured solely for tax purposes. Rev Rul 75-291, 1975-2 Cum Bull 333; *Leslie Q. Coupe* (1969) 52 TC 394, acq in result 1970-2 Cum Bull xix; *Hubert Rutland,* TC Memo 1977-8; *Boise Cascade Corp.,* TC Memo 1974-315.

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§2.59 a. Multiparty Exchanges: Buyer Acquires Replacement Property From Third Party

The taxpayer may undertake the following activities in an exchange in which the buyer acquires the replacement property from a third party and then exchanges it with the taxpayer for the relinquished property (see §§1.39-1.40):

- Locate and negotiate the purchase of the replacement property. See Rev Rul 77-297, 1977-2 Cum Bull 304; *Biggs v Commissioner* (5th Cir 1980) 632 F2d 1171; *Alderson v Commissioner* (9th Cir 1963) 317 F2d 790; *Leo A. Woodbury* (1967) 49 TC 180, acq 1969-2 Cum Bull xxv; *Hubert Rutland,* TC Memo 1977-8; *Antone Borchard,* TC Memo 1965-297.

- Agree to sell the relinquished property to the buyer of the property if the taxpayer cannot find suitable replacement property before the close of escrow. See *Starker v U.S.* (9th Cir 1979) 602 F2d 1341; *Alderson v Commissioner, supra; Leslie Q. Coupe* (1969) 52 TC 394, acq in result 1970-2 Cum Bull xix; *Antone Borchard, supra*; *Mercantile Trust Co.* (1935) 32 BTA 82.

- Transfer an option to acquire the replacement property to the buyer of the relinquished property. See *Coastal Terminals, Inc. v U.S.* (4th Cir 1963) 320 F2d 333.

- Enter into a contract to purchase the replacement property and then assign his or her rights under the contract to the buyer of the relinquished property to facilitate a three-party exchange. See Reg §1.1031(k)-1(g)(4)(v); *Alderson v Commissioner, supra*.

- Pay additional money to the buyer of the relinquished property to enable the buyer to acquire the replacement property. See Reg §1.1031(a)-1(a), (c).

- Make the deposit for the purchase of the replacement property. See *Carlton v U.S.* (5th Cir 1967) 385 F2d 238.

- Pay the entire purchase price of the replacement property. See *Biggs v Commissioner, supra*.

- Purchase an option to acquire the replacement property before transferring the relinquished property. See *Fred L. Fredericks,* TC Memo 1994-27.

- Guarantee the check that the buyer of the relinquished property uses to purchase the replacement property. See *Hubert Rutland, supra*.

- Pay all closing costs incurred by the buyer of the relinquished property to acquire the replacement property. See *Biggs v Commissioner, supra*.

WARNING: The taxpayer may not first buy the replacement property and then sell it to the intermediary at cost in order to exchange the relinquished property for the return of the replacement property. In *Donald DeCleene* (2000) 115 TC 457, taxpayers purchased unimproved property with the intention of moving their business to the newly acquired site. The taxpayers arranged the sale of the new property to a prospective buyer of the property then occupied by their business. The buyer built a commercial facility on the new site to the specifications of the taxpayers, who then exchanged the property they occupied for the newly improved property. The court held that there had been a taxable sale of the old property to the buyer and not a like-kind exchange. See also *Smith v Commissioner* (8th Cir 1976) 537 F2d 972. This topic is discussed in greater depth in chapter 5.

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§2.60 b. Seller of Replacement Property Is Cooperating Party

When the seller of replacement property will be a cooperating party, the taxpayer may undertake the following activities (see §§1.39-1.40):

- Locate and negotiate with the buyer of the relinquished property for the subsequent purchase of the relinquished property following the exchange. *Leo A. Woodbury* (1967) 49 TC 180, acq 1969-2 Cum Bull xxv.

- Enter into a contract to sell the relinquished property and then exchange the property for the replacement property. The owner of the replacement property would then complete the taxpayer's obligation to convey the relinquished property. Any agreement by the taxpayer to sell the relinquished property, however, should recite the taxpayer's intention to complete the transaction as an exchange. See §6.4. If the taxpayer has entered into a contract to sell the relinquished property, the exchange must occur first. The seller of the replacement property would then complete the sale of the relinquished property. See *John M. Rogers* (1965) 44 TC 126, aff'd per curiam (9th Cir 1967) 377 F2d 534 (taxpayer granted option on relinquished property, which was exercised; sale closed before exchange took place).

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§2.61 3. Cooperating Parties' Permitted Activities

Because the taxpayer may take the active roles described in §§2.59-2.60 to carry out the exchange without disqualifying the transaction from IRC §1031 treatment, participation by an intermediary may be correspondingly minimal. Thus, the intermediary need not have the burdens and obligations of owning property before exchanging it but may acquire title solely for the purpose of the exchange. *Alderson v Commissioner* (9th Cir 1963) 317 F2d 790; *Hubert Rutland,* TC Memo 1977-8; *Boise Cascade Corp.,* TC Memo 1974-315; *Mercantile Trust Co.* (1935) 32 BTA 82. In a three-party exchange in which the buyer of the relinquished property cooperates by acquiring the replacement property and exchanging it with the taxpayer for the relinquished property, the intermediary-buyer need not enter into any agreement to acquire the replacement property. *Hubert Rutland, supra*. Furthermore, the buyer may acquire the replacement property solely to transfer it to the taxpayer. *Alderson v Commissioner, supra; Leslie Q. Coupe* (1969) 52 TC 394, acq in result 1970-2 Cum Bull xix; *Boise Cascade Corp., supra; Mercantile Trust Co., supra*.

In a three-party exchange in which the seller of the replacement property cooperates by exchanging the replacement property for the taxpayer's relinquished property and then selling the relinquished property to the buyer, the intermediary-seller may convey title to the relinquished property immediately after the exchange. *W. D. Haden Co. v Commissioner* (5th Cir 1948) 165 F2d 588; *Mays v Campbell* (ND Tex 1965) 246 F Supp 375; *Arthur E. Brauer* (1980) 74 TC 1134.

For scope of activities permitted a qualified intermediary under regulations' safe harbor, see Treas Reg §1.1031(k)-1(g)(4), providing a "safe harbor" for exchanges using qualified intermediaries, discussed in §§4.53-4.57.

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§2.62 4. Effects of Direct Deeding

Under the integrated-plan test favored by the courts, the intermediary that facilitates the exchange is not required to assume the benefits and burdens of ownership of the exchanged property. See §2.55. The following questions therefore arise:

- In a three- or four-party exchange in which the buyer of the relinquished property acts as the intermediary by acquiring the replacement property and exchanging it with the taxpayer for the relinquished property, may the seller of the replacement property deed that property directly to the taxpayer rather than deeding it to the intermediary, who would then transfer it to the taxpayer?

- In a three- or four-party exchange in which the seller of the replacement property acts as the intermediary by exchanging the replacement property for the taxpayer's relinquished property and then selling the relinquished property to the buyer, may the taxpayer deed the relinquished property directly to the buyer of that property rather than deeding it to the intermediary, who would then deed it to the buyer?

These are not merely academic questions for the taxpayer, because the recording of an additional deed generally results in additional recording fees, escrow fees, and transfer taxes. Moreover, it can be difficult to find an intermediary willing to accept record title to facilitate the exchange, because the risk of liability under environmental laws is great if the property is contaminated with hazardous substances. For discussion of potential owner liability under hazardous substance laws, see California Real Property Sales Transactions, chap 7 (4th ed Cal CEB 2007). For form provision requiring direct deeding, see paragraph 4.4 in Form 4.80-1.

In the past, the IRS frequently attacked exchanges when the taxpayer deeded the relinquished property directly to the buyer rather than first deeding it to the intermediary, who would then deed it to the buyer. See, *e.g., Carlton v U.S.* (5th Cir 1967) 385 F2d 238, discussed in §2.54; *Arthur E. Brauer* (1980) 74 TC 1134. Revenue rulings and regulations, however, have largely mooted the risk associated with the use of direct deeds.

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§2.63 a. Four-Party Exchanges (Using Separate Intermediary)

The use of direct deeds in a four-party exchange has no adverse effect as long as a qualified intermediary has contractually agreed to acquire both the relinquished property and the replacement property, because the intermediary is considered to be the party who acquired the properties. See Reg §1.1031(k)-1(g)(4)(iv)-(v). Example 4 of Reg §1.1031(k)-1(g)(8) describes a typical deferred exchange involving the use of a qualified intermediary to facilitate the exchange because the buyer of the relinquished property was not willing to participate in the exchange transaction. In the example, the use of direct deeding for both the disposition of the relinquished property and the acquisition of the replacement property does not disqualify the exchange as long as the intermediary is assigned all the taxpayer's contractual rights and obligations to sell the relinquished property and to purchase the replacement property.

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§2.64 b. Three-Party Exchanges

Buyers and sellers in three-party exchanges who act as intermediaries do not fit the definition of a "qualified intermediary" in Reg §1.1031(k)-1(g)(4)(iii). See §§4.53-4.57. Although there seems to be no policy reason to limit the use of direct deeds to exchanges in which a qualified intermediary is used, the regulations do not address this issue. The IRS, however, has approved the use of direct deeding. In Rev Rul 90-34, 1990-1 Cum Bull 154, the IRS ruled that the use of direct deeding in the acquisition of replacement property in a three-party exchange, in which the buyer of the relinquished property acquires the replacement property and exchanges it with the taxpayer for the relinquished property, did not invalidate the exchange.

In cases arising before publication of Rev Rul 90-34 and Reg §1.1031(k)-1(g)(4)(iv)-(v), the courts had upheld the use of direct deeding in some instances (see *Biggs v Commissioner* (5th Cir 1980) 632 F2d 1171; *W. D. Haden Co. v Commissioner* (5th Cir 1948) 165 F2d 588; *Raymond St. Laurent*, TC Memo 1996-150) but not in others (see *Carlton v U.S., supra,* discussed in §2.54; *Leo A. Woodbury* (1967) 49 TC 180, acq 1969-2 Cum Bull xxv; *John M. Rogers* (1965) 44 TC 126, aff'd per curiam (9th Cir 1967) 377 F2d 534; *Carroll A. Nixon,* TC Memo 1987-318). In each case in which direct deeding did not disqualify the exchange, the intermediary had become contractually obligated to the owner of the replacement property to purchase that property.

In most exchange transactions, the intermediary's contractual obligation to acquire the replacement property or transfer the relinquished property is created by amending the purchase and sale agreement or the escrow instructions to make the intermediary a party to the transaction. See §6.7. The key element in cases approving direct deeding and in Rev Rul 90-34 appears to be the presence of a contractual obligation between the intermediary and the buyer of the relinquished property, and a contractual obligation between the intermediary and the seller of the replacement property, evidencing the interdependence of the transactions and the parties' intent to complete an exchange qualifying for nonrecognition of gain or loss under IRC §1031.

A partnership does not qualify for like-kind exchange treatment if it relinquishes property but has the replacement properties deeded directly to partners (in liquidation of their partnership interests), using as intermediaries the closing agents at the bank where sales proceeds were disbursed. IRS Letter Ruling 9818003.

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§2.65 F. Effect of Treating Intermediary as Taxpayer's Agent

Even if a court uses the integrated-plan test to analyze an exchange transaction (see §2.55), the exchange may be disqualified if a third party intermediary is deemed to have served as the taxpayer's agent, because the taxpayer, through his or her agent, may be deemed to have received the sale proceeds. See *Biggs v Commissioner* (5th Cir 1980) 632 F2d 1171; *Halpern v U.S.* (ND Ga 1968) 286 F Supp 255; *Leslie Q. Coupe* (1969) 52 TC 394, acq in result 1970-2 Cum Bull xix. Both the buyer of the relinquished property and the seller of the replacement property, however, may be persons or entities related to the taxpayer without necessarily being considered the taxpayer's agent in the exchange. Rev Rul 72-151, 1972-1 Cum Bull 225 (two-party exchange between taxpayer and corporation of which taxpayer was sole shareholder); *Mays v Campbell* (ND Tex 1965) 246 F Supp 375 (buyer of relinquished property was family corporation); *Boise Cascade Corp.,* TC Memo 1974-315 (buyer of relinquished property acquired replacement property from taxpayer's parent corporation).

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§2.66 1. Safe Harbor for Qualified Intermediary

Treasury Regulation §1.1031(b)-2(a), (k)-1(g)(4) creates a "safe harbor" from agency problems for exchanges in which a "qualified intermediary" is used. This safe harbor has led most advisors to favor use of such intermediaries even in simultaneous exchanges. See §§4.53-4.57 for a description of the safe harbor.

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2. Nonqualified Intermediaries: Factors Determining Agency

§2.67 a. Relationship Between Taxpayer and Intermediary Apart From Exchange

A taxpayer who uses an intermediary other than a "qualified intermediary," as defined in Reg §1.1031(k)-1(g)(4)(iii), must avoid an agency relationship with the intermediary. The first factor in determining whether the intermediary is the taxpayer's agent is the relationship between them apart from the exchange. An intermediary who is an employee of the taxpayer or is the taxpayer's agent for purposes other than the exchange will probably be considered the taxpayer's agent in the exchange. The intermediary may, however, be a corporation controlled by the taxpayer (see *Hubert Rutland,* TC Memo 1977-8), a corporation wholly owned by the taxpayer (see *Fred L. Fredericks,* TC Memo 1994-27), a corporation wholly owned by the taxpayer's attorney and that attorney's family (see *Biggs v Commissioner* (5th Cir 1980) 632 F2d 1171), or the taxpayer's attorney (see *Leslie Q. Coupe* (1969) 52 TC 394, acq in result 1970-2 Cum Bull xix). See §4.42.

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§2.68 b. Intermediary's Activities

Even if the taxpayer and the intermediary are unrelated persons or entities, the intermediary may be considered the taxpayer's agent because of the intermediary's activities. In early cases, the courts indicated that the intermediary must act as a principal in the exchange, assuming the full benefits and burdens of ownership, and is not to be considered the taxpayer's agent. See, *e.g., Mercantile Trust Co.* (1935) 32 BTA 82. In some later cases, the courts apparently required that an intermediary who does not act as a principal must at least be the agent for another party to the exchange in order to avoid being considered the taxpayer's agent. See *Leslie Q. Coupe* (1969) 52 TC 394, acq in result 1970-2 Cum Bull xix (taxpayer's attorneys were not taxpayer's agents in exchange, because attorneys were found to be agents of another party to exchange); *Hubert Rutland,* TC Memo 1977-8 (intermediary, a controlled corporation, was not taxpayer's agent). More recently, courts have held that the intermediary need not even be an agent of any other party to the exchange but may participate in the transaction, with or without compensation, merely to facilitate the exchange. See, *e.g., Biggs v Commissioner* (5th Cir 1980) 632 F2d 1171.

EXAMPLE: The decision in *124 Front St., Inc.* (1975) 65 TC 6, nonacq 1976-2 Cum Bull 3, illustrates the current liberality of the courts. In this case, the court approved an exchange in which the buyer of the relinquished property lent the taxpayer all the money necessary to purchase the relinquished property so that the taxpayer could then convey it to the buyer in exchange for replacement real property.

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§2.69 c. Relationship Between Taxpayer and Party Other Than Intermediary

Agency problems may arise regarding the relationship between the taxpayer and a party other than the intermediary. For example, there is a widespread misconception concerning nonsimultaneous exchanges that the proceeds from the sale of the relinquished property may be left in escrow after the buyer of the relinquished property receives a deed to that property but before the taxpayer acquires the replacement property. In such a situation, however, the escrow company may be held to be the taxpayer's agent, resulting in the taxpayer's constructive receipt of the proceeds and the disqualification of the exchange. See *Halpern v U.S.* (ND Ga 1968) 286 F Supp 255. On the escrow holder's agency relationships under California law, see California Real Property Sales Transactions, chap 15 (4th ed Cal CEB 2007). For further discussion of constructive receipt of funds, see §§2.53, 4.36-4.73.

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§2.69A G. Change of Taxpayer Identity During Exchange

A fundamental premise of IRC §1031(a) is that a single taxpayer is engaged in an exchange (*i.e.,* in transfer of relinquished property and receipt of replacement property). This is reflected in the requirement that qualified intermediaries, as exchange counterparties, be involved in the transfer of both relinquished and replacement properties. See §4.53. However, in certain instances the IRS has permitted an exchange to occur when there was a change in the taxpayer's identity during the course of the exchange. This occurs in corporate reorganization transactions, when a surviving corporation can complete an exchange initiated by a disappearing corporation. See §7.45.

The IRS expanded its view that certain exchanges can be completed when there is an intervening change in the organization of an entity. In Letter Ruling 200921009, which involved IRC §1033, the IRS approved a split-up involving a series of partnerships. The facts of Letter Ruling 200921009 were as follows: Two limited partnerships (AB and CD) are equal general partners owning half interests in the taxpayer (P1), a general partnership. P1 held property (Blackacre) for use in its farming business. When a portion of Blackacre was sold to a government entity under threat of condemnation, P1 elected to defer the gain from the sale under §1033. After failing to agree on suitable replacement property, AB and CD decided to acquire multiple properties in two separate continuing partnerships (P2 and P3) created by P1. AB and CD also planned to continue as partners in P1 to hold the remaining portion of Blackacre held by P1.

P1 transferred a portion of the sale proceeds of Blackacre and its obligation to acquire replacement property under §1033 to P2 and P3 in exchange for partnership interests. AB would be a general and a limited partner in one of the new partnerships and CD would be the same in the other. P2 and P3 would thus both be continuing partnerships of P1 because AB and CD together had greater than a 50-percent interest in the capital and profits of P1. See Reg §1.708-1(d)(1). P2 and P3 will each reinvest their portion of condemnation proceeds, together with borrowed funds, in replacement properties. If this is not done, P1 will report the income from the lack of reinvestment under §1033 on an amended income tax return for the year in which the condemnation occurred. In Letter Ruling 200921009, the IRS ruled that both P2 and P3 were entitled to complete the IRC §1033 replacement of property transferred by P1.

PRACTICE TIP: Although it involved IRC §1033, Letter Ruling 200921009 may have implications for §1031 transactions when individual partners want to acquire and separately control replacement property. Letter Ruling 200921009 seems to imply that an election to defer gain under §1031 might be preserved in subsequently created partnerships that are considered continuing partnerships of the original exchanger.

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VI. EXCHANGES BETWEEN RELATED PARTIES

§2.70 A. Overview

Internal Revenue Code §1031(f)-(g) restricts, but does not prohibit, planned exchanges between related parties who seek basis shifting as a prelude to sale of formerly low-basis property. See §§2.71-2.73 for definition of related parties. If related parties exchange properties under IRC §1031, both parties must hold their replacement properties for at least 2 years after the exchange. If either party disposes of its replacement property in the 2-year period, then the gain or loss deferred by each on the original exchange is recognized by both parties as of the date of the subsequent disposition. IRC §1031(f)(1). The related party rules of IRC §1031 are similar to the restrictions imposed on installment sales between related parties under IRC §453(e).

Internal Revenue Code §1031(f) does not absolutely prohibit related party exchanges or basis shifting between properties. Instead, it restricts disposition of the properties involved in the exchange in the 2-year period following the exchange by creating a taxable event on such disposition. Because the section causes *both* parties to a related party exchange to recognize deferred gain, it penalizes a party who deferred relatively little gain on the exchange as well as one whose deferral was substantial. If, however, related parties are willing to wait 2 years after an exchange before disposing of property received in the exchange, then they can obtain the tax advantages of the original like-kind exchange. Even if related parties engage in like-kind exchange planning at the time of the exchange to dispose of one or both properties immediately after expiration of the 2-year holding period mandated by IRC §1031(f), the original exchange is valid so long as all other requirements are met. See IRS Field Service Advice 200137003.

An anti-abuse provision, IRC §1031(f)(4), provides that §1031 shall not apply to any exchange that is part of a transaction (or series of transactions) structured to avoid the purposes of the related party rules. As described in more detail in §2.78, §1031(f)(4) is intended to prevent taxpayers from doing indirectly what they cannot do directly.

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B. Who Are Related Parties?

§2.71 1. Generally

"Related persons" are defined by reference to IRC §§267(b) and 707(b)(1). IRC §1031(f)(3). Related persons include members of a family as defined in IRC §267(c)(4), *e.g.,* the taxpayer and the taxpayer's spouse, ancestors, descendants, brothers, and sisters. Stepparents, uncles, aunts, in-laws, cousins, nephews, nieces, and former spouses are not related, nor are employees, business associates, or friends. Corporations or partnerships are not related to the taxpayer as long as they are not owned more than 50 percent by the taxpayer, including indirect ownership. Two corporations or partnerships are not related as long as they are not owned more than 50 percent by the same persons.

"Ownership" for related party purposes refers to the value of the outstanding stock of the corporation and not the voting power. In the case of partnerships, ownership refers to capital and profit interests and not management rights.

"Related persons" also includes certain relationships between grantors, beneficiaries, and fiduciaries of trusts such as a grantor and fiduciary of a trust (IRC §267(b)(4)), fiduciaries of separate trusts if the same person is the grantor of both trusts (IRC §267(b)(5)), a fiduciary and beneficiary of a trust (IRC §267(b)(6)), and a fiduciary of one trust and a beneficiary of another trust if the same person is the grantor of both trusts (IRC §267(b)(7)).

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§2.72 2. Affiliated Corporations

Within groups of affiliated corporations, intercompany exchanges of property are governed by the intercompany transaction rules of Reg §1.1502-13, not by IRC §1031(f). Transfers between affiliated corporations are treated as deferred intercompany transactions. Gain will be generated to the transferring entity on disposition of a property by the transferee. Reg §1.1502-13(c)(7)(ii), Example 1(h) clearly establishes that subsequent disposition in a qualifying like-kind exchange of property obtained by either party to a prior intercompany exchange does not trigger recognition of deferred intercompany gain.

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§2.73 3. Preexchange or Postexchange "Disassociation"

Limited guidance exists on the effect of "disassociation" between related parties before an exchange subject to IRC §1031(f). However, the IRS considered this question in IRS Letter Ruling 200730002. The ruling involved a taxpayer who planned to resign as fiduciary of a trust and then engage in a like-kind exchange with the trust beneficiary, who was now not related under IRC §267(b)(6) (see §2.71). The trust beneficiary planned to dispose of the replacement property within 2 years. The IRS held that as a result of this preexchange change in relationships, IRC §1031(f)(1) would not apply.

The IRS also assessed whether the transaction had been structured to avoid the purposes of IRC §1031(f) so as to come within the scope of IRC §1031(f)(4). It wanted to address any concern that the resignation (which made the taxpayer and the beneficiary unrelated) could be considered "structuring" with the meaning of IRC §1031(f)(4). The IRS concluded that the disassociation was not entered into to avoid IRC §1031(f).

In Letter Ruling 200730002, the IRS implied that it would take a literal approach to the question of who are related parties for IRC §1031(f) purposes. If formerly related parties are able to terminate the characteristics that make them related before a like-kind exchange, this seems to be sufficient to escape the consequences of the section. Of course, if such "disassociation" is transitory, the IRS can always assert sham transaction or step transaction analyses in challenging taxpayers.

To date there is no guidance on other types of disassociations that may commonly occur after an exchange has been completed, such as

- divorce of married couples following exchange; or
- ownership changes in corporations or partnerships bringing common ownership below 50 percent following exchange.

Likewise, no authority exists on the effect of related party relationships created *after* an exchange, such as marriage or unplanned acquisition of a controlling interest in an entity by a party to a prior exchange, although this is probably not within the purview of §1031(f) unless part of a prearranged step transaction, because no related party exchange occurred at the outset.

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§2.74 C. What Dispositions Result in Exchange Disallowance?

The term "disposition" is very broad in scope and may encompass any kind of transfer of property. Dispositions include sales of every kind, exchanges, contributions to an entity, distributions from an entity, transfers to a trust, charitable contributions, and gifts (unless excepted under IRC §1031(f)(2), discussed in §2.76). Dispositions may also include the granting of easements or other interests in the property, depending on the facts. There is no guidance on whether a partial disposition results in complete or partial reversal of like-kind exchange treatment. Dispositions do not include transfers to a grantor trust (see IRS Letter Ruling 9116009) and should not include a mortgage or a true lease.

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§2.75 1. Indirect Dispositions

Legislative history provides that indirect property dispositions via disposition of corporate stock or partnership interests are within the scope of the rules triggering application of IRC §1031(f)(1). H Conf Rep No. 386, 101st Cong, 1st Sess (1989), reprinted in 1989 US Code Cong & Ad News 3018, 3216. The methodology for applying this rule is unknown and there are no current guidelines for monitoring or enforcing the concept.

EXAMPLE: Individual A owns 60 percent and individual B owns 40 percent of the stock of corporations X and Y. This makes X and Y related under IRC §267(c). X and Y engage in a like-kind exchange, in which X realizes but does not recognize $100 gain and Y realizes $0 gain. One year after the exchange B sells all her stock in X to individual C. Six months later, A sells all his stock in Y to individual D. The possibilities for application of §1031(f) include the following:

- Application only on a complete termination of an interest in an entity. Because one of the original owners remains in each X and Y after the 2-year period expires, neither sale would result in disallowance of the original exchange.
- Application when an interest falls below a de minimis amount. If this applies, the question arises whether B's continuing 40 percent interest in Y will be sufficient.
- Application when an interest falls below a level that creates related person status between parties to the original exchange. A's sale of his stock in Y would trigger gain deferred by X, even though A still controls 60 percent of X.
- Application on some prorata basis on changes of ownership. Whether recognition of 40 percent of deferred X gain on Y's sale and the balance on X's sale is possible is unclear.

The difficulty of applying an indirect disposition test is obvious when an entity is widely held. One possible analogy in the partnership area would be to adopt rules similar to those of IRC §708, which provide for dissolution of a partnership when more than 50 percent of the capital or profits interest of the partnership have been transferred in any 12-month period, or in the corporate arena, rules similar to those applicable to creeping reorganizations under IRC §368(a)(1)(B).

To date none of these analogies has been the subject of any judicial or official analysis or published authority.

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§2.76 2. Exempt Dispositions

Certain presumably unplanned dispositions are exempted from the gain recognition effect of IRC §1031(f)(1) by IRC §1031(f)(2). Section 1031(f)(2) addresses postexchange events deemed by Congress to reflect a lack of intent to undertake a related party exchange as a planned basis-shift transaction. Events include the following:

- Death of the related person who is a taxpayer's exchange counterparty.
- Compulsory or involuntary conversion (under the meaning of IRC §1033) of a property involved in the exchange. In a condemnation, this applies only if the exchange occurred before the threat or imminence of condemnation was known. It is unclear how much "knowledge" is required to cause the exception to apply (*i.e.,* does the initiation of a study by a government agency that might affect a property and that ultimately leads to condemnation give rise to the requisite degree of knowledge?).
- Dispositions with respect to which "it is established to the satisfaction of the Secretary [of the Treasury] that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax."

The standard appears to be very difficult to meet. Legislative history indicates that intrafamily transfers of undivided interests to realign family ownership interests in property are an example of dispositions qualifying for this exception. The same legislative history also indicates that subsequent nonrecognition transfers with carryover basis result should qualify, as well as transactions not involving any basis shifting. These could include corporate contributions under IRC §351, partnership contributions under IRC §721, and further IRC §1031 like-kind exchanges. In IRS Letter Ruling 199926045, the IRS, for the first time, found that a related-party exchange followed by a disposition within 2 years would not trigger gain based on qualification of the exchange under the tax avoidance "exception" of IRC §1031(f)(2)(C). The ruling request involved an intrafamily exchange of undivided interests in timberland. The taxpayers represented that the exchange was conducted to accommodate differing objectives regarding the property (some parts of the family wanted to sell and some did not).

Further, in IRS Letter Ruling 200706001, the taxpayer exchanged with a trust a 25-percent undivided fractional interest in timberlands for a 100-percent fee interest in other timberlands. Within 2 years of the exchange, the trust sold the interest previously held by the taxpayer to an unrelated third party. Citing the history of IRC §1031(f), the IRS concluded that the disposition did not trigger gain deferred by the taxpayer. In concluding that the principal purpose of the exchange and subsequent sale was not to avoid tax consequences under IRC §1031(f)(2)(C), the IRS noted that the tax basis of the relinquished property and the tax basis of the replacement property were equivalent.

In IRS Letter Ruling 200440002, the IRS followed congressional intent reflected in the legislative history of IRC §1031(f) by holding that a taxpayer's purchase of replacement property from a related party would not result in gain recognition when the related party also engaged in a like-kind exchange on its sale of the property. The IRS stated that, because the related party intended to acquire like-kind replacement property in another exchange under IRC §1031, §1031(f)(4) would not apply because such a disposition fell within the non-tax-avoidance exception contained in IRC §1031(f)(2)(C). The IRS reasoned that there was no "cashing out" of either party's investment, and on completion of the series of transactions, both related parties would own property that is like-kind to the property they exchanged. See also Letter Ruling 200616005.

If a transfer of property received in a related-party exchange is a tax-deferred disposition because gain realized is not recognized, as in an IRC §351 or §721 contribution or another §1031 exchange, it is unknown whether subsequent direct or indirect disposition of the replacement asset (*i.e.,* stock, partnership interest, replacement property) within the 2-year period commencing with the original exchange will result in application of §1031(f)(1).

EXAMPLE: Taxpayer (T) holds Property 1 with value of $1000 and basis of $0. A related party (RP) holds Property 2 with value of $1000 and basis of $1000. On Day 1 of Year 1, T and RP exchange properties. On Day 1 of Year 2, RP disposes of Property 1 for $1100 and acquires Property 3 (having value of $1100) in a qualifying like-kind exchange. On the last day of Year 2, RP sells Property 3 for $1200 and recognizes gain of $200. Assume RP can demonstrate "qualified use" of Properties 2 and 3 in connection with its second like-kind exchange.

What happens to T's $1000 deferred gain? The 2-year "taint" period may be extended under §1031(g) if either party enters into a contract of sale, put, or similar arrangement that substantially diminishes the owner's risk of loss.

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§2.76A 3. Tolling of Postexchange Holding Period Requirement

The 2-year postexchange holding period following related party exchanges may be extended in certain circumstances. Under IRC §1031(g), the running of that holding period is suspended during any period when the holder's risk of loss with respect to a property involved in the exchange is subject to a substantial diminution of risk of loss. This can occur because of several types of contractual arrangements, such as the following:

- The property owner holds a put option (right to sell on fixed terms) relating to the property;
- A third party holds a call option (right to purchase on fixed terms) relating to the property; or
- Use of a short sale (or, presumably, other hedging arrangements) designed to lock in gain relating to the property.

Entering into a contract of sale or an option to sell within the 2-year period following a related-party exchange may be fatal even if the sale closes after the 2-year period has run. It is also unclear whether an option that grants the optionee a right to purchase at fair market value at the time of grant or exercise results in substantial diminution of risk of loss to the optionor, particularly if the option is granted for nominal consideration.

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§2.77 D. Effect of IRC §1031(f) on Direct Related-Party Exchanges

The impact of IRC §1031(f)-(g) on direct exchanges between related parties is relatively straightforward: If either party disposes of the property received in the exchange within 2 years (or any applicable extended period), both parties must recognize their gain or loss on the exchange as of the date of the subsequent disposition. This may occur in a different taxable year than the exchange itself, thus avoiding the need to amend returns for the year of the exchange. Adjustments to the basis of the properties are also made as of the date of the subsequent disposition.

The gain recognized may be treated as ordinary income if the property is depreciable and the parties are related under IRC §1239 or §707(b)(2). Losses realized may be disallowed under IRC §267(a)(1) or §707(b)(1) because the loss now arises on an exchange between related persons.

The 2-year period begins on the date of the last transfer that was part of the related party exchange (*i.e.,* in a deferred exchange, the date of the last transfer may be up to 180 days after the transfer of the relinquished property). Exchanges involving related parties may require assurances between the parties as to their disposition plans for the properties. The related parties could agree to prohibit dispositions in the 2-year period or provide compensation if an impermissible disposition causes the exchange to be taxed. See IRS Letter Ruling 9517005 for a sample contract provision.

Transactions involving a change in ownership of an entity must take into account any related party exchanges in the 2-year period. The committee reports state that dispositions include "indirect dispositions" of property through dispositions of stock in a corporation or interests in a partnership. This further complicates mergers and acquisitions.

Section 1031(f) may rule out the use of a related person as the taxpayer's intermediary or accommodator in an exchange. Such use is further discouraged by Reg §1.1031(k)-1(k), which provides that "disqualified persons" include, but are not limited to, "related persons" under §1031(f). A "disqualified person" may not be a "qualified intermediary" under the exchange safe harbors.

PRACTICE TIP: IRS Form 8824, used to report all like-kind exchanges, requires taxpayers to disclose whether any property in any exchange was directly or indirectly given to or received from a related party. If so, the form contains specific questions designed to determine whether IRC §1031(f)(1) applies.

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E. Effect of IRC §1031(f) on Indirect Related-Party Exchanges

§2.78 1. Scope of Application

Internal Revenue Code §1031(f) must be analyzed whenever a related party is involved in a series of transactions of which the taxpayer's like-kind exchange is a part. For example, the related party could be a buyer, seller, or prior owner of any property involved in the taxpayer's exchange. Even if no direct exchange occurs between related parties, the taxpayer's exchange may be taxable under IRC §1031(f)(4) if a related party disposes of property involved in the exchange.

If §1031(f)(4) applies, the exchange should not receive nonrecognition treatment under IRC §1031. Section 1031(f)(4) provides 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 Committee Reports indicate that §1031(f)(4) was intended to prevent related parties from avoiding the purposes of the related party rules through the structuring of transactions involving unrelated parties. If a disposition is not taken into account under IRC §1031(f)(2), the disposition is permitted and does not avoid the purposes of the rules. Thus, §1031(f)(4) should not apply to permitted dispositions under §1031(f)(2).

In addition to its effect on simultaneous or deferred like-kind exchanges, Internal Revenue Code §1031(f)(4) has the potential to "poison" various transactions in which a related party sells the eventual replacement property of the taxpayer in the 2-year period, including the following (see chap 5):

- Exchange-first reverse exchanges;
- Build-to-suit exchanges or other exchange-last exchanges in which the related party constructs and sells the replacement property in connection with the taxpayer's exchange;
- "Warehousing transactions" in which a related party buys the taxpayer's relinquished property and sells it within 2 years after the exchange (although an argument may be made that the related party has a new cost basis and IRC §1031(f) should not apply to such transactions); and
- "Parking transactions" in which the taxpayer acquires a related party's property as a last resort in a deferred exchange.

The Committee Report example illustrates a prior disposition of property by the related party to an unrelated accommodation party, followed by an exchange of that property between the accommodator and the taxpayer within the 2-year period.

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2. Taxpayer Acquisition of Replacement Property From Related Party

§2.78A a. IRS Letter Rulings and Other Guidance

In various letter rulings, the IRS has analyzed whether IRC §1031(f)(4) applies to transactions in which a taxpayer acquires replacement property from a related party in two situations. When the related party transfers property to the taxpayer and is paid (by the taxpayer's qualified intermediary), the related party has, in effect, facilitated a "cash out" of the taxpayer's investment property. See §§2.79-2.82. However, when the taxpayer sells property to a third party with the use of a qualified intermediary and acquires replacement property from a related party, and the related party engages in its own like-kind exchange, there is no cashing out and thus §1031(f)(4) is not activated. See §2.82A.

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(1) Cash Out by Related Party Seller

§2.79 (a) IRS Letter Ruling 9748006

The first publicly available IRS analysis of IRC §1031(f)(4) was IRS Letter Ruling 9748006. In this letter ruling, the taxpayer (T) owned a one-third interest in unimproved investment property and his mother (RP) owned the remaining two-thirds interest. An unrelated buyer (B) wanted to acquire the land; T and RP agreed to sell. RP then purchased a residence for her own use. T decided that he wanted to exchange his interest for like-kind property under IRC §1031. After learning that acquiring replacement property from an unrelated party was not feasible, T entered into a purchase agreement with RP to acquire the residence (at the same price she paid for it). In a "simultaneous" exchange T assigned and transferred to a qualified intermediary (QI) his rights to the land and his rights and obligations under the sale agreement with B; T assigned to QI his rights and obligations under the purchase agreement with RP to acquire her residence (the taxpayer's replacement property); QI sold the land to B; QI paid all of the sales proceeds to RP (with T paying an additional amount); and RP transferred the residence through QI to T. After the exchange, T owned the residence, B owned the land, and RP received cash.

The IRS assumed that T's exchange would qualify for nonrecognition treatment under §1031 absent IRC §1031(f) and reviewed the legislative history of IRC §1031(f) before concluding that the transaction was both within its purview and not excluded by any exception. Citing the House Budget Committee Report, which provided that "if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment," the IRS concluded that, based on the legislative history, §1031(f) is intended to deny nonrecognition treatment for transactions in which related parties make like-kind exchanges of high-basis property for low-basis property in anticipation of the sale of the low-basis property. H Rep No. 247, 101st Cong, 1st Sess (1989), reprinted in 1989 US Code Cong & Ad News 1906, 2810.

The IRS conceded that the exchange itself was not a "related party exchange" because T actually exchanged with QI but explained that IRC §1031(f)(4) was enacted to prevent related parties from circumventing IRC §1031(f)(1) through the structuring of transactions to involve unrelated parties. The economic result of the series of transactions was found identical to a direct exchange of the land for the residence between T and RP, followed by RP's sale of the land to B.

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§2.80 (b) IRS Field Service Advice 199931002

In IRS Field Service Advice 199931002, a father and his four children had developed two properties, called XY and Z. XY consisted of land and improvements separately owned: X was held by the children as tenants in common under the common name "A," and Y was held by Partnership "B," consisting of Father, Child 1, Child 2, and unrelated parties. Z was owned by a partnership of Father and two of the children (Related Party). The family wanted to sell XY and apply the proceeds to retire debt whose proceeds had been used to construct Z, but which was secured by both Z and XY. A series of intermediate transfers was arranged, which put XY into the hands of two new family-controlled partnerships, T and C, which then transferred XY to a qualified intermediary, who subsequently sold XY to an unrelated third party. QI used the XY sale proceeds to purchase 88 percent of Z from the Related Party and then transferred 51 percent of Z to T and 37 percent of Z to C. This apparently occurred in Year 2. The QI used the proceeds from sale of XY to pay down debt of Related Party. In Year 3, within 2 years after the original exchange, T sold its interest in Z to another unrelated party and reported a loss, together with cancellation of indebtedness income resulting from mortgage loan forgiveness at the time of the sale.

The IRS had no trouble concluding that all the family entities were related under applicable rules of IRC §§267(b) and 707(b). Citing its prior position in IRS Letter Ruling 9748006 (see §2.79), the IRS reiterated that a qualified intermediary cannot be interposed to turn a prohibited transaction into an acceptable one and thus concluded that IRC §1031(f)(4) was applicable.

The IRS went on to analyze the interaction of IRC §1031(f)(1) and (f)(4) and concluded that it could challenge the year of the exchange under an (f)(4) analysis, or the year of the disposition under an (f)(1) approach. Year 2 did not appear to be under examination in Field Service Advice 199931002, which meant that the taxpayer would not be exposed if only the (f)(4) analysis applied. If, however, the IRS could ignore the QI's disposition of XY in Year 2 as a disqualifying event, it could bring the Year 2 deferred income into Year 3 by treating the taxpayer's disposition of its Z interest in that year as the disqualifying disposition.

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§2.81 (c) IRS Letter Ruling 200126007

In IRS Letter Ruling 200126007, the taxpayer (T) was a corporation. T and two families that owned stock in T together owned more than 50 percent of the stock of another corporation (RP). Thus T and RP were related parties within the meaning of IRC §§267(b).

T undertook two like-kind exchanges. In Exchange 1, T wanted to sell Property 1, a high-rise residential rental property. RP had previously acquired a parcel of land and subdivided it into one large parcel on which a shopping center was developed (Property 2) and two small properties on which commercial buildings were developed (together, Property 5). Although there are no specific facts in the letter ruling, it appears that RP had a high basis in Properties 2 and 5 relative to their fair market values. RP also owned the fee interest in another property adjacent to one of its stores (Property 3). T wanted to control this property because of its impact on RP's operations. T closed the sale of Property 1, using a qualified intermediary. On that same date, the QI purchased Properties 2 and 3 from RP and transferred them (or caused them to be transferred) to T. T reported no recognized gain on sale of Property 1. RP reported gain realized on sale of Property 3 and deferred loss on sale of Property 2 under IRC §267(f).

In Exchange 2, T owned the fee interest in a parcel of land that had been ground-leased in connection with the development of a condominium project. The developer (or some intervening party) appears to have subleased the land to the condominium Owners' Association. The Owners' Association wanted to purchase the fee interest in the land. T agreed to sell the land to the Owners' Association. A qualified intermediary received the proceeds, and on the same date, applied the sales proceeds plus additional funds supplied by T to purchase Property 5 from RP and transfer it to T.

T asserted that IRC §1031(f)(4) is limited to circumstances in which a direct related party exchange would have been feasible but was replaced with an indirect transaction. T argued that various business and market imperatives made a direct exchange impractical. It also argued that direct exchanges would have subjected T shareholders, who were on RP's board of directors, to conflict of interest charges. In short, T argued, it could *not* have completed a direct related party exchange and, by extension, the device argument of IRC §1031(f)(4) should not apply.

T also argued that IRC §1031(f) does not apply when there are related party *sales* (as here, with respect to RP's sale of Properties 2, 3, and 5) rather than exchanges. T made the interesting argument that use of a qualified intermediary, which is not considered the taxpayer's agent under Reg §1.1031(b)-2(a), should insulate a related party sale transaction from being recast as a related party exchange. T asserted that, because the RP sale did not involve tax avoidance (because RP reported gain and deferred loss), the entire transaction fell within the "no tax avoidance" exception of §1031(f)(2)(C).

Finally, T also argued that there is a "tax planning" exception to IRC §1031(f) and that only transactions that are the result of "abusive tax avoidance" are tainted.

In its ruling, the IRS rejected T's arguments, focusing on the legislative history of IRC §1031(f) as an anti-basis-shift regime, specifically referring to the analogy between IRC §1031(f) and IRC §453(e) in creating an "economic unit" characterization of related parties. According to the IRS, the scope of the §1031(f)(4) antiabuse provision is broad because it is intended "to deny nonrecognition treatment to *any* [emphasis in original] exchange (other than direct exchanges specifically addressed in IRC §1031(f)(2)) that is part of a transaction (series of transactions) which involves related parties and is structured to avoid the purposes of §1031(f), *e.g.* denial of nonrecognition treatment for an exchange that is part of a transaction (series of transactions) that involve basis shifting, 'cashing out' of an investment, reduction or avoidance of gain, or acceleration of losses." Under the IRS analysis, the feasibility of a direct related party exchange is not a criterion for applying IRC §1031(f).

It is worth noting that the taxpayer's sophistication and knowledge of the rule of §1031(f)(1) was also used as a basis for concluding that the transactions were structured to avoid the purposes of §1031(f) and thus failed.

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§2.82 (d) Rev Rul 2002-83

The IRS followed issuance of the letter rulings discussed in §§2.79-2.81 with broader guidance, confirming that if related parties interpose a qualified intermediary (QI) into an exchange to circumvent the anti-basis shifting rules of IRC §1031(f)(1), the IRS will disregard the transfers to and from the QI and will treat the transaction as an exchange between related parties. In Rev Rul 2002-83, 2002-2 Cum Bull 927, the taxpayer seeking tax deferral under §1031 transferred low-basis investment property with substantial realized gain to a QI, which sold it for cash to an unrelated buyer.

The QI then used the cash to purchase replacement property from a person related to the taxpayer. The related party's basis in the replacement property was relatively high, and thus the gain realized was minimal. The QI then transferred this property to the taxpayer. This was viewed as an attempt to evade the effects of §1031(f)(1) and was subject to §1031(f)(4). Thus, the IRS concluded that the described exchanger (and, thus, all others similarly situated) failed to achieve nonrecognition treatment.

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§2.82A (2) Further Exchange by Related Party Seller

In IRS Letter Ruling 200440002, the IRS reviewed the consequences of a taxpayer's sale of property to a third party and the use of a qualified intermediary to acquire replacement property from a related party. The related party intended to engage in its own like-kind exchange and warranted that it would hold its ultimate replacement property for 2 years from the date of its receipt. The IRS distinguished this case from the fact pattern discussed in Rev Rul 2002-83, 2002-2 Cum Bull 927, because there was no cashing out of stepped-up basis as between the related parties at the time of the exchange or within 2 years thereafter, thereby satisfying the "no tax avoidance" exception contained in IRC §1031(f)(2)(C) and avoiding application of IRC §1031(f)(4). See also IRS Letter Rulings 200616005 and 2008010016, which reached the same conclusion on a virtually identical set of facts, and IRS Letter Rulings 200820017 and 200820025, which reach the same conclusion even when the related party received some boot from the taxpayer in the transaction.

PRACTICE TIP: These rulings suggest that when a taxpayer acquires replacement property from a related party to complete the first party's like-kind exchange, receiving covenants from the transferor that it intends to complete its own like-kind exchange and hold replacement property for 2 years thereafter may avoid application of IRC §1031(f)(2) to the taxpayer.

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§2.82B b. Tax Court Analysis

In *Teruya Bros.* (2005) 124 TC 45, the Tax Court arrived at the same result as the IRS's conclusion in Rev Rul 2002-83, 2002-2 Cum Bull 927, but went further, concluding that even when basis shifting does not occur, acquisition of replacement property from a related party violates IRC §1031(f)(4) if gain recognition by the selling related party is offset by the seller's preexisting net operating losses, thereby creating less tax liability than if the exchanging taxpayer had sold the relinquished property.

In this case, the taxpayer was a corporation (TB) that owned 62.5 percent of the common shares of another corporation (X). Thus TB and X were related parties.

TB entered into two separate real property exchange transactions involving three relinquished properties sold to two unrelated purchasers. The contracts included the following clause: "[t]he purchase will be subject to a [section] 1031 four party exchange." *Teruya Bros.,* 124 TC at 46. In advance of selling the properties, Teruya transferred the properties to a qualified intermediary (QI) after which the transactions were completed and the proceeds were delivered to the QI. Within the prescribed time period for each exchange, the taxpayer instructed the QI to purchase multiple replacement properties from a related party.

According to the IRS and the Tax Court, the transfer of the relinquished properties in both transactions was an attempt to circumvent the IRC §1031(f)(1) limitations that would have applied to exchanges directly between related persons. The Tax Court reconstituted the transactions to achieve a result economically equivalent to direct exchanges of properties between the taxpayer and the related party (with boot from the taxpayer to the related party), followed by the related party's sale of the properties to unrelated third parties. *Teruya Bros.,* 124 TC at 56. In *Ocmulgee Fields v Commissioner* (2009) 132 TC 6, the Tax Court reached the same conclusions as in *Teruya Bros.* and denied §1031 treatment when replacement property was purchased from a related party in a prearranged transaction.

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§2.82C 3. Sale of Relinquished Property to Related Party

In IRS Letter Ruling 200709036, the taxpayer, an operating partnership of a publicly traded real estate investment trust (REIT), transferred relinquished property to a related taxable REIT subsidiary (TRS) for cash consideration at fair market value using an unrelated qualified intermediary (QI). The taxpayer directed the QI to use the proceeds from the sale to acquire replacement property from a third party seller. The taxpayer represented that the TRS planned to sell the relinquished property within 2 years of the exchange.

The IRS distinguished the case from Rev Rul 2002-83, 2002-2 Cum Bull 927 (see §2.82), citing the legislative history of IRC §1031(f). The IRS held that under §1031(f)(4) the transactions were not designed to avoid application of the related party rules of §1031(f) because there was no cashing out of stepped-up basis as between the related parties. The IRS reasoned that the taxpayer and the TRS did not actually exchange properties because the TRS did not own the replacement property before the exchange. Accordingly, the taxpayer would not be required to recognize gain under §1031(f)(1)(C)(i) if the TRS disposed of the relinquished property within 2 years of the exchange. The same conclusion was expressed in IRS Letter Ruling 200712013, which also involved disposition of relinquished property by a REIT to its wholly owned TRS. See also Letter Ruling 200728008, which reached a similar conclusion involving a taxpayer other than a REIT and TRS.

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§2.83 4. General Principles

Several lessons are to be learned about IRC §1031(f)(4) as applied in light of the IRS pronouncements to date:

- First, there is no support for the proposition that criteria other than the relationship of the parties is relevant to application of IRC §1031(f), and the definition of related parties is the one expressly provided in IRC §1031(f)(3), regardless of any evidence that might show that such parties are precluded from acting in collusion or otherwise behaving as if they are at arm's length. In other words, Congress meant what it said by adopting a limited set of exceptions in the form of §1031(f)(2), and facts and circumstances extraneous to those exceptions are not relevant to the threshold question of whether IRC §1031(f)(1) applies to a transaction involving parties who are "related" for tax purposes.

- Second, IRS Letter Rulings 200126007, 200440002, 200616005, 200706001, 200709036, 200712013, and 200728008 all specifically cite the legislative history of IRC §1031(f)(2) and its inclusion of three examples of "no tax avoidance" circumstances: certain undivided interest exchanges, nonrecognition transaction dispositions, and transactions not involving basis shifting. The IRS apparently views these specific circumstances as defining the scope of §1031(f)(2).

- Third, the safe harbor characterization that a QI is not considered the taxpayer's agent applies only for purposes of §1031(a) and this characterization does not extend to §1031(f). This assertion should remind taxpayers and their advisers of the limited nature of the deferred exchange safe harbors from constructive receipt.

- Fourth, Letter Ruling 200730002 involved a "preexchange disassociation." In effectively concluding that the test of the relationship between the taxpayer as former trustee and a trust beneficiary was to be made at the time of the exchange, without consideration of the immediate, preexchange resignation as fiduciary, the IRS suggests that the same result might be reached in other contexts, such as those involving related corporations or partnerships.

- Finally, and in response to the "it's okay if planned" argument, the IRS stated that, "if tax planning were a basis for exception from anti-abuse provisions such as §1031(f), the provisions would have no impact as many tax abusive transactions evidence significant and ingenious planning."

It remains to be seen whether any acquisition of property from a related party following disposition of property in a deferred (not simultaneous) exchange can fall within IRC §1031(f)(2)(C). Some experts have suggested that, when a taxpayer can demonstrate intent to acquire third party property but identifies related party property as a "back-up" to other property in a deferred exchange, it might be possible to acquire the related property if (but presumably only if) the third party property cannot be acquired despite good faith efforts to do so.

WARNING: The safe approach is not to purchase related-party property as replacement property in any like-kind exchange when the transferor is not doing its own exchange, on the assumption that a §1031 deferral will not be available for transactions involving the following characteristics:

- Before any property dispositions, two related parties each own property;

- At least one of the properties has a fair market value different from its adjusted basis;

- One of the parties (T) undertakes a like-kind exchange in which the other related party's property is obtained as replacement property;

- The other party (RP) treats the transaction as a sale and either recognizes a loss, or recognizes a gain that is less than the gain realized by T on its exchange, or recognizes any gain that is offset by virtue of RP's tax attributes—such as net operating losses, passive loss carryovers, effective tax rate, or available credits—that are not equally available to T.

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3

Tax Consequences of Like-Kind Exchanges

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§3.1 I. GENERAL PRINCIPLES

Internal Revenue Code §1031 provides that no gain or loss shall be recognized (*i.e.,* currently taxed) in an exchange of like-kind property except to the extent of the sum of the money and the fair market value of other property received in the exchange that is not like-kind, is not held for investment or use in a trade or business, or is specifically excluded as qualifying property by IRC §1031(a)(2). IRC §1031(a)-(b). Thus, two basic calculations must always be made to evaluate the overall tax consequences of an exchange:

- *Realized* gain must be computed to find the amount of gain from disposition of the taxpayer's relinquished property that is potentially subject to tax (see §§3.2-3.5); and
- *Recognized* gain must be computed to ascertain whether any of the realized gain will be taxed (see §§3.6-3.53).

Losses are not recognized in a like-kind exchange under §1031 even if money or other nonqualifying property (*i.e.,* property that is either not like-kind, not held for investment or use in a trade or business, or is statutorily excluded) is received in the exchange. IRC §1031(a), (c). If, however, a taxpayer *transfers* nonqualifying property in the exchange, in addition to qualifying property, losses may be recognized as if the nonqualifying property had been sold. See §3.33.

NOTE: In reviewing the gain realization and recognition rules established by Treasury Regulations, Revenue Rulings, and court decisions, the attorney should remember that a two-party exchange paradigm often serves as the basis for analysis. Conforming application of these rules to fit modern multiparty exchanges, most of which are deferred, is thus often necessary.

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II. CALCULATING REALIZED GAIN OR LOSS

§3.2 A. Basic Computation

Calculating the taxpayer's realized gain or loss in a like-kind exchange requires three steps:

- **Calculate amount realized by taxpayer.** The amount realized in an exchange is the sum of any money received plus the fair market value of any property (other than money) received. IRC §1001(b). Money received includes the taxpayer's liabilities assumed by another party to the exchange and any liabilities subject to which that party acquires the relinquished property. Reg §1.1031(d)-2, Example 1; *Crane v Commissioner* (1947) 331 US 1, 91 L Ed 1301, 67 S Ct 1047. See §3.8 for further discussion of "money" received by the taxpayer.

- **Calculate adjusted basis of property transferred.** The taxpayer's adjusted basis, in general, is the initial basis in the transferred property or properties, both qualifying and nonqualifying, increased by capital expenditures and decreased by allowable depreciation or cost recovery. IRC §§1011-1012, 1016.

- **Subtract adjusted basis from amount realized to determine taxpayer's realized gain or realized loss.** The realized gain from a sale or other disposition of property (including disposition through a like-kind exchange) is the excess of the amount realized over the adjusted basis of the property transferred. The realized loss is the excess of the adjusted basis of the property transferred over the amount realized. IRC §1001(a); Reg §1.1031(d)-2.

The taxpayer's realized gain is the maximum amount of gain that may be recognized. IRC §1001(a)-(c). Further calculations are required if the taxpayer will report gain on the installment method (see §§3.43-3.45) or has taken accelerated depreciation or cost recovery on the relinquished property (see §§3.46-3.52). The taxpayer's basis in the replacement property must be determined to determine the allowable depreciation or cost recovery on the replacement property and the deferred gain to be recognized on a later taxable disposition of the replacement property. See §§3.59-3.68. When multiple properties or classes of properties are involved in an exchange, the transaction must be broken down into component parts, with fair market value allocated to each asset according to prescribed rules. See §§3.63-3.65.

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B. Adjustments to Amount Realized

§3.3 1. Effect of Relinquished Property Sale Expenses

Sales and other relinquished property transaction expenses paid by the taxpayer are treated as money paid by the taxpayer and reduce the taxpayer's amount realized. Sales expenses include the following:

- Brokerage commissions;
- Escrow fees;
- Title insurance premiums;
- Recording fees;
- Documentary transfer taxes;
- Legal fees; and
- Similar expenses.

In Rev Rul 72-456, 1972-2 Cum Bull 468, the Internal Revenue Service ruled that brokerage commissions reduce the taxpayer's amount realized. The effect of Rev Rul 72-456 should not be limited to brokerage commissions; it should apply to all the taxpayer's sales expenses. See IRS Letter Ruling 8328011, which implies that all exchange expenses, not just brokerage commissions, reduce gain recognized. See §3.62 for discussion of Rev Rul 72-456 and the effect of transaction expenses on calculating basis in the replacement property. See also *Samuel C. Chapin* (1949) 12 TC 235, aff'd on other grounds (8th Cir 1950) 180 F2d 140 (all sale expenses factored into computation of gain); *Mercantile Trust Co.* (1935) 32 BTA 82 (commission and title fee reduced amount realized). The position reflected in Rev Rul 72-456 is incorporated into IRS Form 8824, which taxpayers must file with their federal income tax returns for the year of a relinquished property disposition. See §§3.77-3.78 for description of this form. Form 8824, line 15, directs the taxpayer to reduce the amount of cash or the fair market value net of liabilities of any property received by the taxpayer by the amount of any exchange expenses incurred. Although the Form 8824 instructions are silent on this point, it is reasonable to conclude that line 15 refers to exchange expenses incurred with respect to the relinquished property.

Prorations for items such as interest, property taxes, property insurance, and credits for lease deposits are *not* sales expenses and thus do not affect the amount realized. See Reg §1.1031(k)-1(g)(7) (taxpayer's receipt of or right to receive proration items that are not included in the amount realized from disposition of the relinquished property is disregarded in ascertaining whether an exchange satisfies certain "safe harbors" for deferred exchanges). See §4.55.

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§3.4 2. Effect of Amounts Paid for Replacement Property

Expenses incurred by the taxpayer in connection with the acquisition of real property generally increase the taxpayer's cost basis in the acquired property and are not deductible. Costs such as title insurance premiums, recording fees, and legal expenses are capitalized to the buyer's basis in the property acquired and, in the context of a like-kind exchange, these are costs incurred by the taxpayer in connection with acquisition of the replacement property. There is no authority analogous to Rev Rul 72-456, 1972-2 Cum Bull 468, in the context of replacement property acquisition expense; however, the approach implied by the instructions given the taxpayer by the IRS on Form 8824 appear to be consistent with the general rule on capitalization of the expense. Line 18 of Form 8824 increases the taxpayer's basis in the relinquished property by net amounts paid to the other party and any amounts paid as expenses that are not accounted as exchange expenses on line 15. See §3.3. If line 15 is intended to account for expenses paid in connection with the relinquished property consistent with Rev Rul 72-456, then line 18 appears to account for the balance of transactional expenses incurred by the taxpayer in connection with the replacement property. The effect of this is to increase the taxpayer's basis in the replacement property. This has significance beyond basis adjustments, however. The taxpayer will be treated as having given cash boot to the extent of the exchange expense attributable to the replacement property.

EXAMPLE: Taxpayer exchanges land held for investment with a fair market value of $100,000 for land with a fair market value of $95,000. The taxpayer also incurs acquisition expenses of $5,000 in connection with the replacement property. The result is that no net boot is received by the taxpayer, assuming that the taxpayer never actually or constructively received cash from the buyer of the relinquished property.

Expenses incurred by a taxpayer in connection with a loan obtained to acquire the replacement property, such as loan application fees, points, mortgage insurance, lender's title insurance, and others, are not included in the taxpayer's basis in the acquired real property. Rather, these costs are capitalized and amortized over the life of the loan. When these costs are added to the principal amount of the loan, gain could be recognized if the taxpayer's equity in the replacement property is reduced as a result. If the loan expenses are paid with sale proceeds, gain could also be recognized because loan expenses neither reduce the amount realized on the sale of the relinquished property nor increase the taxpayer's basis in the replacement property.

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§3.5 C. Quick-Check Calculation of Realized Gain

The basic calculation described in §3.2 follows from a two-party exchange paradigm, in which the value of relinquished property is established by the value of cash plus replacement property received in exchange. In modern multiparty exchanges, the taxpayer's realized gain may be calculated by an alternative method: The taxpayer's realized gain equals the fair market value of the relinquished property, less the taxpayer's sales expenses and the taxpayer's adjusted basis in the relinquished property. See Reg §1.1031(d)-2, Example 2(a). This method is more appropriate when the relinquished property is purchased by a third party as part of the exchange because it looks to the value of the relinquished property, not the replacement property.

EXAMPLE: The following example is from Reg §1.1031(d)-2, Example 2(a): A owns an apartment house (Whiteacre) with a fair market value of $220,000, encumbered by a mortgage of $80,000. A's adjusted basis in Whiteacre is $100,000. B owns an apartment house (Blackacre) with a fair market value of $250,000, encumbered by a mortgage of $150,000. B's adjusted basis in Blackacre is $175,000.

A and B exchange apartment houses, each acquiring the new property subject to the existing mortgages. B pays A $40,000 in cash. Although not in the example provided in the regulations, assume that A and B each have sales expenses equal to 7 percent of the fair market value of the respective properties. There are no proration items.

A's realized gain is calculated under the regulations (see §3.2) as follows:

Value of replacement property received (Blackacre)	$250,000	
Plus cash received by *A*	40,000	
Plus liabilities to which *A*'s relinquished property (Whiteacre) is subject	80,000	
TOTAL CONSIDERATION RECEIVED		$370,000
Liabilities to which replacement property (Blackacre) is taken subject	$150,000	
A's sales expenses	15,400	
TOTAL CONSIDERATION PAID		($165,400)
A's amount realized		$204,600
Less *A*'s adjusted basis		(100,000)
A's REALIZED GAIN		$104,600

The alternative computation of A's realized gain is as follows:

Value of *A*'s relinquished property (Whiteacre)	$220,000	
Less *A*'s sales expenses	15,400	
A's amount realized		$204,600
Less *A*'s adjusted basis		100,000
A's REALIZED GAIN		$104,600

B's realized gain is computed under the regulations as follows:

Value of replacement property (Whiteacre)	$220,000	
Plus liabilities to which *B*'s relinquished property (Blackacre) is subject	150,000	
TOTAL CONSIDERATION RECEIVED		$370,000
Liabilities to which replacement property (Whiteacre) is taken subject	$80,000	

Cash paid by *B*	40,000	
B's sales expenses	17,500	
TOTAL CONSIDERATION PAID		($137,500)

B's amount realized	$232,500
Less *B*'s adjusted basis	(175,000)
B's REALIZED GAIN	$57,500

The alternative computation of B's realized gain is as follows:

Value of *B*'s relinquished property (Blackacre)	$250,000	
Less *B*'s sales expenses	17,500	
B's amount realized		$232,500
Less *B*'s adjusted basis		175,000
B's REALIZED GAIN		$57,500

See Reg §1.1031(d)-2, Example 2(b), for this example without regard to selling expenses. See §3.57 for discussion of the amount of gain recognized by A and B in this example and for several tax-planning alternatives to minimize the recognized gain. See also §§3.70-3.75 for examples of calculations of taxability and basis.

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III. CALCULATING RECOGNIZED GAIN

A. Realized Gain Must Be Recognized to Extent Taxpayer Receives Money or "Other Property" in Exchange

§3.6 1. General Principles

In an exchange that qualifies under IRC §1031, the taxpayer's realized gain is recognized only to the extent of the sum of money and the fair market value of "other property" received by the taxpayer. IRC §1031(b). Thus, after the taxpayer's realized gain is computed, the next step in ascertaining the taxability of an exchange is to calculate the amount of money and the fair market value of property the taxpayer received in the exchange. If there is no realized gain, there can be no recognized gain, making this calculation unnecessary.

If the taxpayer *transfers* nonqualifying property in the transaction, however, the taxpayer generally recognizes gain or loss on the nonqualifying property as if it had been sold, regardless of whether the taxpayer recognizes gain on the like-kind exchange. See §3.33.

Sometimes a taxpayer relinquishes and receives personal property in what is primarily a real property exchange. For example, if an exchange of apartment buildings includes personal property (*e.g.,* refrigerators, washing machines, furniture), the transaction will be considered an exchange of real property and an exchange of personal property, both of which qualify under §1031. See §§3.36-3.42 for discussion of such multiple property exchanges.

Where a taxpayer has used a property consecutively or concurrently as a home and a business (*e.g.,* rental residence), a taxpayer may benefit from both the home-sale exclusion under IRC §121 and the like-kind deferral under IRC §1031. Rev Proc 2005-14, 2005-1, Cum Bull 528. See §2.38 for further discussion.

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§3.7 2. Different Equities Create Need to Transfer Money or Other Property

In the paradigm of the two-party exchange, the amount of money and other property to be transferred depends on the parties' relative equities in their properties. An owner's equity in unencumbered property is the fair market value of the property; an owner's equity in encumbered property is the fair market value of the property less the balance of the existing encumbrances that are to be retired, assumed, or taken subject to in the exchange. In most real property exchanges, the taxpayer's equity in the relinquished property is not equal to the seller's equity in the replacement property. Accordingly, the taxpayer must usually give or receive cash or other nonqualifying property to balance the equities. See, *e.g., Halpern v U.S.* (ND Ga 1968) 286 F Supp 255; *Earlene T. Barker* (1980) 74 TC 555.

EXAMPLES: The fair market value of relinquished property is $200,000; the property is encumbered by an existing deed of trust securing a note with a balance of $60,000; the new owner assumes the note in the exchange. The taxpayer's equity in the relinquished property is $140,000 ($200,000 less $60,000).

The fair market value of replacement property is $150,000. The taxpayer takes it subject to an existing deed of trust securing a note with a balance of $100,000. The seller's equity in the replacement property is $50,000 ($150,000 less $100,000).

The taxpayer's equity exceeds the seller's equity by $90,000 ($140,000 less $50,000). To equalize the equities, the taxpayer must receive $90,000 in money or other property, which could include a promissory note from the buyer of the relinquished property.

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3. Definition of "Money" Received by Taxpayer

§3.8 a. Generally

Money received by the taxpayer includes the following:

- Cash received (Reg §1.1031(b)-1);
- All cash equivalents received (*e.g.,* bank certificates of deposit or treasury notes) (Reg §1.1031(b)-1);
- The amount of any liabilities of the taxpayer, secured or unsecured, that another party assumes or takes property subject to in the exchange (Reg §1.1031(b)-1(c)); and
- A promissory note executed by another party to the exchange in favor of the taxpayer (such a note is a cash equivalent and is treated as money received by the taxpayer to the extent of its fair market value) (Reg §1.1031(b)-1(c)).

If the party acquiring the taxpayer's relinquished property takes it subject to an existing debt secured by a deed of trust or mortgage, and gives the taxpayer a new promissory note that includes the principal balance of the existing debt, the new note is referred to as a "wraparound" or "all-inclusive" note. The holder of the wraparound note (here, the taxpayer) typically is obligated to pay off the underlying debt while being paid by the maker of the wraparound note. In this event, the amount treated as money received by the taxpayer is the difference between the fair market value of the wraparound note and the balance of the underlying debt that is included in it. The amount of the underlying debt is treated as mortgage boot received by the taxpayer. Temp Reg §15A.453-1(b)(3)(ii).

The taxpayer would achieve the same result by transferring the relinquished property subject to existing indebtedness and receiving from the transferee a note secured by a second deed of trust instead of a wraparound note and deed of trust. On wraparound notes generally, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 9 (4th ed Cal CEB 2009). For further discussion of mortgage boot, see §3.20.

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§3.9 b. Definition of "Liabilities" for IRC §1031 Purposes

Although the term "liabilities" is not specifically defined in IRC §1031, the regulations assume a broad definition. Regulations §§1.1031(b)-1(c), 1.1031(d)-2 refer to the offset of "liabilities" without specifying any limitation on the type of liability. See also IRS Letter Ruling 8328011 (nonmortgage liabilities are part of the boot-netting process under Reg §1.1031(b)-1(c)). Moreover, the regulations on multiple property exchanges expressly state that all liabilities assumed by the taxpayer may be offset against all liabilities of which the taxpayer is relieved, regardless of whether the liabilities are recourse or nonrecourse or whether they are secured by or otherwise relate to specific property transferred or received in the exchange. Reg §1.1031(j)-1(b)(2)(ii). Thus, in the authors' opinion, liabilities may be retired or assumed in an exchange and treated as mortgage boot (see §3.14), even if the liabilities are unsecured or are secured by property not involved in the exchange.

It is clear from the language of Reg §§1.1031(b)-1(c), 1.1031(d)-2, and 1.1031(j)-1(b)(2)(ii) that mortgage boot includes preexisting indebtedness if the debt is assumed or property is acquired subject to the debt. Mortgage boot might also include new financing created as part of the exchange, but this characterization is not clear. Instead, the authors believe that new financing (whether received or given) is more likely to be regarded as cash boot than mortgage boot. See §3.24.

In *Louis G. Wittig*, TC Memo 1995-461 (withdrawn Nov. 9, 1995), the court held that purchase money financing of new replacement property could not be used to offset debt relief realized on retirement of relinquished property financing, but the opinion was quickly withdrawn at the request of the IRS, indicating that the IRS did not wish to litigate the position on appeal.

In IRS Letter Ruling 8328011, the IRS concluded that items listed in escrow account balances that relate to sums certain, due at fixed or determinable dates of maturity, are liabilities under IRC §1031. Thus, interest paid by the new owner of the relinquished property before closing was held to be a liability.

When analyzing whether an item is a liability for IRC §1031 purposes, IRC §1031(d) requires an additional determination of whether a taxpayer or the taxpayer's transferee has assumed that liability within the meaning of IRC §357(d). The latter section provides that a recourse liability (or portion of it) will be treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed, and is expected, to satisfy such liability (or portion), whether or not the transferor has been relieved of such liability. The transferee of an asset subject to a nonrecourse liability will be treated as having assumed that liability, except when the amount of the nonrecourse liability is reduced by the lesser of (1) the amount of such liability that an owner of other assets not transferred to the transferee and also subject to such liability has agreed with the transferee to, and is expected to, satisfy, or (2) the fair market value of such other assets (determined without regard to IRC §7701(g)).

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§3.10 4. Definition of "Other Property" Received by Taxpayer

"Other property" consists of all nonqualifying property, except money, received by the taxpayer in the exchange. Other property includes the following (Reg §1.1031(a)-1, (a)-2):

- Property specifically excluded from like-kind exchange treatment by IRC §1031(a)(2) (*e.g.,* stock, bonds, choses in action, partnership interests);
- Value of goodwill given or received;
- Property held for a nonqualifying purpose (*e.g.,* for personal use); and
- Property that may otherwise be eligible for like-kind exchange treatment but is not like in kind to the relinquished property in the transaction.

The following example illustrates the difference between nonqualifying other property and like-kind qualifying property:

EXAMPLE: A taxpayer exchanges unimproved real estate for an industrial warehouse, a utility truck, and General Motors stock. The unimproved real estate and the industrial warehouse are like-kind qualifying property. See §§2.41-2.42. The utility truck is property that is eligible for exchange under IRC §1031 but is not like-kind to the real estate; thus, it is "other property" or "boot." Because the General Motors stock is nonqualifying property, it is also boot received in the exchange. For further description of boot, see §§3.12-3.14.

Other property may consist of nonqualifying property that may not be considered boot if the taxpayer's relinquished property satisfied the requirements of both IRC §§121 and 1031, and the taxpayer availed itself of the benefits of Rev Proc 2005-14, 2005-1, Cum Bull 528. See §2.38 for further discussion.

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§3.11 5. When Is Money or Other Property "Received?"

Money or other property is considered "received" by the taxpayer if the taxpayer has unfettered use of or access to it. See *Earlene T. Barker* (1980) *74* TC 555. If a taxpayer who receives cash is contractually obligated to use it to pay off an existing mortgage on the relinquished property and has no option to use it for any other purpose, the taxpayer is not considered to have received the cash in the exchange. See Reg §1.1031(k)-1(f)(2) (deferred exchanges). See also *Coleman v Commissioner* (8th Cir 1950) 180 F2d 758; *Commissioner v North Shore Bus Co.* (2d Cir 1944) 143 F2d 114.

For discussion of when taxpayer is considered to be in constructive receipt of funds and "safe harbors" for avoiding constructive receipt in deferred exchanges, see §§4.36-4.73.

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§3.11A 6. Taxable Sales or Exchanges of Non-California Property Received in Exchange for California Property

The Franchise Tax Board has taken the position, without clear statutory authority, that gain may be deferred in a like-kind exchange when the relinquished property is located in California and the replacement property is located outside of California, but that the realized but unrecognized gain is subject to California taxation on a subsequent taxable sale or exchange of the out-of-state replacement property. See FTB Pub 1100: *Taxation of Nonresidents and Individuals Who Change Residency,* §F. In effect, the Franchise Tax Board asserts the right to collect tax on income attributable to earlier California-source realized but unrecognized gain at a point when neither the taxpayer nor the property sold is otherwise subject to California taxation. The ultimate enforceability of this assertion and the administrative process for implementing it remain uncertain. It is also uncertain how California's position will be reconciled with the currently typical regime involving taxation of all gain by the state in which the replacement property is located on a taxable sale of the property.

EXAMPLE: Assume California relinquished property is exchanged for Texas replacement property in a transaction governed by IRC §1031(a) and $15,000 realized gain is not recognized. The FTB's position is that if the Texas property is sold at a later date for a $20,000 recognized gain, the $15,000 gain previously deferred is attributable to California and is subject to taxation by California. FTB Pub 1100, §F at 12.

A host of problems arise from this position, because it will require nonresidents trading from California property into non-California property to compute and track California sourced gain. This may create at least two levels of gain and potentially many more if prior or future exchanges involve other states that adopt similar rules.

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§3.11B 7. Sales of California Property Received in Exchange for Non-California Property

California does not offer any reciprocity to other states with respect to inbound exchanges, *i.e.,* exchanges in which the relinquished property is not located in California but the replacement property is. In FTB Pub 1100: *Taxation of Nonresidents and Individuals Who Change Residency*, the FTB asserts that California will be entitled to tax all gain associated with a taxable disposition of California property that has been acquired in exchange for non-California property.

EXAMPLE: Assume Nevada relinquished property is exchanged for California replacement property in a transaction in which $10,000 realized gain is deferred. When the California property is sold in a transaction in which $50,000 gain is recognized, the entire gain is treated as California-source gain regardless of the Nevada source of the $10,000. FTB Pub 1100, §F at 13.

At present the implications of the inconsistency between California's position on inbound and outbound exchanges are unclear, as are the consequences of multiple exchanges involving interim gains (or losses) associated with properties in different states that are connected in a series of exchanges by a single taxpayer.

WARNING: Other states have begun to propose legislation or adopt administrative regulations asserting "clawback" rights to income realized but not recognized when taxpayers dispose of property in the state and acquire property in another state. Three states have regimes similar to California: Massachusetts, Montana, and Oregon. See 830 Mass Code Regs §62.5A.1; Montana Admin R 42.2.308; Oregon Rev Stat §§316.738, 317.327. In the authors' view, this trend is likely to continue.

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B. Money or Other Property as "Boot"

§3.12 1. Definition of "Boot"

In a like-kind exchange under IRC §1031, money or other nonqualifying property transferred or received by the taxpayer is known as "boot." The concept of boot is not exclusive to §1031 exchanges and applies to a wide variety of transactions. In the context of the modern federal tax code, the functional purpose of boot is to provide a means to measure the extent to which realized gain should be recognized in a transaction in which a taxpayer has converted relinquished property to something other than a statutorily prescribed form of replacement property. Thus, when a taxpayer contributes property to a controlled corporation within the meaning of IRC §351 and receives, in exchange, both stock in the controlled corporation and *other property or money*, gain might be recognized to the extent of such money or the fair market value of the other property received under IRC §351(b). To draw the §1031 analogy, the "relinquished property" in this example can be considered to be the property contributed to the controlled corporation. The permissible form to which that property may be converted (*e.g.,* the "replacement property") is solely corporate stock, and gain is recognized to the extent that the contributing taxpayer has converted the relinquished property to something other than corporate stock. This concept is analogous to the tax effect of corporate reorganizations under IRC §§361-368, and contributions of property to partnerships in exchange for partnership interests and other property or money under IRC §§721-724.

In ascertaining the net amount of money and other property received by the taxpayer in an exchange (to compute the recognized gain), certain offsets are permitted. Because the Treasury Regulations establish different rules for netting mortgage liability boot and all other forms of boot, the terms "cash boot" and "mortgage boot" are often used. Although these terms do not appear in IRC §1031 or the Regulations, the Tax Court has used them in several cases. See, *e.g., Earlene T. Barker* (1980) 74 TC 555; *Estate of Rollin E. Meyer* (1972) 58 TC 311, nonacq 1975-2 Cum Bull 3, aff'd per curiam (9th Cir 1974) 503 F2d 556; *Frederick W. Behrens*, TC Memo 1985-195, aff'd without published opinion (8th Cir 1986) 786 F2d 1170. The distinction between cash boot and mortgage boot is sometimes unclear, however, and the definition may change, depending on whether the boot is given or received by the taxpayer.

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§3.13 2. Cash Boot

The term "cash boot" is somewhat of a misnomer because it includes cash, cash equivalents, and nonqualifying property (*i.e.,* property specifically excluded from like-kind exchange treatment by IRC §1031(a)(2), property not held for a qualifying purpose (see §§2.20-2.22), or property that otherwise qualifies under IRC §1031 but is not like in kind to the property being exchanged in a particular transaction). A taxpayer who pays money or gives nonqualifying property in the exchange is considered to have paid or given cash boot. A promissory note given to a taxpayer by the transferee of the relinquished property is cash boot to the taxpayer. IRC §1031(d).

Proration items (*e.g.,* prorated rents) are also cash boot, but transactional expenses are not. See §3.27.

If the taxpayer in a deferred exchange has the contractual right to elect to receive any portion of the exchange equity in cash, that portion is considered to be cash boot, regardless of whether the taxpayer exercises the right to demand the cash. See Reg §1.1031(k)-1(j)(3), Example 4. If the taxpayer obtains the contractual right at any time before receipt of the replacement property to demand the entire fair market value of the relinquished property in cash, the transaction is classified as a sale rather than an exchange. Reg §1.1031(k)-1(j)(3), Example 3. This black-letter principle can be somewhat misleading, however, because a sale can be converted into an exchange before the taxpayer conveys the relinquished property. See §2.59.

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§3.14 3. Mortgage Boot

Mortgage boot consists of liabilities that a party assumes or subject to which a party acquires property in the exchange. If another party to the exchange assumes the taxpayer's liabilities or acquires the taxpayer's relinquished property subject to such liabilities, the taxpayer is considered to have received mortgage boot, even if the buyer of the relinquished property refinances it as part of the exchange and uses the proceeds to pay off the taxpayer's mortgage. *Earlene T. Barker* (1980) 74 TC 555. The same treatment will apply if the taxpayer's liability is retired using the buyer's funds rather than a lender's. Reg §1.1031(d)-2. A taxpayer who assumes another party's liabilities or acquires replacement property subject to those liabilities in the exchange is considered to have paid or given mortgage boot. Reg §1.1031(b)-1(c). As discussed in §3.9, whether a taxpayer has assumed a liability is determined in accordance with IRC §357(d).

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§3.15 4. Adjusting Mortgage Balances Before Exchange

Taxpayers sometimes wish to change the amount of mortgage debt on the relinquished property or the replacement property before or during the exchange. The taxpayer may wish to refinance the relinquished property to obtain tax-free loan proceeds, or the taxpayer may need to adjust the liabilities on either property to balance the equities and complete the exchange. See §3.7. The adjustment of liabilities before or during an exchange could be motivated by tax or economic considerations. It is not uncommon for a taxpayer to refinance a property and then, for reasons unrelated to the refinancing, decide to dispose of the property in a like-kind exchange.

Whatever the motivation, the Internal Revenue Service or the California Franchise Tax Board can be expected to scrutinize any refinancing if it occurs shortly before or during the pendency of an exchange and reduces the amount of gain recognized in the exchange. Taxing authorities may take the position that loan proceeds received on or before an exchange should be treated as cash boot, not nontaxable loan proceeds, on the theory that the refinancing was undertaken solely to avoid taxes. Sections 3.54-3.55 review the available authority on adjusting liabilities on or before a like-kind exchange and methods of planning a refinancing to improve its chances of surviving scrutiny under the substance-over-form test.

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§3.16 a. Independent Economic Substance Test: Offset Permitted

In *Phillip M. Garcia* (1983) 80 TC 491, acq 1984-2 Cum Bull 1, the court permitted the taxpayer to offset mortgage boot received (debt relief) with mortgage boot created during the exchange. In *Garcia,* as a precondition to the exchange, the exchange documentation required the seller of the replacement property to obtain a loan secured by a new deed of trust on that property to increase the encumbrances on it from $78,526 to $107,200.

At the close of escrow, the seller transferred the newly encumbered replacement property to the taxpayer, who assumed the outstanding liabilities of $107,250. In a concurrent escrow, the taxpayer transferred the relinquished property (with total liabilities of $106,463) to the seller, who immediately deeded it to the ultimate buyer. The Internal Revenue Service argued that the amount of liabilities that the taxpayer claimed to have assumed ($107,250) reflected an artificial attempt to reallocate liabilities for tax avoidance purposes and did not reflect the substance of the transaction. Although the Tax Court acknowledged that substance must control over form, it held that the adjustment of liabilities during the pendency of the exchange, which was accomplished by the *seller* through a third-party lender, was an act of independent economic substance. Thus, the taxpayer was entitled to offset mortgage boot received by the new indebtedness created during the exchange and assumed by the taxpayer.

In *Fred L. Fredericks,* TC Memo 1994-27, the taxpayer received more than $2 million through refinancing the relinquished property 1 week after entering into the sales contract and 3 weeks before transferring the relinquished property as part of the exchange. The court held that the refinance proceeds were not received as part of the exchange and thus were not taxable as boot. The facts revealed that the taxpayer had attempted to secure permanent long-term financing for 3 years before the exchange was consummated and that the existing financing was almost due. Under those circumstances, the court held that the refinancing was unrelated to the exchange.

In a series of IRS letter rulings citing *Garcia* and *Fredericks,* the IRS ruled that proceeds from a preexchange refinancing were not considered payments of boot in the exchange transaction, because the refinancing had an economic significance independent of the proposed exchange: The taxpayers received lower interest rates on their loans, and they used the proceeds to acquire more property. See IRS Letter Rulings 200019014-200019019, discussed in §2.14. In an older ruling (IRS Letter Ruling 8248039), the IRS stated that a new mortgage obtained by the taxpayer in anticipation of the exchange could be offset with mortgage boot given (through the taxpayer's receipt of replacement property subject to mortgage debt), in effect concluding that the taxpayer's receipt of loan proceeds before the exchange did not result in the taxpayer's receiving cash boot.

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§3.17 b. Substance-Over-Form Test: No Independent Economic Substance

In IRS Letter Ruling 8434015 the IRS reached the opposite conclusion discussed in §§3.15-3.16 on similar facts. The taxpayer had obtained a third party loan before the exchange to increase the mortgage debt on the relinquished property so that the properties' equities would balance. Applying the substance-over-form test, the IRS concluded that the loan did not have independent economic substance. Thus, the taxpayer's debt relief obtained by transferring the relinquished property subject to the new mortgage could not be offset against liabilities assumed by the taxpayer in the exchange, because in substance that would enable the taxpayer to "cash out" a portion of the investment in the relinquished property without a corresponding recognition of gain for money received under IRC §1031(b). In effect, the IRS treated the loan proceeds as cash boot.

In *Frederick W. Behrens,* TC Memo 1985-195, aff'd without published opinion (8th Cir 1986) 786 F2d 1170, the Tax Court rejected the taxpayer's argument that cash the taxpayer received in a two-party exchange was the product of a nontaxable loan from the other party rather than the taxable proceeds of the disposition of the relinquished property. In *Behrens,* the taxpayer traded in four old trucks to International Harvester for four new trucks. The taxpayer reinvested some of the proceeds from the disposition of the old trucks in the new trucks and executed a new purchase money note in favor of the seller, International Harvester, to cover the balance of the purchase price. The taxpayer received the remaining $22,000 of cash proceeds and used them in the operation of his business. The taxpayer argued that the $22,000 received were the proceeds of an indirect loan from the seller, on the theory that the principal amount of the note given by the taxpayer to the seller would have been $22,000 less if the taxpayer had reinvested all the exchange equity. Thus, the taxpayer argued, the cash was nontaxable loan proceeds.

The Tax Court pointed out that the taxpayer had conceded that the price of the new trucks represented their fair market value, and the amount financed represented only the balance owed on the new trucks, not the balance owed *plus* $22,000. That the taxpayer could have applied the $22,000 to the down payment, thus reducing the amount financed, did not mean that the $22,000 was an extension of credit by International Harvester to the taxpayer. The court held that the $22,000 received in the exchange constituted a liquidation of a part of the taxpayer's net equity in the old trucks, which should be recognized to the extent of this cash boot received.

The court also refused to permit the netting of the cash received against the consideration given in the form of a newly created note. The taxpayer had argued that the rule against offsetting cash boot received with mortgage boot given should not apply when the boot given is in the form of new debt rather than the assumption of preexisting debt. In rejecting this approach, the court noted that such a rule would enable taxpayers to circumvent IRC §1031(b) and the limited boot-netting permitted by the regulations by simply creating new debt. If that was the case, any taxpayer could cash out a portion of the equity in an exchange transaction without triggering recognition of gain.

In *Arthur E. Long* (1981) 77 TC 1045, the taxpayers reallocated liabilities at the partnership level less than six weeks before a complex exchange of partnership interests (which is now prohibited by IRC §1031(a)(2)(D)). Applying the substance-over-form test, the Tax Court found that the taxpayers adjusted liabilities for the sole purpose of reducing the amount of mortgage boot received in the exchange (in the form of debt relief). Thus, the court held that the reallocation of liabilities lacked independent economic substance and should be disregarded in ascertaining the tax effects of the exchange. 77 TC at 1080. The result was that the taxpayers recognized the entire amount of gain realized in the exchange.

NOTE: One feature distinguishing the nontaxable refinancing in *Phillip M. Garcia* (1983) 80 TC 491, acq 1984-2 Cum Bull 1, and *Fred L. Fredericks,* TC Memo 1994-27 (see §3.16), from the taxable adjustments of liabilities in *Frederick W. Behrens, supra* (see §3.18), and *Long* is that the refinancing in *Garcia* and *Fredericks* was through a third party. The Tax Court contrasted this third-party refinancing to the adjustment of liabilities in *Long,* which involved a reallocation of liabilities among the taxpayers themselves, who were partners in a partnership. See *Phillip M. Garcia* (1983) 80 TC 491, 505. In *Behrens,* the taxpayer's purported loan was obtained from the other party to the exchange. The court stated in dictum that, if the taxpayer had borrowed the money from a third-party lender, the funds would have been received tax-free.

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§3.18 c. Continued Uncertainty in Preexchange Liability Adjustments

The Treasury Department issued a proposed regulation in 1990 that would have amended Reg §1.1031(b)-1(c) to eliminate some of the uncertainty surrounding the treatment of liabilities incurred before an exchange. This proposed regulation would have prohibited taxpayers from offsetting mortgage boot received with mortgage boot given when the liabilities were incurred in anticipation of the exchange. In its explanation accompanying the notice of the proposed regulation, the Internal Revenue Service stated that the amendment was intended merely to "clarify current law." 55 Fed Reg 17,636 (1990). The IRS cited no authority for that statement, however, and did not mention *Phillip M. Garcia* (1983) 80 TC 491, acq 1984-2 Cum Bull 1, or *Fred L. Fredericks*, TC Memo 1994-27. See §3.17. When the final regulations on deferred exchanges were promulgated in April 1991, this proposed regulation was omitted on the ground that commentators had shown that "the proposed rule could create substantial uncertainty in the tax results of exchange transactions involving liabilities on both relinquished and replacement properties." 56 Fed Reg 14,853 (1991).

Thus, it is uncertain whether a taxpayer may adjust the mortgage balances on the relinquished property before an exchange without jeopardizing the tax benefits of the exchange. With careful planning, however, a taxpayer can achieve a level of certainty under existing case law. See §§3.54-3.58.

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§3.19 5. Security Deposits as Cash Boot or Mortgage Boot

It is not always clear whether a security deposit should be treated as cash boot or mortgage boot for purposes of IRC §1031. The determination depends on whether the deposit is viewed as cash held by the landlord or as an obligation or liability of the landlord to the tenants. Although §1031 does not specifically define "liability," the regulations dealing with multiple property exchanges include in that term unsecured monetary obligations. Reg §1.1031(j)-1(b)(2)(ii). Under general tax principles, state law should be applied to determine whether a security deposit is a liability for exchange purposes. But see IRS Letter Ruling 8328011.

Security deposits that are required to be held in a separate interest-bearing trust account by a landlord as a trustee for the tenants should be treated as cash boot when transferred. Rev Rul 77-260, 1977-2 Cum Bull 466. If security deposits are not required to be segregated but represent an obligation of the landlord to the tenants, the deposits should be treated as liabilities and thus as mortgage boot. California law does not require the landlord to hold security deposits in trust for the tenants in a separate, interest-bearing account. Instead, they create a debtor-creditor relationship between the landlord and the tenants. See CC §§1950.5 (residential), 1950.7 (nonresidential). Thus, in California, a taxpayer should be treated as having received mortgage boot when security deposits are credited to the transferee of the relinquished property and as having given mortgage boot when the taxpayer assumes the security deposit obligation on receipt of the replacement property. But see Rev Rul 77-260, 1977-2 Cum Bull 466.

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§3.20 6. Prepaid Rents as Cash Boot or Mortgage Boot

The Internal Revenue Service takes the position that prepaid rents are cash boot and not mortgage boot for purposes of IRC §1031. See IRS Letter Ruling 8328011. Logically, the argument that can be made with respect to security deposits could also be made with respect to prepaid rents, *i.e.,* that the characterization should depend on whether local law considers the prepaid rents to be liabilities of the landlord or cash held by the landlord. See §3.19. In practice, however, taxpayers and their accountants are fairly consistent in treating prepaid rents as cash boot.

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C. Tax Consequences of Boot in Exchanges

§3.21 1. Generally

If a taxpayer receives cash boot, mortgage boot, or both, and gives no boot in the exchange, the realized gain is recognized to the extent of the total boot received. See Reg §1.1031(d)-2, Example 1. If a taxpayer gives either cash or mortgage boot but receives none, no gain is recognized unless the depreciation recapture rules apply (see §§3.46-3.52), but the taxpayer obtains a basis increase in the replacement property. See §§3.65, 3.69. If a taxpayer receives and gives one or more items of cash boot and mortgage boot, the analysis becomes more difficult.

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§3.22 2. Applying Boot-Netting Rules

After characterizing the money or other property given and received by the taxpayer as cash boot or mortgage boot, the attorney must apply a set of principles sometimes referred to as the "boot-netting" rules. These rules are summarized in §§3.23-3.29. The rules determine whether and to what extent the taxpayer recognizes gain in the transaction. A thorough understanding of the boot-netting rules along with proper tax planning and documentation can often reduce or eliminate the recognition of gain without any other economic impact on the taxpayer.

To understand and apply the boot-netting rules, the attorney should remember the following rule of thumb: Taxpayers cannot accomplish a fully like-kind exchange under IRC §1031 if they exit the transaction with cash (with the possible exception of loan proceeds; see §§3.15-3.18, 3.54-3.58). This rule helps explain why mortgage boot received by the taxpayer can be offset by cash or mortgage boot given (see §§3.24-3.28), but cash boot received by the taxpayer usually may not be offset by cash and may never be offset by mortgage boot given. See §§3.25-3.29.

Many attorneys use the short-cut method described in §§3.30-3.32 when applying the boot-offset rules. To avoid an inaccurate result, attorneys should use this method only to double-check the more thorough method of computation, described in §§3.23-3.29.

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§3.23 a. Mortgage Boot Received May Be Offset by Mortgage Boot Given

Mortgage boot received may be offset by mortgage boot given. Reg §§1.1031(b)-1(c), 1.1031(d)-2, Examples 1-2; Rev Rul 79-44, 1979-1 Cum Bull 265. This rule permits a taxpayer to offset mortgage boot received (in the form of another party's payoff or assumption of existing liabilities of the taxpayer or acquisition of the taxpayer's property subject to existing liabilities) with mortgage boot given (in the form of the taxpayer's assumption of liabilities or taking property subject to liabilities).

EXAMPLE: If the taxpayer is relieved of liability on a $50,000 mortgage and assumes an $80,000 mortgage in the exchange, the $50,000 debt relief is treated as money received by the taxpayer, but is offset by the $80,000 mortgage assumed by the taxpayer, which is treated as money paid. The net effect is that the taxpayer has given $30,000 of mortgage boot.

Thus, net mortgage boot received or given is calculated by subtracting the amount of mortgage boot received from the amount of mortgage boot given. For other examples of calculations of net mortgage boot, see Reg §§1.1031(d)-2, Examples 1-2, 1.1031(k)-1(j)(3), Example 5.

For purposes of mortgage boot-netting, IRC §1031(d)'s cross-reference incorporation of IRC §357(c) results in a rule that the taxpayer is considered to have been relieved of a liability on the relinquished property whether the liability is assumed by the purchaser or is paid on acquisition. See also IRS Letter Ruling 9853028.

In a deferred exchange, mortgage boot received (debt relief) is not recognized until the replacement property is acquired and the mortgage boot is given, on the premise that the consequences of the exchange remain open until the taxpayer acquires the replacement property and completes the exchange. See Reg §1.1031(k)-1(d)(1), Example 5; *Starker v U.S.* (9th Cir 1979) 602 F2d 1341, 1356. This issue has particular application to partnerships and is discussed in that context in chapter 7.

In an exchange of multiple properties, the determination and allocation of net mortgage boot is governed by the special rules of Reg §1.1031(j)-1(b)(2)(ii). See §§3.39-3.40.

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§3.24 b. Net Mortgage Boot Received May Be Offset by Cash Boot Given

Net mortgage boot received may also be offset by cash boot given, which permits a taxpayer to invest cash in an exchange to offset debt relief. Reg §§1.1031(b)-1(c), 1.1031(d)-2, Example 2(c); Rev Rul 79-44, 1979-1 Cum Bull 265.

EXAMPLE: If the taxpayer is relieved of an $80,000 mortgage on relinquished property but pays $100,000 cash (or executes a note for $100,000) in connection with acquisition of replacement property in the exchange, the money that the taxpayer receives in the form of debt relief is offset by the cash consideration (or promissory note) that the taxpayer gives in the exchange. The result is $20,000 of net boot given.

In this example, a note given by the taxpayer offsets net mortgage boot received, without requiring the characterization of the note as cash boot or mortgage boot. Arguably, if this note constitutes mortgage boot (similar to preexisting indebtedness), it offsets the mortgage boot received, under the rule described in §3.23, with the same result.

Although Reg §§1.1031(b)-1(c) and 1.1031(d)-2, Example 2(c) address the situation in which the taxpayer gives mortgage boot by assuming an existing mortgage, they do not specifically address the situation in which the boot given by the taxpayer is in the form of a new promissory note payable to the seller. In an interesting—but ultimately inconsequential—exercise, the Tax Court initially concluded that new financing used to acquire replacement property could not serve as an offset against mortgage boot received on disposition of relinquished property. *Louis G. Wittig*, TC Memo 1995-461. This decision was withdrawn and has no surviving effect. The case illustrates the lack of direct authority on this point, however, with the cited portions of the regulations being indirect rather than direct authority. Fortunately for the taxpayer, the IRS has accepted the position that new financing used to acquire replacement property can offset mortgage boot received on disposition of relinquished property. IRS Letter Ruling 8003004. See also Rev Rul 79-44, 1979-1 Cum Bull 265.

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§3.25 c. Cash Boot Received May or May Not Be Offset by Cash Boot Given

One could logically conclude that any cash boot received should be offset by any cash boot given in an exchange. There is some support for this proposition in early authority:

- Revenue Ruling 72-456, 1972-2 Cum Bull 468, cites Reg §1.1031(d)-2, Example 2 for the proposition that, in computing gain realized and recognized in an exchange, money paid out offsets money received.
- In *Mercantile Trust Co.* (1935) 32 BTA 82, the IRS did not challenge the taxpayer's offset of cash boot received against sales expenses paid out.
- In *Franklin B. Biggs* (1978) 69 TC 905, aff'd (5th Cir 1980) 632 F2d 1171, a taxpayer was permitted to offset cash boot received in the form of a promissory note with cash boot paid in the form of money. *Biggs* is weak authority for offsetting cash boot received by cash boot given, however, because the cash boot-offset issue was neither raised by the IRS nor squarely confronted by the court. See also *Earlene T. Barker* (1980) 74 TC 555.

Before 1991, all analysis of the effect of cash boot occurred in the context of simultaneous exchanges. At its core, the principle that cash boot given can be offset by cash boot received stems from the principle that money is fungible and that if a taxpayer simultaneously receives from and transfers to the same party an equal amount of money, nothing has been realized.

The adoption of Reg §1.1031(k)-1(j)(3) in 1991 created significant uncertainty on this issue. Example 2 of this regulation provides that a taxpayer is not permitted to offset cash received on transfer of relinquished property with cash given by the taxpayer at a later point in a deferred (nonsimultaneous) exchange. In this example, the taxpayer's receipt of $10,000 on transfer of the relinquished property is not offset by the taxpayer's payment of $10,000 almost 4 months later in connection with acquisition of replacement property. Instead, the taxpayer is required to recognize $10,000 of gain. Sections 3.26-3.28 discuss scenarios in which this rule may come into play.

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§3.26 (1) Option Payments and Other Cash Received Before Exchange

Frequently, a taxpayer receives cash from a potential buyer either as consideration for an option to purchase the property at a later date or as an earnest money deposit. The taxpayer may receive these funds before a like-kind exchange of the subject property is being considered, or in anticipation of a like-kind exchange. A careful analysis of the tax effect of the payment is necessary at each stage of the transaction to ascertain when, and if, the payment is treated as income to the seller.

The general rule for option payments is that their receipt is not an income-recognition event until the option transaction is complete either by sale of the property or by expiration of the option. Similar rules apply to an earnest money deposit made in consideration of a purchase and sale agreement: The payment is not income to the seller until the transfer contemplated by the contract has been executed. IRC §1234.

EXAMPLE 1: Buyer and taxpayer enter into an option agreement on 1/1/X1 for Whiteacre, a parcel of raw land in which the taxpayer has a basis of $90,000, which is being held for investment purposes. In consideration for taxpayer's agreement to convey Whiteacre to buyer at any time on or before 12/31/X2, buyer makes a nonrefundable payment of $10,000 to taxpayer. Buyer and taxpayer agree that the payment will be a credit against the purchase price if buyer exercises the option before it expires. If so, taxpayer does not recognize income on receipt of the option payment. IRC §1234.

These rules do not change when a taxpayer anticipates undertaking a like-kind exchange but has not yet conveyed the relinquished property to the buyer. Receipt of cash before a like-kind exchange neither results in income to the seller nor "taints" the cash as boot for IRC §1031 purposes. If the seller subsequently conveys both the option payment or earnest money proceeds to a qualified intermediary (QI) before or concurrent with the conveyance of the relinquished property, and the QI subsequently exchanges the relinquished property and the proceeds of the option payment or earnest money deposit for a replacement property that is conveyed to the taxpayer, then the cash will not be treated as cash boot received for §1031 purposes.

EXAMPLE 2: Assume the same facts as in Example 1, except that on 6/1/X2, buyer exercises the option right to purchase Whiteacre for $100,000. In anticipation of the sale of the property to the buyer, taxpayer enters into an exchange agreement with QI meeting the requirements of Reg §1.1031(k)-1(g) and concurrently transfers $10,000 to QI, who subsequently gives the buyer a $10,000 credit, and conveys Whiteacre to buyer for $90,000 cash. Taxpayer later identifies replacement property and QI purchases it on taxpayer's behalf for $100,000 cash, using the $10,000 transferred to QI by taxpayer and the $90,000 paid by buyer. Result: Taxpayer realizes gain of $10,000, but no gain is recognized. See IRS Letter Ruling 7952086.

Crucial to this analysis is the taxpayer's transfer of the option or deposit money to the QI *before the exchange*. If the taxpayer does not convey the option proceeds to the QI before the exchange, the cash option or earnest money payment would be treated as boot. If, in this example, the taxpayer did not transfer $10,000 to the QI, and instead purchased replacement property for $100,000 with $90,000 cash proceeds from sale of the relinquished property and $10,000 mortgage loan proceeds on the replacement property, the taxpayer would have cash boot of $10,000 in the exchange and, thus, have realized and recognized gain of $10,000.

A taxpayer who receives option payments from the buyer of the relinquished property and retains the payments following transfer of the property must treat the option payments as cash boot in the year of the exchange. See IRS Letter Ruling 9413024. For methods of minimizing cash boot received, see §3.57.

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§3.27 (2) Cash Received During Exchange

The issue of whether cash boot received in a deferred exchange may be offset with cash boot given is resolved against the taxpayer in Reg §1.1031(k)-1(j)(3), Example 2. In effect, the regulation provides that cash received by a taxpayer on transfer of relinquished property but before acquisition of the replacement property in a deferred exchange is "tainted" and cannot be offset by cash given or otherwise paid during the exchange transaction.

One could reasonably argue that this result occurs only in deferred exchanges when the taxpayer is allowed the use of relinquished property exchange proceeds before acquiring the replacement property. The taxpayer should be able to offset cash boot received against cash boot given in a concurrent exchange, because the offsetting does not thwart the continuity-of-investment rationale for exchanges. See §1.7. Under the same principle, the taxpayer arguably should be permitted to offset cash boot "received" in a deferred (nonsimultaneous) exchange, if the cash boot was not actually or constructively received by the taxpayer *before* the taxpayer received the replacement property. This idea has not been endorsed by the Internal Revenue Service or any court, however. Thus, the attorney planning a like-kind exchange transaction for maximum tax deferral should structure the exchange to minimize the taxpayer's receipt of cash boot. See §3.57.

Virtually all exchanges involve some cash boot in both disposition of relinquished property and acquisition of replacement property, such as proration items (*e.g.,* mortgage interest, property taxes, insurance), security deposits, and other items deducted from the exchange equity that are not transactional expenses. These items, which are treated independently of the exchange under general tax principles, are generally offset by a corresponding deduction under IRC §162 (expenses), §163 (interest), or §164 (taxes). When no corresponding deduction offsets the boot received, however, gain recognition will be avoided only if cash boot received on one side of the exchange is offset by cash boot given on the other. To date no authority directly reaches this result.

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§3.28 (3) Cash Received After Exchange

It is unclear whether a taxpayer may use cash boot given in the exchange to offset cash boot that is received after the transaction has been completed, *e.g.,* a refund from escrow following acquisition of the replacement property. Because such a receipt of funds more closely resembles reimbursement for amounts previously paid than the receipt of cash boot, it may avoid the "taint" associated with an early receipt of cash discussed in §3.26. Although not free from doubt, taxpayers may consider treating any cash received after completion of the exchange as a reimbursement of cash paid before or during the exchange. See *Franklin B. Biggs* (1978) 69 TC 905, aff'd (5th Cir 1980) 632 F2d 1171.

If cash boot is received after completion of the exchange transaction, but the taxpayer gave no cash boot before or during the exchange, the offset issue does not arise and the receipt of cash boot is taxable under the general rule of IRC §1031(b).

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§3.29 d. Cash Boot Received May Not Be Offset by Mortgage Boot Given

Cash boot received may *not* be offset by mortgage boot given. Reg §1.1031(d)-2, Example 2(c); *Coleman v Commissioner* (8th Cir 1950) 180 F2d 758; Rev Rul 79-44, 1979-1 Cum Bull 265.

EXAMPLE 1: Taxpayer who receives $40,000 in cash in the exchange but also assumes a liability of $40,000 is treated as having received $40,000 net cash boot and recognizes gain in that amount as long as realized gain equals or exceeds $40,000. Reg §1.1031(d)-2, Example 2(c).

This rule is easy to understand in light of the general rule that an exchange cannot be fully like-kind if the taxpayer exits the transaction with cash. See §3.22. See also *Frederick W. Behrens,* TC Memo 1985-195, aff'd without published opinion (8th Cir 1986) 786 F2d 1170, discussed in §3.17.

An installment note received by the taxpayer is also treated as cash boot received that may *not* be offset by mortgage boot given. See IRC §453(f)(6), discussed in §§3.44-3.45.

EXAMPLE 2: Taxpayer receives a $40,000 installment note on the transfer of the relinquished property as part of the exchange and assumes a liability of $40,000. The installment note is treated as cash boot received by the taxpayer. Taxpayer realizes gain to the extent of the $40,000 note received but may be entitled to recognize the gain on the installment method under IRC §453. See §3.47.

If taxpayer transferred the relinquished property subject to existing indebtedness (or transferee assumed taxpayer's liability), taxpayer would be entitled, under the rule described in §3.22, to offset this mortgage boot received by the mortgage boot given. Thus, the tax consequences of receiving a new promissory note and being relieved of preexisting indebtedness significantly differ.

For methods of minimizing the impact of the rule that cash boot received may not be offset by mortgage boot given, see §§3.54-3.58.

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§3.30 3. Short-Cut Method for Applying Boot-Netting Rules

Planners have developed a short-cut method for applying the boot-netting rules to ascertain whether gain must be recognized in a like-kind exchange that meets all the technical requirements of IRC §1031(a) and, if so, the amount of recognized gain. The calculation is necessary only when a taxpayer realizes gain. The short-cut calculations in §§3.31-3.32 should be used only to double check the application of the boot-netting rules described in §§3.22-3.29, not as a substitution for those calculations.

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§3.31 a. General Rule for Avoiding Gain Recognition in Exchanges

If gain will be realized, the exchange is generally fully tax-deferred (*i.e.,* no gain will be recognized unless depreciation or depletion recapture rules apply) if the taxpayer trades even or up in

- value (*i.e.,* the fair market value of the replacement property equals or exceeds that of the relinquished property reduced by selling costs); *and*
- equity (*i.e.,* all the taxpayer's equity in the relinquished property is either invested in the replacement property or used to pay transactional expenses).

A taxpayer who trades even or up in value and equity will not receive net mortgage boot (debt relief), because a greater amount of cash boot or mortgage boot must be given to acquire the more valuable replacement property and trade even or up in value. As discussed in §§3.22-3.23, mortgage boot received may be offset by either cash boot or mortgage boot given.

EXAMPLE 1: A taxpayer transfers relinquished property with a fair market value of $100,000 and a basis of $50,000, subject to a $20,000 mortgage (realized gain of $50,000 and equity of $80,000), and receives replacement property with a fair market value of $110,000, free and clear of indebtedness. To complete the exchange, the taxpayer must give $30,000 cash boot or mortgage boot (either preexisting debt or new financing) to balance the equities and trade up in value. If the taxpayer does not receive cash, actually or constructively, for any of the $80,000 equity in the relinquished property, the taxpayer will have a fully tax-deferred exchange. The same result would occur if the replacement property were subject to a mortgage of $30,000 or more.

EXAMPLE 2: On the same facts as in Example 1, the taxpayer takes the replacement property subject to a $40,000 mortgage. Taxpayer has exchanged up in value but down in equity and will need to receive $10,000 cash to make this an economically equal exchange. This will result in net cash boot received and gain recognized because realized gain exceeds the net boot received.

EXAMPLE 3: On the same facts as in Example 1, the replacement property is worth only $90,000. Taxpayer pays $10,000 additional consideration to complete the transaction. Taxpayer has exchanged up in equity but down in value. The $10,000 cash boot given only partially offsets the $20,000 mortgage boot received, resulting in $10,000 net boot received. This will also result in gain recognized.

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§3.32 b. Calculating Amount of Recognized Gain

When the taxpayer trades down in either value or equity, a second rule is applied to calculate the amount of gain recognized. The amount of the recognized gain will always be the greater of the amounts traded down (value or equity) but not more than the realized gain.

EXAMPLE: A taxpayer transfers relinquished property worth $100,000, subject to a $20,000 mortgage (equity of $80,000), and receives replacement property worth $90,000, subject to a $25,000 mortgage (equity of $65,000), and $15,000 in cash.

	Relinquished Property	**Replacement Property**
Fair Market Value	$100,000	$90,000
Debt	–20,000	–25,000
Equity	$80,000	$65,000
Cash to Equalize		$15,000

The taxpayer trades down in value by $10,000 ($100,000 less $90,000) and trades down in equity by $15,000 ($80,000 less $65,000). Thus, the taxpayer will recognize gain in the amount of $15,000, representing the greater of the amounts traded down, if there is realized gain of at least that amount. Under a full analysis, the taxpayer receives cash boot of $15,000 and gives net mortgage boot of $5000 ($25,000 mortgage boot given less $20,000 mortgage boot received). Mortgage boot given does not offset cash boot received. See §3.28. Thus, the taxpayer recognizes gain of $15,000 in the full amount of the cash boot received and receives a basis increase of $5000 because of the net mortgage boot given. See §3.58.

The taxpayer should be permitted to use transactional expenses to offset a trade-down in value or equity. See §3.5. To the extent that Reg §1.1031(k)-1(j)(3), Example 2, applies, however, the cash boot received cannot be offset. The regulation would not apply if the transaction involved net mortgage boot received but no cash boot received. In addition, it may not apply to concurrent exchanges or deferred exchanges in which the taxpayer does not actually or constructively receive cash boot before acquiring the replacement property. Proration items such as property taxes, interest, insurance, and, in some cases, security deposits, which are paid at closing, are not transactional items and may result in cash boot received. See §3.29.

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§3.32A 4. Special Rules for Partnerships and Their Partners, With Offsetting Mortgage Boot

Because of the interplay of IRC §1031 and IRC §752 (dealing with the taxation of partnerships and partners when there has been a change in the liabilities of the partnership), until recently there have been no guidelines on (1) how a partnership should account for the offsetting of "mortgage boot given" and "mortgage boot received" if these two events occur in different tax years or (2) when partners should treat the reduction or increase in their share of partnership liabilities resulting from a tax-deferred exchange as having occurred.

In 2003, the IRS issued Rev Rul 2003-56, 2003-1 Cum Bull 985, which provides guidance in these areas. This revenue ruling provides that if the exchange straddles two tax years, then the excess of mortgage boot received (the net between the [greater] debt on the relinquished property and the [lesser] replacement property) is treated as money or other property received in the first tax year of the transaction because the excess is attributable to the disposition of the relinquished property. Gain resulting from the receipt of such mortgage boot must be recognized and realized for that tax year.

If there is a net reduction in liabilities (because the amount of mortgage boot received is greater than the amount of mortgage boot given), then this difference is treated, under IRC §752(b) as a deemed distribution of money to the partner(s). This deemed distribution is treated as having been made in the first year in which the exchange transaction occurs.

If, on the other hand, there is a net increase in liabilities (because the amount of mortgage boot given on the replacement property exceeds the amount of mortgage boot received on the relinquished property), then each partner will be allocated its share of the total net increase in liabilities in the second year of the transaction (when the replacement property is acquired).

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§3.33 D. Recognizing Gain or Loss on Transfer of Nonqualifying Property

If the taxpayer transfers property in an exchange that is not like in kind to the property received, is not held for investment or use in a trade or business, or is statutorily excluded by IRC §1031(a)(2) in addition to the like-kind qualified use property, the taxpayer generally recognizes a gain or loss on the nonqualifying property as if it had been sold. See Reg §§1.1031(a)-1(a)(2), 1.1031(d)-1(e). See also *R & M Prop. Co.* (1932) 27 BTA 436. This gain or loss is recognized regardless of whether the taxpayer recognizes all or any part of the gain on the transfer of the qualifying property. IRC §1031.

The same is true if the exchange is a multiple property exchange, as defined in Reg §1.1031(j)-1(a)(1). For a detailed discussion of multiple property exchanges, see §§3.36-3.42.

If the exchange is between related parties as defined in IRC §267(b), the taxpayer is prohibited from deducting any loss realized, even a loss on the transfer of nonqualifying property. IRC §267(a). See §3.35.

If the nonqualifying property disposed of by the taxpayer is the taxpayer's personal residence, the first $250,000 of taxable gain ($500,000 if the taxpayer is a married couple filing a joint return) may still be excluded under IRC §121. See also §2.38.

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E. Recognizing Gain or Loss in Related-Party Exchanges

§3.34 1. IRC §1031(f) Transactions

When a taxpayer engages in a like-kind exchange with a related person, both the relinquished property and the replacement property are subject to a 2-year holding requirement. IRC §1031(f). See §§2.70-2.83. For this purpose, "related person" means anyone with a relationship to the taxpayer as described in IRC §267(b) or §707(b)(1). See §2.71. If the taxpayer disposes of the replacement property (or the related person disposes of the taxpayer's relinquished property) within 2 years after the date of the last transfer that is part of the exchange between them, the taxpayer must recognize gain or loss realized on the transfer of the relinquished property, but only as of the date on which the subsequent disposition occurs. As a result, the taxpayer will not be required to amend his or her tax return for the year in which the exchange occurred but must report the original gain or loss in the year in which the disqualifying disposition occurs. See §2.77.

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§3.35 2. Boot in Exchanges of Depreciable Property Between Related Parties

Internal Revenue Code §1239(a) generally requires any gain recognized in an exchange of depreciable property between related persons to be treated as ordinary income. For this purpose, "related persons" generally means

- the taxpayer and a trust in which the taxpayer (or the taxpayer's spouse) is a beneficiary (IRC §1239(b)(2));
- the taxpayer and a partnership or corporation, more than 50 percent of which is owned by or for the taxpayer (IRC §1239(b)(1), (c)(1)(A)-(B));
- two entities of which the same person owns more than 50 percent (IRC §1239(b), (c)(1)(C)); or
- an executor of an estate and a beneficiary of such estate, except for a sale or exchange in satisfaction of a pecuniary bequest (IRC §1239(b)(3)).

Although IRC §1239 applies only to recognized gain and thus should not apply in a fully tax-deferred exchange (see IRS Letter Ruling 8038099), it may be applicable when an exchange between related parties is not fully tax-deferred. See, *e.g.,* §3.29.

WARNING: Taxpayers should exercise caution in undertaking exchanges with relatives or affiliated corporations or partnerships, even if the exchange is structured to be totally tax-deferred. All the taxpayer's recognized gain may be treated as ordinary income rather than capital gain if the exchange is later challenged and disqualified or if the exchange falls within IRC §1031(f) but the 2-year holding period is not satisfied. See IRC §1239(a).

No deduction is allowed for losses from the sale or exchange of property between certain related persons. IRC §267(a). For this purpose, "related person" means anyone bearing a relationship to the taxpayer described in IRC §267(b) (see §2.71). This rule should have no effect on most exchanges because IRC §1031(c) specifically precludes any loss deductions on like-kind exchanges. The rule will, however, preclude the taxpayer from deducting any loss on the transfer of nonqualifying property in an exchange between related persons. See §3.34. Further, if an exchange between related persons is disqualified, the taxpayer is precluded by IRC §267 from taking any loss deduction on the transfer of qualifying property.

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§3.36 F. Calculating Recognized Gain or Loss in Multiple Property Exchanges

Special rules govern the computation of recognized gain and the calculation of basis when a transaction qualifies as a multiple property exchange under Reg §1.1031(j)-1(a):

- The taxpayer relinquishes at least one qualifying property and receives two or more replacement properties of like kind or like class;
- The taxpayer relinquishes two or more qualifying properties of like kind or like class and receives at least one replacement property of the same kind or class; or
- The taxpayer relinquishes two or more qualifying properties of different kinds or classes and receives qualifying replacement properties of like kind or like class to at least two of the different types of relinquished property.

The major impact of the multiple property exchange rules of Reg §1.1031(j)-1 is the need to analyze separately the personal property components of all exchanges, even those involving predominantly real property. There is no de minimis rule for the transfer and receipt of small amounts of like-kind or like-class personal property in an exchange that involves predominantly real property.

WARNING: In this regard, practitioners should note that the "incidental property rule" of Reg §1.1031(k)-1(c)(5) applies only in ascertaining whether personal property to be acquired as replacement property in a nonsimultaneous real property exchange must be separately identified in the taxpayer's written notice describing the replacement property. This rule does not mean that a taxpayer who receives "incidental property" within the meaning of Reg §1.1031(k)-1(c)(5) is excused from the multiple property exchange rules of Reg §1.1031(j)-1. Thus, if an exchange involves the transfer and receipt of any like-kind or like-class personal property, no matter how minimal, the multiple property analysis must be used to calculate the gain realized and recognized from the disposition of personal property.

For a definition of "like-class property," see §2.49. For further discussion of the incidental property rule, see §4.27 in connection with deferred exchange.

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§3.37 1. Effect of Multiple Property Exchange Rules

An exchange of personal property with real property often requires the reporting of some gain or loss. Gain may be recognized when a share of excess liabilities assumed is allocated to personal property if the exchange is predominantly of real property but includes an exchange of like-kind or like-class personal property. See §3.40. Alternatively, gain may be recognized if the taxpayer transfers some personal property without receiving any personal property of like-kind or like-class and the value of the personal property transferred exceeds its basis. Under general rules applicable to losses in nonexchange transactions, a taxpayer who realizes a loss on the disposition of personal property that is not exchanged for personal property of like-kind or like-class, may recognize the loss as if the property transferred were sold. See §3.34.

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§3.38 a. Step One: Allocating Property to Exchange Groups

The first step in calculating recognized gain and new basis in an exchange of multiple properties is to separate the properties into exchange groups. Reg §1.1031(j)-1(a)(2), (b)(2). An exchange group consists of all properties relinquished and all properties acquired in the exchange that are of like-kind or like-class. Reg §1.1031(j)-1(b)(2)(i). On like-class property, see §2.49. Each exchange group must include at least one relinquished property and one replacement property. Reg §1.1031(j)-1(b)(2)(i). Property is not eligible for inclusion in an exchange group if it is of a type excluded from like-kind exchange treatment by IRC §1031(a)(2) (*e.g.,* stocks, bonds, partnership interests). Reg §1.1031(j)-1(b)(2)(i). For discussion of excluded property, see §§2.6-2.18.

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§3.39 b. Step Two: Creating Residual Group

The second step in analyzing a multiple property exchange is to create a residual group. Reg §1.1031(j)-1(a)(2). A residual group must be used if the aggregate fair market value of the relinquished property in all exchange groups does not equal the aggregate fair market value of the replacement property in all exchange groups. The taxpayer must allocate to a residual group either (a) an amount of money or other property *received* by the taxpayer in the exchange, having an aggregate fair market value equal to that difference; or (b) an amount of money or other property *relinquished* by the taxpayer in the exchange, having an aggregate fair market value equal to the difference. Reg §1.1031(j)-1(b)(2)(iii). For this purpose, "other property" includes the following:

- Property described in IRC §1031(a)(2) (*e.g.,* stocks, bonds, choses in action, notes, partnership interests; see §§2.6-2.18; see also Reg §1.1031(j)-1(b)(2)(ii)(C), discussed in §3.40);
- Property transferred by the taxpayer that is not of a like kind or like class with any property received by the taxpayer in the exchange; and
- Property received by the taxpayer that is not of a like kind or like class with any property transferred by the taxpayer in the exchange.

The money and other property are allocated to the residual group from the asset classes mandated by Reg §§1.338-6(b), 1.1031(j)-1(b)(2)(iii).

- First from Class I assets (*e.g.,* cash and demand deposits);
- Second from Class II assets (*e.g.,* certificates of deposit and readily marketable stocks);
- Third from Class III assets (*i.e.,* assets that are annually marked to market, including most debt instruments not involving related parties or convertible debt);
- Fourth from Class IV assets (*i.e.,* inventory and stock in trade);
- Fifth from Class V assets (*i.e.,* all assets other than Class I, II, III, IV, VI, and VII assets);
- Sixth from Class VI assets (*i.e.,* intangible assets subject to IRC §197 except those in the nature of goodwill and going concern value); and
- Seventh from Class VII assets (*i.e.,* intangible assets in the nature of goodwill and going concern value). See Reg §1.1060-1(d), Example 1.

These allocation rules apply to asset transactions completed on and after March 16, 2001. For asset acquisitions completed after January 5, 2001, until March 15, 2001, former Temp Reg §1.1060-1T was applicable. For asset acquisitions completed before February 14, 1997, there was no distinction between Classes V through VII.

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§3.40 c. Step Three: Offsetting Liabilities

The third step in analyzing gain recognition consequences of a multiple property exchange is to calculate the taxpayer's net liabilities. Reg §1.1031(j)-1(a)(2). All liabilities assumed by the taxpayer as part of the transaction and liabilities subject to which the taxpayer acquires property are offset against all liabilities of which the taxpayer is relieved as part of the transaction. Reg §1.1031(j)-1(b)(2)(ii)(A). The terms "assumed" and "relieved" include liabilities subject to which a taxpayer acquires a property. Reg §1.1031(j)-1(b)(2)(ii). Moreover, the liability offset process applies regardless of whether the liabilities are recourse, nonrecourse, secured by specific exchange property, or unsecured. Reg §1.1031(j)-1(b)(2)(ii)(A).

If the aggregate amount of the liabilities assumed exceeds the aggregate amount of the liabilities of which the taxpayer is relieved, the excess liabilities assumed (*i.e.,* net mortgage boot given) are allocated among the exchange groups in proportion to the aggregate fair market value of the properties received by the taxpayer in each exchange group; however, the amount of excess liabilities allocated to each exchange group may not exceed the aggregate fair market value of the replacement property in that group. Reg §1.1031(j)-1(b)(2)(ii)(B).

If the liabilities of which the taxpayer is relieved in the exchange exceed the liabilities assumed by the taxpayer, the excess (net mortgage boot received) is treated as a Class I asset (cash and demand deposits) for purposes of allocating property to the residual group, as discussed in §3.39. Reg §1.1031(j)-1(b)(2)(ii)(C).

If the exchange is part of a larger transaction, excess liabilities are calculated as provided in Reg §1.1031(j)-1(b)(2)(ii)(D). In some circumstances, unexpected boot consequences can arise owing to mandatory allocation of liabilities on the basis of the relative fair market values of exchange groups, such as, *e.g.,* when debt secured only by real property must be allocated between real and personal property groups in an exchange.

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§3.41 d. Step Four: Calculating Gain or Loss in Each Group

The fourth step in analyzing a multiple property exchange is to apply the general rules of IRC §1031 separately to each exchange group to calculate the amount of gain realized and recognized in the exchange. Realized gain or loss is calculated for each exchange group by computing the aggregate fair market value of the properties transferred in that group and the properties' aggregate adjusted basis. See §3.4.

Gain is recognized in each exchange group to the extent of any "exchange group deficiency," but the gain recognized may not be more than the amount of gain realized with respect to the group. Reg §1.1031(j)-1(b)(2)(iv), (j)-1(b)(3). An exchange group deficiency is the excess of the aggregate fair market value of the properties transferred in an exchange group over the aggregate fair market value of the properties received in an exchange group (less excess liabilities assumed by the taxpayer that are allocated to the group). Reg §1.1031(j)-1(b)(2)(iv).

Under the general principles of IRC §1031(a) and (c), losses realized in an exchange group are not recognized. See also Reg §1.1031(j)-1(b)(2)(iv).

An "exchange group surplus" will exist if the aggregate fair market value of the properties received (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group) exceeds the aggregate fair market value of the properties transferred in that group. Reg §1.1031(j)-1(b)(2)(iv). An exchange group surplus will increase the basis of property received in the exchange. Reg §1.1031(j)-1(c). See §3.62 for an explanation of how basis is allocated among multiple replacement properties under Reg §1.1031(j)-1(c).

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§3.42 2. Recognizing Gain or Loss in a Residual Group

Recognized gain or loss in the residual group is calculated under general rules applicable to gains and losses in other transactions. Reg §§1.338-6(b), 1.1031(j)-1(b)(2)(iii). Realized and recognized gain or loss on disposition of the other property, if any, that falls within neither the residual group nor the exchange groups is also computed under such general rules. Reg §1.1031(j)-1(b)(3)(ii).

EXAMPLE 1:

U transfers the following items to V:

Item	Fair Market Value	Adjusted Basis	Liabilities
Real Estate A	$5,000	$2,000	
Real Estate B	$13,500	$8,000	
Grader A	$2,000	$500	
TOTAL	$20,500	$10,500	$0

And V transfers the following items to U:

Item	Fair Market Value	Adjusted Basis	Liabilities
Real Estate R	$26,500	$20,000	$7,000
Railroad Car R	$1,000	$1,200	$0
TOTAL	$27,500	$21,200	$7,000

With respect to U, the analysis of this exchange is as follows:

a. Real Estate A, B, and R are of like-kind and comprise one exchange group. The amount of gain realized is the excess of the aggregate fair market value of the real estate relinquished over the aggregate adjusted basis of the properties, or $8500. The amount of gain recognized is the lesser of the gain realized ($8500) or the exchange group deficiency ($0), or $0.

b. The exchange group has a surplus of $1000 because the fair market value of the properties relinquished exceeds the fair market value (net of liabilities) of the property received by $1000. This amount is allocated to a residual group which consists of one-half the value and one-half the basis of Grader A. The amount of gain realized with respect to the residual group is the excess of the fair market value of the allocable portion of Grader A ($1000) over its adjusted basis ($250), or $750.

c. Grader A (North American Industrial Classification System Code 333120; see §2.49) and Railroad Car R (General Asset Class 00.25) are not like-kind and gain realized on the exchange of these assets is not deferred under IRC §1031(a). The portion of Grader A which has not been allocated to the residual group (*e.g.,* $1000) is considered to have been exchanged for Railroad Car R in a taxable exchange. This results in gain realized of $1000. Since U's adjusted basis in Grader A is $500, one-half of which is allocated to the residual group, U recognizes gain of $750 on the taxable exchange of Grader A ($1000 amount realized less $250 adjusted basis). Ultimately, therefore, all $1500 of the inherent gain attributable to Grader A is recognized.

d. The basis of the property received (*i.e.,* the replacement property) in the exchange group is the aggregate adjusted basis of the property transferred (*i.e.,* the relinquished property, $10,000), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of exchange group surplus ($1000) and increased by the amount of excess liabilities assumed allocated to the exchange group ($7000), or $18,000. Because real estate is the only property received within the exchange group, the entire basis is allocated to Real Estate R.

With respect to V, the analysis is as follows:

e. Real Estate A, B, and R are like-kind and comprise one exchange group. The amount of gain realized is the excess of the aggregate fair market value of the real estate relinquished (R, $26,500) over its adjusted basis ($20,000), or $6500. The amount of gain recognized is the lesser of the gain realized ($6500) or the exchange group deficiency ($8000), or $6500.

f. Because V has no exchange group surplus, there is no residual group and, therefore, no recognition of residual group gain or loss.

g. With respect to the taxable exchange of Railroad Car R for the 50-percent portion of Grader A not allocated to the residual group, V realizes and recognizes a loss of $200, which is the excess of the adjusted basis of Railroad Car R ($1200) over the amount realized of $1000 (the portion of the fair market value of Grader A not allocated to the residual group).

h. The basis of the property received (*i.e.,* the replacement property) in the exchange group is the aggregate adjusted basis of the property transferred (*i.e.,* the relinquished property, $20,000), increased by the amount of gain recognized with respect to that exchange group ($6500), and decreased by the amount of exchange group deficiency ($8000). The $18,500 of basis is allocated among the assets in the exchange group pro rata according to their fair market values. Thus, V's basis in Real Estate A is $5000 ($18,500 × $5000/$18,000) and in Real Estate B is $13,500 ($18,500 × $13,500/$18,500).

EXAMPLE 2:

J transfers to H the following items:

Item	Fair Market Value	Adjusted Basis
Computer A	$5,000	$1,500
Computer B	$3,000	$500
Printer C	$1,500	$2,000
Real Estate D	$2,000	$1,200
Real Estate E	$1,800	$0
Scraper F	$2,500	$3,300
Inventory	$1,700	$1,000
TOTAL	$17,500	$9,500

And H transfers to J the following items:

Item	Fair Market Value
Computer Z	$4,500
Printer Y	$2,500
Real Estate X	$1,000
Real Estate W	$4,000
Grader V	$2,000
Truck T	$1,700
Cash	$1,800
TOTAL	$17,500

The analysis of the exchange is as follows:

a. There are three exchange groups and a residual group. The first exchange group consists of computers and printers A, B, C, Z, and Y because all are within the same General Asset Class. As to this group, there is an exchange group deficiency of $2500 because the fair market value (FMV) of the assets transferred exceeds the FMV of the assets received. The amount of gain realized for this group is the excess of FMV of the properties transferred over the aggregate adjusted basis of the transferred properties ($9500 – $4000 = $5500 gain realized). The amount of gain recognized is the lesser of the gain realized ($5500) or the exchange group deficiency ($2500) or $2500.

b. The second exchange group consists of real estate D, E, X, and W because all are like-kind. As to this group, there is an exchange group surplus of $1200 and gain realized of $2600 (aggregate FMV of transferred properties of $3800 less their aggregate adjusted basis of $1200). The gain recognized is the lesser of the gain realized ($2600) or the exchange group deficiency ($0) or $0.

c. The third exchange group consists of graders F and V, which has a deficiency of $500. This group realizes a loss of $800 (aggregate adjusted basis of $3300 over aggregate FMV of properties received $2500). Under IRC §1031(a) and (c), this loss cannot be recognized.

d. Because the aggregate FMV of the property transferred exceeds the aggregate FMV of the property received by $1800, there is a residual group in that amount which consists of $1800 cash. The exchange includes the taxable exchange of inventory, which is excluded property under IRC §1031(a)(2) for Truck T, which is not like-kind to any other property transferred in the exchange.

e. The aggregate amount of gain recognized by J is the sum of the gains recognized under IRC §1031 with respect to each exchange group ($2500) and any gain recognized outside of §1031 ($700) or $3200.

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G. Reporting Recognized Gain on Installment Method

§3.43 1. Availability of Installment Method in Exchange

Often a taxpayer receives a promissory note secured by a deed of trust or mortgage as part of the consideration for the relinquished property in a like-kind exchange. If the transaction qualifies as an installment sale under IRC §453(b)(1), the taxpayer may report the gain applicable to the note on the installment sale method under IRC §453(a). See §1.25.

An installment sale is a disposition of property in which at least one payment is to be received after the close of the taxable year in which the disposition occurs (except that dispositions by dealers and dispositions of personal property inventory do not qualify as installment sales). IRC §453(b). Under IRC §453, the term "payment" does not include "the receipt of evidences of indebtedness of the person acquiring the property." IRC §453(f)(3). Thus, the taxpayer's receipt of the note does not itself constitute receipt of payment if the note is executed by "the person acquiring the property."

If the taxpayer uses a qualified intermediary in a deferred or simultaneous exchange, the taxpayer may receive the note from the intermediary or the intermediary's transferee and still qualify for installment sale reporting. Reg §§1.1031(b)-2(b), 1.1031(k)-1(j)(2). The IRS adopted these regulations to permit installment sale reporting when the taxpayer completes a like-kind exchange with an intermediary but receives a note executed by the actual buyer instead of the intermediary, who is treated as the buyer under the construct provided by Reg §1.1031(k)-1(g)(4).

The taxpayer usually benefits from using the installment method because gain attributable to the installment note is reported only as the taxpayer receives payments of principal under the note. Interest received on the note is taxable under the general principles of IRC §§1, 61(a), and 63. A taxpayer may wish to report all recognized gain in the taxable year of the exchange if he or she has offsetting losses in that year or anticipates being in a higher tax bracket in succeeding years. The taxpayer may do this by electing out of the installment method under IRC §453(d).

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Source: Real Property/Real Property Exchanges/3 Tax Consequences of Like-Kind Exchanges/§3.44 2. Interplay of IRC §§453 and 1031

§3.44 2. Interplay of IRC §§453 and 1031

The same items must be computed to report gain on the installment method in a like-kind exchange as in a sale transaction: selling price, contract price, gross profit, and gross-profit ratio.

In applying the installment reporting rules, the attorney or accountant first determines the selling price. The selling price is the sum of the following:

- The face amount of the installment obligation (reduced by any imputed interest under IRC §483 or §1274);
- Any net qualifying indebtedness (a mortgage or other indebtedness encumbering the property and other indebtedness not secured by the property but incurred or assumed by the taxpayer incident to the taxpayer's purchase, holding, or operation of the property in the ordinary course of business) (Temp Reg §15A.453-1(b)(2)(iv));
- Cash received in excess of cash paid by the taxpayer; and
- The fair market value of any other boot received.

The contract price in an ordinary installment sale is the selling price reduced by that portion of any net qualifying indebtedness that does not exceed the seller's basis in the property. See Temp Reg §15A.453-1(b)(2)(iii).

Gross profit in an ordinary installment sale is the selling price less the adjusted basis of the property, which, for this purpose, is increased by commissions and other selling expenses. Temp Reg §15A.453-1(b)(2)(v). In most installment sales, the gross profit is the same as realized gain.

The gross profit ratio in an installment sale is the ratio of the gross profit to the contract price. Temp Reg §15A.453-1(b)(2)(i). In installment sale reporting, the gross profit ratio is applied to the payments received by the taxpayer in a particular year. The payments received by the taxpayer in the year of sale generally include the amount of the net qualifying indebtedness that exceeds the taxpayer's basis in the property sold.

Internal Revenue Code §453(f)(6) makes three significant changes to these installment method rules as they apply to a note received in a like-kind exchange:

- Total contract price is reduced by the amount of qualifying like-kind property received;
- Gross profit is reduced by gain not recognized because of the exchange (the deferred gain); and
- Qualifying, like-kind property that the taxpayer is entitled to receive in the exchange without recognition of gain is not considered "payment" under the installment reporting rules.

It is unclear whether the amount of mortgage exceeding basis constitutes a payment received in the year of a sale in a hybrid like-kind exchange/installment sale. In the authors' opinion, if all mortgage relief received in the transaction is offset by mortgage boot given in the exchange, any gain associated with an excess of mortgage over basis should be deferred under §1031's netting rules.

The general effect of these changes is to cause the gross profit ratio in any installment note received as boot in a like-kind exchange, when any gain recognition is deferred, to be 1.0, with the result that all principal payments received on such a note are taxable as gain. Only when like-kind property received in the exchange has a value less than the adjusted basis of the relinquished property will "excess basis" be allocable to the note and reduce the gross profit ratio below 1.0.

Former Prop Reg §1.453-1(f) provided detailed rules and many examples of the interplay between IRC §§453 and 1031. However, these rules were withdrawn in 1989 (see TD 8270, 1989-2 Cum Bull 83), and no replacements have been promulgated. There is thus a dearth of currently effective authority relating to the computations required under IRC §453(f)(6). In the absence of new rules, the authors believe it is reasonable to follow the rules established under the withdrawn regulations.

Under the withdrawn regulations, the nonrecognition rules of IRC §1031 were usually applied first. In establishing the character of notes received as boot in an exchange, the withdrawn regulations provided various rules:

- Selling price was the sum of the face value of the note, "net qualifying indebtedness," net cash received, and fair market

value of other non-like-kind property received;

- Basis in the note consisted of "excess basis," defined as basis in relinquished property that exceeds the fair market value of like-kind replacement property received by the taxpayer;
- Total contract price was the selling price less net qualifying indebtedness that did not exceed excess basis; and
- Payments received in the year of sale included only the amount of net qualifying indebtedness that exceeds excess basis. In this formulation, "net qualifying indebtedness" is the excess of net mortgage boot received by the taxpayer less net cash boot paid by the taxpayer in the exchange.

It is important to reemphasize that these rules do not have the force of law. Because no other rules exist, however, they can serve as a guide. Applying these principles, a like-kind exchange coupled with an installment sale can be illustrated with the following examples:

EXAMPLE 1: Taxpayer exchanges real property with a fair market value of $1 million for replacement property with a fair market value of $800,000 and an installment note in the principal amount of $200,000, bearing adequate stated interest. Taxpayer's basis in the relinquished property is $400,000. Neither the relinquished property nor the replacement property is encumbered by a mortgage. Taxpayer's entire basis of $400,000 is first allocated to the replacement property. Taxpayer's basis does not exceed the fair market value of the replacement property, so there is no excess basis. Thus, the basis in the replacement property is $400,000, the note has a zero basis, and all principal payments received under the note result in the recognition of gain.

EXAMPLE 2: The facts are the same as in Example 1, except that taxpayer receives replacement property worth $200,000 and an installment note for $800,000, bearing adequate stated interest. Taxpayer's basis of $400,000 in the relinquished property is allocated first to the replacement property up to its fair market value of $200,000. Taxpayer has excess basis of $200,000 ($400,000 less $200,000), which is allocated to the installment note, the only boot taxpayer received in the exchange. Taxpayer is treated as having made an installment sale of appreciated property with a basis equal to the excess basis of $200,000 for consideration equal to the $800,000 face amount of the installment note. Because the selling price is $800,000 (the face amount of the installment obligation) and there is no qualifying indebtedness, the contract price is $800,000. The gross profit is $600,000 (selling price of $800,000 less excess basis of $200,000 allocated to the installment obligation). The gross profit ratio is 75 percent ($600,000 gross profit divided by $800,000 contract price). The taxpayer holds the replacement property with a basis of $200,000 equal to its fair market value and an installment note with a face amount of $800,000 and a basis of $200,000. Because the taxpayer receives payments on the installment obligation, 75 percent of each payment will be recognized gain, and 25 percent will be recovery of basis.

EXAMPLE 3: Taxpayer exchanges the same real property worth $1 million, but subject to a mortgage of $200,000, for unencumbered replacement property worth $200,000 and an installment note for $600,000, bearing adequate stated interest. Taxpayer's basis in the relinquished property is $400,000, which is first allocated to the replacement property to the extent of its fair market value ($200,000), resulting in excess basis of $200,000. Taxpayer is treated as having made an installment sale of appreciated property with a basis equal to the excess basis of $200,000, in which the consideration received was the installment obligation of $600,000 and $200,000 net mortgage boot received. The mortgage liability of which taxpayer is deemed relieved ($200,000), reduced by any cash paid by taxpayer ($0) and any mortgage liability encumbering the replacement property ($0), is treated as net qualifying indebtedness. The net qualifying indebtedness of $200,000 does not exceed taxpayer's excess basis of $200,000, so the debt relief to taxpayer does not constitute payment in the year of the exchange. Under the installment method, the selling price is $800,000 and the total contract price is $600,000 (selling price of $800,000 less $200,000 of qualifying indebtedness that does not exceed the taxpayer's excess basis). Gross profit is also $600,000 ($800,000 selling price less $200,000 excess basis). The gross profit ratio is 1 ($600,000 divided by $600,000). Taxpayer does not recognize any gain until principal payments are received on the installment obligation, at which time the full amount taxpayer received will be gain attributable to the exchange. The basis in the replacement property will be $200,000.

The most significant risk in adopting the foregoing approach will be that a court or the IRS might not adopt the principle that the net mortgage boot is offset by "excess basis" in a transaction subject to IRC §453(f)(6). However, this approach is consistent with the principle of Reg §15A.453-1(b)(3)(i) that only debt in excess of basis will be treated as a payment in the year of an installment sale. If relinquished property basis that exceeds replacement property value did not serve as an offset, then the basic rule of IRC §1031(b) providing that gain is recognized in an exchange to the extent of the lesser of boot received or gain realized would be violated, because the excess basis would have to attach to the replacement property or vanish.

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§3.45 5. Coordination of IRC §453 With Deferred Exchanges

Regulation §1.1031(k)-1(j)(2) coordinates the installment sale rules under IRC §453 with the regulations on deferred (nonsimultaneous) exchanges under IRC §1031. Basically, this regulation provides that the taxpayer's use of a qualified escrow account, qualified trust, or qualified intermediary will not by itself result in the taxpayer's having received a payment under the installment sale rules of IRC §453 and Temp Reg §15A.453-1(b)(3)(i). This topic is covered in more detail in §§4.70-4.73.

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H. Recapture of Depreciation

§3.46 1. Generally

Although IRC §1031 provides that no gain or loss will be recognized in an exchange solely of qualifying, like-kind property, its nonrecognition provisions are overridden to the extent that the depreciation recapture rules of IRC §1245 or §1250 apply. The effect of depreciation recapture is generally to recharacterize all or part of recognized gain as ordinary income under IRC §§1245(a)(1) and 1250(a)(1) instead of as capital gain. This will apply to a like-kind exchange with boot.

The recapture rules may also result in the recognition of gain when the exchange would otherwise be fully tax-deferred under IRC §1031(a).

Most improved real property is IRC §1250 property, which is defined as any real property, other than IRC §1245 property, that is subject to the allowance for depreciation. IRC §1250(c). The definition of §1245 property has changed from time to time but, in general, is limited to depreciable personal property. Certain depreciable improvements on real property are included in the definition of §1245 property (*e.g.,* a single purpose agricultural structure, a petroleum storage facility (other than a building), or a railroad tunnel bore). IRC §1245(a)(3).

Dispositions of real property classified as §1245 property can result in §1245 recapture. Before 1987, commercial real estate subject to the Accelerated Cost Recovery System (ACRS) was defined by former IRC §1245(a) as §1245 property and the property's classification as real property for purposes of a like-kind exchange did not necessarily negate the recapture provisions of §1245. See §3.51.

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§3.47 2. Recapture of Depreciation on IRC §1250 Property

Internal Revenue Code §1250 generally requires the taxpayer, on the disposition of depreciable real property, to recognize all or part of the gain as ordinary income if the taxpayer took depreciation or cost-recovery deductions in excess of those allowed under the straight-line method. IRC §1250(a)-(b)(1).

The amount of the taxpayer's depreciation or cost recovery that is subject to recapture under IRC §1250 is called the taxpayer's §1250 gain. Generally, the amount of §1250 gain recognized and taxed at ordinary rates depends on when the depreciation or cost recovery was taken, the length of time that the property was held before disposition (see §3.66), and the use of the property during the holding period. In most situations, however, the amount of the §1250 gain recaptured, and thus recognized and taxed at ordinary income rates, is the excess of accelerated depreciation or cost recovery taken over straight-line depreciation. In like-kind exchanges, IRC §1250(d)(4) limits the amount of §1250 gain that must be recognized. See §3.53.

The importance of the recapture rules under IRC §1250 has significantly declined in recent years. The Tax Reform Act of 1986 (Pub L 99-514, 100 Stat 2085) amended IRC §168 to require the general use of straight-line depreciation for residential and nonresidential real property. IRC §168(b)(3). For depreciable real property placed in service after December 31, 1986, there should be no excess depreciation to recapture. See Pub L 99-514, §201, 100 Stat 2085. For §1250 property that was placed in service before January 1, 1987, only the excess depreciation computed under §1250(a) is still subject to recapture.

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§3.48 3. Limits on IRC §1250 Recapture in IRC §1031 Exchanges

The amount of excess depreciation recaptured under IRC §1250 as a result of a like-kind exchange is equal to the greater of (1) the amount of gain recognized on the exchange under IRC §1031(b), or (2) the excess of the amount of depreciation available for recapture under IRC §1250(a) (*i.e.,* the §1250 gain) over the fair market value of the §1250 property acquired in the exchange. IRC §1250(d)(4). Subsection (d)(4) has the effect of requiring any gain recognized as a result of an exchange of §1250 property to be characterized as ordinary income in the amount of the "applicable percentage" of any "additional depreciation" deducted. Additional depreciation is the excess of accelerated depreciation over straight-line depreciation. IRC §1250(b)(1). The applicable percentage is usually 100 percent, except for certain subsidized or rehabilitated properties. IRC §1250(a)(1)(B).

If a taxpayer receives no net boot in the exchange and acquires replacement property that is depreciable real property, the taxpayer will not recognize any §1250 gain if the fair market value of the depreciable improvements acquired exceeds the taxpayer's §1250 gain. If the §1250 gain exceeds the fair market value of the §1250 property acquired by the taxpayer in the exchange, however, the taxpayer may still be required to recognize that gain to the extent of the excess. IRC §1250(d)(4)(A)(ii).

EXAMPLE 1: Taxpayer transfers an apartment building with a fair market value of $1 million, an adjusted basis of $400,000, and §1250 gain of $500,000 for a parcel of raw land worth $1 million. There is no debt in the exchange. Because the land is not §1250 property, taxpayer will recognize $500,000 of gain under IRC §1250(d)(4)(A)(ii), even though the exchange otherwise satisfies IRC §1031 and taxpayer receives no boot in the exchange.

EXAMPLE 2: The facts are the same as in Example 1, except that taxpayer acquires another apartment building as replacement property. Taxpayer is not required to recognize any §1250 gain as long as the fair market value of the depreciable improvements on the replacement property is at least $500,000.

See §3.63 on allocating basis to the replacement property when not all the §1250 gain is recognized. See §3.48 on the requirement that excess depreciation recapture be carried over to the replacement property.

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§3.49 4. Alternative Capital Gain Rate Application to IRC §1250 Cost Recovery

Under post-1986 law, capital gain recognized on the sale of property subject to IRC §1250 recapture may be taxed at a 25-percent rate instead of the 20-percent rate usually accorded capital gain. IRC §1(h)(1)(D). This alternative rate must be used to compute the tax attributable to "unrecaptured §1250 gain," which is generally the amount of depreciation claimed on §1250 property that is not recaptured as ordinary income. IRC §1(h)(6). Any gain attributable to §1250 property in excess of the amount recaptured as ordinary income plus unrecaptured §1250 gain can be subject to the 15-percent capital gains rate in effect since 2003, however.

EXAMPLE: *A* sells depreciable real property held for more than 12 months for $1,000,000. *A* claimed $500,000 of depreciation, the adjusted basis of the building is $200,000, and the total gain realized is therefore $800,000. If $200,000 of depreciation is recaptured as ordinary income under §1250, $600,000 ($800,000 total gain less $200,000 recaptured as ordinary income) would be treated as long-term capital gain (assuming no other property dispositions). Of this amount, $300,000 would be subject to the 25-percent rate ($500,000 depreciation less $200,000 recaptured as ordinary income), and the balance of the gain ($300,000) would be subject to the 15-percent capital gain rate.

Significantly, since §1031 will operate to defer recognition of realized gain on an exchange of improved for improved property, there will be no 25-percent tax on unrecaptured §1250 gain on an exchange of the property in this example for raw land. Further, no current authority addresses the question of whether the unrecaptured §1250 gain carries over in the replacement property in a §1031 exchange. Absent a statutory mandate or regulations on point, the authors believe taxpayers can take the position that there is no carryover.

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§3.50 5. Carryover of Depreciation Recapture on Transfer of IRC §1250 Property

If all the depreciation recapture under IRC §1250(a) does not create recognized gain, the amount of "§1250 gain" not recognized is treated as additional potential §1250 gain with respect to the replacement property. IRC §1250(d)(4)(E); Reg §1.1250-3(d)(4). The unrecognized §1250 gain will continue to be treated as additional depreciation subject to recapture when the replacement property is disposed of in a taxable transaction. Reg §1.1250-3(d)(4). This is not necessarily true of "unrecaptured §1250 gain" subject to the 25-percent tax rate. At present there is no published guidance compelling carryover of the amount into replacement property in a §1031 exchange.

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§3.51 6. Recapture of Depreciation on IRC §1245 Property

Internal Revenue Code §1245 property generally consists of depreciable personal property, although certain types of real property might fall within the §1245 definition. IRC §1245(a)(3). If property is §1245 property, then all depreciation taken is subject to recapture as ordinary income, unlike IRC §1250 property for which the recapture as ordinary income is limited to the excess of the depreciation taken over straight-line depreciation. IRC §§1245(a)(1)-(2), 1250(a)-(b)(1).

Section 1245 usually operates to recharacterize gain on the disposition of §1245 property as ordinary income in the full amount of depreciation claimed. It is triggered by any disposition of the property, but the statute is limited in its effect on like-kind exchanges by IRC §1245(b)(4). In an exchange under IRC §1031, IRC §1245(b)(4) recharacterizes gain recognized under IRC §1031(b) as ordinary income to the extent of the fair market value of the property acquired in the exchange that is not §1245 property. Thus, if a taxpayer exchanges §1245 property for like-kind §1245 property so that no gain is recognized under §1031, then §1245 recapture is not triggered. If §1245 property is exchanged for like-kind property that is not §1245 property, then the fair market value of the non-§1245 property received is treated as if it were boot for purposes of §1245, requiring the recapture of depreciation in full even though no gain would otherwise be recognized under §1031. Also, the exchange of §1245 property in a partial like-kind exchange will result in depreciation recapture to the extent of the recognized gain under §1031.

EXAMPLE: Taxpayer exchanges a printing press for another printing press in a transaction qualifying under IRC §1031(a) without any boot in the transaction. Both printing presses are §1245 property, so no §1245 gain is triggered on the disposition of the relinquished printing press because only §1245 property is received. Reg §1.1245-4(d)(2), Example 1.

On the basis consequences when IRC §1245 or §1250 property is exchanged, see §§3.47-3.52.

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§3.52 7. Pre-1987 §1245 Real Property

Before 1987, commercial real property was classified as IRC §1245 property. As discussed in §3.51, there is no §1245 recapture in a like-kind exchange of §1245 relinquished property when §1245 replacement property of sufficient value is received. After 1987 it became impossible to receive §1245 replacement commercial real property, because the category was abolished. Since then, an often-asked question is whether this meant that it became impossible to escape §1245 recapture on an exchange of commercial real property placed in service before 1987.

To date the Internal Revenue Service has not taken a position on this question. As a policy matter, it seems inappropriate to cause an otherwise valid like-kind exchange for an identical property type (*i.e.,* commercial for commercial) to suffer gain recognition under §1245 when IRC §1031 fully defers gain. In the authors' view, it is legitimate to take a position that, if replacement property under the pre-1987 regime would have been §1245 commercial real property, such property can be received in an exchange for pre-1987 §1245 property using the same rules as applied to the original categorization of the property. There is, however, no published legal support for this position. Only a few taxpayers might still need to contend with this issue, and the numbers will move to zero within several years. This is because by its terms §1245 applies only to the excess of cost recovery deductions taken over those available on a straight-line basis. For commercial real property placed in service in 1986 that was recovered on the then available Accelerated Cost Recovery System, the excess of accelerated over straight-line cost recovery has become negligible, because the crossover point of accelerated over straight-line deductions has generally been reached.

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§3.53 I. Alternative Minimum Tax

Individual and corporate taxpayers currently completing like-kind exchanges will not be subject to alternative minimum tax because gain deferred under IRC §1031 is not defined as an item of preference under IRC §§56-59.

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IV. TAX-PLANNING STRATEGIES

§3.54 A. Refinancing to Obtain Cash Before, During, or After Exchange

Taxpayers contemplating a property sale often wish to obtain a portion of the equity from the relinquished property in cash but still completely defer the taxes by structuring an exchange under IRC §1031. The taxpayer's goal of receiving cash from an exchange without recognizing gain directly conflicts with the continuity-of-investment rationale that underlies like-kind exchanges. This rationale justifies the deferral of tax in a like-kind exchange on the basis that the taxpayer has reinvested equity from real property in replacement real property and has realized only a "paper" gain. See §1.7. Despite this direct conflict, tax-planning alternatives are still available.

Taxpayers are normally permitted to obtain cash at any time without recognition of gain by refinancing their properties, on the principle that a loan of money is not a taxable event. *Commissioner v Tufts* (1983) 461 US 300, 307, 75 L Ed 2d 863, 870, 103 S Ct 1826. Under the substance-over-form doctrine, however, if a refinancing is integrated with an exchange transaction, the IRS may challenge the tax-free status of the refinancing or its effect on net boot received or given in the exchange if the refinancing occurs shortly before the exchange, while an exchange is pending, or even potentially following acquisition of replacement property. See §3.29. Thus, a taxpayer who intends to complete both a refinancing and a like-kind exchange should separate the two by as much time as possible and with precise documentation to avoid an undesirable result.

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§3.55 1. Preexchange Refinancing

A taxpayer may be able to refinance the relinquished property before commencing an exchange transaction and receive the loan proceeds tax free. *Fred L. Fredericks*, TC Memo 1994-27, suggests that the greater the amount of time between the refinancing (or attempts to refinance) and the exchange, the more likely it is that the result will be nontaxable. If the refinancing is completed before the taxpayer contracts to sell, exchange, or even list the relinquished property, the refinancing should be considered an act of independent economic substance and not an act in anticipation of an exchange.

After the Tax Court decisions in *Frederick W. Behrens,* TC Memo 1985-195, aff'd without published opinion (8th Cir 1986) 786 F2d 1170, and *Phillip M. Garcia* (1983) 80 TC 491, acq 1984-2 Cum Bull 1 (discussed in §§3.16-3.17), a taxpayer's refinancing of relinquished property concurrently with an exchange but through a separate loan escrow (or separate loan documentation) may be viewed as having independent economic substance. The refinancing is even more likely to survive Internal Revenue Service scrutiny if the lender is independent of the parties to the exchange. This type of transaction was not before the court in *Behrens* or *Garcia,* however, and no clear case authority permits or denies this method of receiving cash during the exchange. Although *Behrens* suggests that such a refinancing and concurrent exchange transaction might be collapsed into a single transaction under the step-transaction doctrine (see *Frederick W. Behrens, supra*), the courts often hesitate to apply the step-transaction doctrine to IRC §1031 exchanges and defer to the formalistic arrangements and documentation of such transactions. See *Earlene T. Barker* (1980) 74 TC 555, 561; *Cary A. Everett,* TC Memo 1978-53. See also §§1.9, 3.58. But see *Redwing Carriers, Inc. v Tomlinson* (5th Cir 1968) 399 F2d 652, 659.

In addition to advising the taxpayer on the timing, documentation, and escrow arrangements for refinancing, the attorney should calculate boot and realized and recognized gain with and without the adjustment of mortgage balances.

PRACTICE TIP: If a taxpayer is contemplating an exchange and desires to refinance the relinquished property before the exchange, the refinancing (or at least attempts to refinance the property) should occur before the property is listed for sale, even if the refinancing occurs after the contract to sell is signed but before the exchange is consummated.

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§3.56 2. Postexchange Refinancing

A taxpayer should be able to refinance replacement property after completing an exchange without income tax consequences if the loan transaction is not integrated with the relinquished property sale. See *Frederick W. Behrens,* TC Memo 1985-195, aff'd without published opinion (8th Cir 1986) 786 F2d 1170. In a two-party exchange in which a third party acts as lender, the source of the taxpayer's funds will not be in doubt and their tax-free nature should not be an issue.

EXAMPLE: Taxpayer structures disposition of property *X*, worth $100,000, in a two-party simultaneous exchange with party *A* for property *Y* worth $150,000. Lender *L* agrees to lend taxpayer $100,000 in connection with acquisition of property *Y*. At closing, taxpayer transfers *X* to *A*, *A* transfers *Y* to taxpayer, taxpayer deposits note to *L* for $100,000, and *L* deposits $100,000, which is distributed $50,000 to *A* and $50,000 to taxpayer. Under *Behrens,* receipt of funds should not be taxable to taxpayer (although *A* will have $50,000 cash boot).

The issue presented by deferred exchanges can be slightly different; because funds received from a lender in form could be considered to be funds paid by the relinquished property purchaser in substance. The IRS could argue, for example, that the source of funds is the relinquished property sale proceeds and not the lender if the replacement property purchase and the refinancing occur concurrently and cash is distributed to the taxpayer. This argument, if successful, would result in boot treatment.

EXAMPLE: Taxpayer structures disposition of property *X*, worth $100,000 as a deferred exchange for property *Y*, worth $150,000. Buyer of *X* pays $100,000 to a qualified intermediary (*QI*) and receives title to *X*. Taxpayer obtains commitment of lender to lend $100,000 toward purchase of *Y*. At closing, *QI* deposits $100,000, lender deposits $100,000, taxpayer deposits note payable to lender for $100,000 and receives title to *Y* plus $50,000 cash. Taxpayer's position is that the $50,000 is nontaxable loan proceeds. The IRS position may be that the $50,000 is a portion of the property *X* sales proceeds.

This example illustrates the need to separate postdeferred exchange refinancings from the replacement property purchase as a transactional matter so that receipt of the loan proceeds is independent of the exchange and tax-free.

As in preexchange refinancings (see §3.55), no time lapse is necessary between the replacement property acquisition closing and completion of a postexchange refinancing, but the general rule is "longer is better." As a theoretical matter, even a "nanosecond" should be sufficient as long as the purchase and the refinancing are considered separate transactions. However, it is generally advisable to allow enough time to pass between acquisition closing and refinancing closing to dissuade the IRS from claiming that the two transactions should be treated as an integrated event. The attorney's role is to be sure that the purchase closing documentation does not reflect the taxpayer's receipt of cash in any manner that could be construed to characterize the source of the cash as funds deposited by a relinquished property buyer or the qualified intermediary in a deferred exchange.

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§3.57 B. Minimizing Taxable Cash Boot

Several additional tax-planning alternatives are available that could minimize or eliminate a taxpayer's receipt of taxable cash boot. In the example in §3.5, *A* traded relinquished property worth $220,000 for replacement property worth $250,000. *A* was relieved of $80,000 of debt and acquired the replacement property subject to $150,000 of debt. To equalize the equities, *A* received $40,000 in cash. *A* also paid $15,400 of sales expenses. Thus, *A* recognizes $40,000 of the total realized gain of $104,600. If Reg §1.1031(k)-1(j)(3), Example 2, applies to the transaction, the sales expenses will not offset the cash boot received. See §3.25. Instead, the amount of sales expenses paid will increase *A*'s basis in the replacement property. See §3.60. *A* has net mortgage boot given of $70,000 ($150,000 incurred less $80,000 relieved), which may not be offset against the $40,000 cash boot received.

With better planning, *A* could have reduced the amount of recognized gain or eliminated it completely:

- *A* could have reduced the amount of recognized gain by requiring in the exchange agreement that *B* pay all of *A*'s sales expenses up to $40,000 and, if *A*'s expenses do not exceed $40,000, pay *A* the balance in cash. Had this been done, *A* would have recognized gain of $24,600, which is the amount that *B* would pay to *A* after paying all of *A*'s sales expenses.

- *A* could have eliminated the recognized gain completely by requiring *B* to use the $40,000 to pay down the existing debt on the replacement property.

- *A* could have combined the preceding tax-planning alternatives to eliminate recognized gain completely by requiring that *B* pay all of *A*'s sales expenses and pay any excess to the holder of the debt on the replacement property.

- *A* could have refinanced or increased the debt on the relinquished property by $40,000 before the exchange, which could have given *A* the use of the loan funds in an independent financing transaction and, if timed correctly, eliminated taxable cash boot. See §3.55.

In the same example in §3.5, *B* was relieved of $150,000 of debt and acquired title to *A*'s property subject to $80,000 of debt, resulting in $70,000 of net mortgage boot received. *B* also paid $40,000 to *A*. This cash boot given offset the net mortgage boot received, resulting in net boot received of $30,000 to *B*. *B* also paid $17,500 in sales expenses, which is cash boot given. This cash boot given reduced the net boot received to $12,500 ($30,000 less $17,500). Thus, even though *B* paid cash in the exchange ($40,000 to *A* and $17,500 of sales expenses), *B* still recognizes $12,500 of $57,500 total realized gain because of the mortgage boot received.

To avoid recognizing the gain, *B* should have reduced his or her debt by at least $12,500 before the exchange. The easiest method would have been to make a prepayment to the lender before consummating the exchange transaction. The prepayment would have saved taxes to *B* by avoiding the recognition of gain and made it easier to balance the equities. Also, payment would have eliminated cash boot being paid to *A,* which would have helped to reduce *A*'s recognized gain. Accordingly, careful tax planning for both *A* and *B* could have minimized or eliminated the recognition of gain by both parties with minimal or no economic impact.

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§3.58 C. Receiving Installment Notes

A new installment note received by the taxpayer is generally considered to be cash boot received, which may not be offset by additional cash invested in replacement property. See §§3.14, 3.25, 3.28. A taxpayer may be able to avoid receiving the note (and thus avoid receiving cash boot) by structuring the transaction so that the person who ultimately acquires the relinquished property executes the note in favor of the intermediary. When the taxpayer transfers the relinquished property to the intermediary, the intermediary will give the taxpayer an exchange equity credit for the full amount of the equity in the property, even though the intermediary will receive cash and a note on sale of the relinquished property to the transferee. The taxpayer or the intermediary can then arrange for an unrelated third person to purchase the note from the intermediary at its original principal balance or even at a discount. The proceeds the intermediary receives from the sale of the note to the third person would be added to the cash portion of the exchange equity credit and invested in replacement property for the taxpayer as part of the exchange. If this scenario is properly documented, the third party would have a basis in the note to the extent of the purchase price paid for the note, resulting in no income tax consequences when the principal amount is paid, unless the note is purchased at a discount. Any discount will be treated as market discount under the market discount bond rules of IRC §§1276-1278. These rules generally require the discount to be characterized as an ordinary income item. The taxpayer, meanwhile, could complete a fully tax-deferred exchange of properties. This transaction may be used in either a simultaneous or deferred exchange employing a qualified intermediary.

If the taxpayer subsequently purchases the note from the third party, or even purchases directly from the qualified intermediary, the note will have a purchase price basis and, other than coming up with sufficient cash outside the exchange to purchase the note, the taxpayer will suffer minimal inconvenience.

This structure might be subject to scrutiny under the step-transaction doctrine if the taxpayer advances the cash for a third person to buy the installment note and then cancels the loan in exchange for the installment note. See *Frederick W. Behrens,* TC Memo 1985-195, aff'd without published opinion (8th Cir 1986) 786 F2d 1170. If the Internal Revenue Service successfully asserts the step-transaction doctrine, the taxpayer would be considered to have received the installment note subject to installment reporting under IRC §453 and an increase in basis equal to the cash boot given by the taxpayer to buy the installment note. See §§3.43-3.45 on installment sale reporting under §453.

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V. CALCULATING BASIS IN REPLACEMENT PROPERTY

§3.59 A. General Principles

In a like-kind exchange, the "price" paid for deferral of gain recognition is reduced basis in replacement property. A taxpayer's basis in the replacement property is the same as the taxpayer's basis in the relinquished property, decreased by the amount of any money received by the taxpayer and either increased by the amount of gain or decreased by the amount of any loss to the taxpayer that was recognized in the exchange. IRC §1031(d). For this purpose, "money received" includes mortgage boot received by the taxpayer in the form of debt relief. IRC §1031(d); Reg §1.1031(d)-2. See also §3.8.

The taxpayer's basis in the replacement property is also increased by the amount of additional consideration given by the taxpayer in the exchange. Reg §1.1031(d)-1(a). The taxpayer can give additional consideration in the form of net cash boot (see §3.13) or mortgage boot (see §3.14).

If the taxpayer transfers more than one property in the exchange, the aggregate bases of the properties transferred, both qualifying and nonqualifying, are included in calculating the basis of the replacement property. Reg §1.1031(d)-1(e). If the adjusted basis of the nonqualifying property transferred exceeds its fair market value, the taxpayer may recognize a loss on the disposition of the nonqualifying property and the loss recognized will reduce the basis of the replacement property received. Reg §1.1031(d)-1(e).

If the taxpayer receives qualifying and nonqualifying property, basis is first allocated to the nonqualifying property received (other than money) to the extent of its fair market value, and the balance is allocated to the qualifying property received. IRC §1031(d); Reg §1.1031(d)-1(c). See §3.63.

When a taxpayer elects to report the recognized gain from an exchange on the installment method, the basis in the replacement property is determined under IRC §1031(d) as if the installment obligation will be satisfied at its face amount. Rev Rul 65-155, 1965-1 Cum Bull 356. The face amount may be reduced by any portion of the obligation that is treated as imputed interest under IRC §483 or §1274. See §§3.43-3.45 on reporting gain on the installment method.

For most types of replacement property obtained in like-kind exchanges, a further calculation will be necessary: separation of basis between "exchanged basis" and "excess basis" under the rules of Reg §1.168(i)-6(b) relating to depreciation allowances applicable to property involved in like-kind exchanges and involuntary conversions. See §3.76.

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§3.60 1. Procedure for Calculating Basis in Replacement Property

The basis in replacement property is calculated after the exchange is completed. Computing the basis in replacement property is the same whether the exchange is simultaneous or not. Even in a deferred exchange that starts in one year and finishes in the next, the basis computation is possible because all replacement properties must be received before the tax return can be filed for the year of the relinquished property disposition. See §4.4. Basis can only be computed, however, after several other calculations have been made. These calculations take into account the boot-offset rules discussed in §§3.23-3.29. The following elements of the exchange must be calculated:

- The aggregate basis in the properties, both qualifying and nonqualifying, that the taxpayer transfers in the exchange.
- Any net boot (cash or mortgage) the taxpayer received in the exchange.
- The net boot given by the taxpayer in the exchange, which includes any transaction expenses paid by the taxpayer with funds from outside the exchange. Usually, because of the offset rules, the taxpayer will either receive net boot or give net boot, but not both. However, a taxpayer who receives cash boot and gives net mortgage boot will both receive and give net boot for purposes of the basis calculation. See §3.28.
- The amount of gain recognized by the taxpayer in the exchange. This number will be zero unless the taxpayer (a) receives net boot (see §§3.22-3.29), (b) transfers nonqualifying property with a fair market value in excess of its adjusted basis (see §3.33), or (c) recognizes IRC §1250 gain (or IRC §1245 gain, if applicable). For discussion of §1250 gain and §1245 gain, see §§3.46-3.52.
- The amount of loss recognized by the taxpayer in the exchange. The taxpayer is not permitted to recognize a loss on the transfer of qualifying like-kind property, but any loss that the taxpayer realizes on the transfer of nonqualifying property will be recognized. See §3.33.

After these items are calculated, the taxpayer's basis in the replacement property is computed by the following formula (IRC §1031(d); Reg §§1.1031(d)-1(a), 1.1031(d)-2):

- The taxpayer's aggregate basis in both qualifying and nonqualifying transferred properties;
- Less any net boot received by the taxpayer;
- Plus any net boot given by the taxpayer;
- Plus the amount of gain recognized by the taxpayer from both qualifying and nonqualifying property;
- Less the amount of loss recognized by the taxpayer on the transfer of nonqualifying property.

For examples of calculations to compute basis, see §§3.70-3.75. For additional examples of the calculation of basis in exchanges, see Reg §1.1031(k)-1(j)(3).

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§3.61 2. Short-Cut Method to Double-Check Calculations of Basis

Another method available to calculate the taxpayer's basis in the qualifying replacement property is to subtract any unrecognized gain (*i.e.,* deferred gain) from, and to add any unrecognized loss to, the fair market value of that replacement property. Thus, the taxpayer's basis in the qualifying replacement property is the difference between its cost basis under IRC §1012 (as if the replacement property were purchased outright without the exchange) and the deferred gain from the relinquished property because of the IRC §1031 exchange. This method is helpful to double-check the basis computation. See the examples in §§3.70-3.75.

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§3.62 3. Treatment of Transactional Expenses in Calculating Basis

If the taxpayer pays transactional expenses in the exchange with funds from outside the exchange, those expenses are treated as additional consideration and increase the basis of the replacement property. See Rev Rul *72-456*, 1972-2 Cum Bull *468* (real estate commissions paid by the taxpayer from funds outside the exchange may be added to the basis of the replacement property and may offset net boot received). Because it is unclear whether the offset of cash boot is permitted in certain deferred exchanges in light of Reg §1.1031(k)-1(j)(3), Example 2, the applicability of Rev Rul *72-456* to deferred exchanges is uncertain. See §3.30.

Revenue Ruling *72-456* contains three examples that illustrate the effect of the payment of brokerage commissions on realized gain and loss, recognized gain, and the basis of replacement property received:

EXAMPLE 1: The taxpayer received $10,000 in cash and paid a commission of $2000 to a real estate broker. The result was a recognized gain of $8000 ($10,000 cash received less $2000 cash paid). Basis was reduced by the total cash received of $10,000 and increased by the recognized gain of $8000 and the brokerage commission paid of $2000. Stated another way, the basis in the replacement property was reduced by the net cash received of $8000 and increased by the amount of the recognized gain of $8000. If the taxpayer received only $8000 cash in the exchange and paid no brokerage commission, the result would be the same.

EXAMPLE 2: The taxpayer received $10,000 in cash, paid a $2000 brokerage commission, and realized a loss of $1500 in the exchange. Because no gain was realized, no gain could be recognized. The basis was reduced by the total cash received of $10,000 and increased by the brokerage commission paid of $2000. The basis in the replacement property was reduced by the net cash boot received of $8000 ($10,000 received less $2000 paid).

EXAMPLE 3: The taxpayer received no cash in the exchange, paid a $2000 brokerage commission, and realized a gain of $8000. Because no cash boot was received, no gain could be recognized. The taxpayer's basis in the replacement property was increased by $2000: the amount paid from the taxpayer's own funds in acquiring the replacement property.

An increase in basis for the additional amount paid in brokerage commissions is consistent with Reg §1.1031(d)-1(a). Basis should be increased for all transactional expenses paid by the taxpayer, not just brokerage commissions. The Internal Revenue Service appears to have taken this position, but no definitive guidance has been issued to clarify the point. See Rev Rul *72-456*, 1972-2 Cum Bull *468*. For examples of transactional expenses, see §3.3.

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B. Calculating Basis in Multiple Replacement Properties

§3.63 1. Ascertaining Whether Reg §1.1031(j)-1 Applies

If the taxpayer receives two or more replacement properties in the exchange, the method of allocating basis among the replacement properties depends on whether the multiple property exchange rules of Reg §1.1031(j)-1 apply. A transaction qualifies as a multiple property exchange under Reg §1.1031(j)-1(a) if any of the following occur:

- The taxpayer relinquishes at least one qualifying property and receives two or more replacement properties of like kind or like class;
- The taxpayer relinquishes two or more qualifying properties of like kind or like class and receives at least one replacement property of the same kind or class; or
- The taxpayer relinquishes two or more qualifying properties of different kinds or classes and receives qualifying replacement properties of like kind or like class to at least two of the different types of relinquished property.

For discussion of multiple property exchange rules, see §§3.36-3.42.

If the transaction is a multiple property exchange under this definition, the allocation of basis is governed by Reg §1.1031(j)-1(c), discussed in §3.64. If the exchange does not fall within the definition of a multiple property exchange but the taxpayer receives multiple replacement properties, the basis in the replacement property is allocated as described in §3.66. This could happen, for example, if the taxpayer relinquishes a single parcel of qualifying real property and receives a single parcel of like-kind replacement real property plus tangible personal property and shares of corporate stock.

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§3.64 2. Calculating Basis in Multiple Replacement Properties Under Reg §1.1031(j)-1

The first step in calculating new basis (as well as recognized gain; see §3.36) in an exchange of multiple properties is to separate the properties into exchange groups. Reg §1.1031(j)-1(b)(2). An exchange group consists of all properties relinquished and all properties acquired in the exchange that are of a like kind or a like class. Each exchange group must include at least one relinquished property and one replacement property. Reg §1.1031(j)-1(b)(2)(i). A residual group must be created if the aggregate fair market value of the relinquished property in all exchange groups does not equal the aggregate fair market value of the replacement properties in all exchange groups. See §3.39 on how property is allocated to the residual group.

Basis is calculated under IRC §1031(d) within each exchange group. The aggregate basis of properties received in each group is the aggregate adjusted basis of the properties transferred by the taxpayer within that group, increased by the amount of gain recognized by the taxpayer in the group, increased by the amount of the exchange group surplus or decreased by the amount of the exchange group deficiency, and increased by the amount of any excess liabilities assumed by the taxpayer that are allocated to that group. Reg §1.1031(j)-1(c). See §§3.36-3.42 on calculating the amount of gain recognized, the exchange group surplus or deficiency, and the excess liabilities assumed.

The resulting aggregate basis of each exchange group is allocated proportionately to each property received in the group in accordance with its fair market value. The basis of each property received within the residual group (other than money) is equal to its fair market value. See Reg §1.1031(j)-1(d) for examples of calculating basis in multiple property exchanges.

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§3.65 3. Calculating Basis in Multiple Replacement Properties When Reg §1.1031(j)-1 Does Not Apply

The multiple property exchange rules of Reg §1.1031(j)-1 do not apply to a transaction that has only one qualifying relinquished property and one qualifying replacement property of like kind or like class, even if other property is transferred or received. See Reg §1.1031(j)-1(a). If the taxpayer receives more than one property in such an exchange, the aggregate basis of all properties received is adjusted first according to the rules described in §3.60. Then, the aggregate adjusted basis is first allocated to the nonqualifying property to the extent of its fair market value, with the balance allocated to the qualifying property received. IRC §1031(d); Reg §1.1031(d)-1(c). This allocation applies regardless of whether the replacement property is nonqualifying because it is (a) not of a like kind with the relinquished real property or (b) real property held for a nonqualifying purpose (*e.g.,* personal use).

Additional allocation rules may apply if the exchange involves the disposition of depreciable real property that is subject to recapture of depreciation under IRC §1250(a). See §§3.47-3.50. If all or part of the taxpayer's IRC §1250 gain is deferred and more than one replacement property is acquired in the exchange, the total basis as computed under IRC §1031(d) is allocated between §1250 property (treated as a class) and the other property (treated as a class) and within each class in proportion to the respective fair market values of the properties on the dates received. Reg §1.1250-3(d)(4)(ii), (d)(2)(iii)-(iv). For a description of §1250 property and §1250 gain, see §§3.46-3.52.

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§3.66 C. Allocating Basis Between Land and Improvements

In an exchange of real property, the taxpayer must allocate the new basis in the replacement property between the land and improvements to compute the depreciable basis in the improvements. This allocation is made regardless of how basis was allocated between the land and improvements in the relinquished property. First, the taxpayer's basis in the replacement property is calculated under IRC §1031. See §§3.63-3.65. Second, the new basis is allocated between the land and improvements according to their respective fair market values at the time of the exchange. Rev Rul 68-36, 1968-1 Cum Bull 357. Because this allocation is purely a factual determination, there is no correlation between the allocation of basis between the land and improvements in the relinquished property and the replacement property.

EXAMPLE: Taxpayer's replacement property has an adjusted basis of $100,000 and a value of $200,000 that is allocable $160,000 to building (80 percent) and $40,000 (20 percent) to land. The $100,000 adjusted basis of the replacement property is allocated $80,000 to the building and $20,000 to the land.

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§3.67 D. Allocating Basis Between New and Old Modified Accelerated Cost Recovery System (MACRS) Categories

Since 2000, basis attributable to property depreciated under the Modified Accelerated Cost Recovery System (MACRS) and carried over to MACRS replacement property is generally recovered on a schedule equal to the remaining term applicable to the relinquished property. Any additions to the taxpayer's basis in the replacement property will be recovered on a term commencing with the date the new property is placed in service, as with any purchase. See §3.76 for a more complete discussion. These rules mean that many exchanges of real estate will create multiple tiers of basis in replacement properties: one tier for each MACRS recovery period applicable to the predecessor (*e.g.,* relinquished properties) and other tiers for additions to basis. Although the regulations contemplate exchanges of property between different MACRS categories (*i.e.,* improved property for unimproved property and commercial property for residential rental property), they leave many questions unanswered about their application.

EXAMPLE: Taxpayer's relinquished property is an apartment project worth $100,000, with $30,000 of adjusted basis allocated to the building and 20 years left on the original 27.5-year recovery period, and $15,000 of basis allocated to land. Taxpayer's replacement property is commercial property costing $200,000 that is allocable $160,000 (80 percent) to building and $40,000 (20 percent) to land. The total basis of $145,000 ($45,000 exchanged basis plus $100,000 excess basis) is allocable $116,000 (80 percent) to building and $29,000 (20 percent) to land. Under the regulations, it appears that all $30,000 of exchanged MACRS basis is allocable to the building. Is the additional $115, 000 of excess basis (1) allocable 80 percent to building and 20 percent to land, making the aggregate building basis $122,000 and the aggregate land basis $23,000; (2) allocable first $15,000 to land and then 80/20, making building basis $110,000 and land basis $35,000; or (3) allocable first $15,000 to land with the $100,000 balance allocable so that the final building and land basis ratio is 80/20, or $116,000 building and $29,000 land?

Taxpayers interested in maximizing their cost recovery deductions are likely to opt for alternative (a) until the IRS provides further guidance.

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§3.68 E. Calculating Basis When Exchange Is Bargain Sale

In an exchange that constitutes a bargain sale (*i.e.*, a transfer of the relinquished property that is in part an exchange and in part a charitable contribution), the taxpayer's adjusted basis in the replacement property is the taxpayer's adjusted basis in the relinquished property multiplied by the ratio of the fair market value of the replacement property to the fair market value of the relinquished property. IRC §1011(b); Rev Rul 78-163, 1978-1 Cum Bull 257.

EXAMPLE: Taxpayer exchanges property with a fair market value of $400,000 and an adjusted basis of $50,000 for replacement property with a fair market value of $100,000. Taxpayer's adjusted basis in the replacement property is $12,500 ($50,000 multiplied by 0.25 ($100,000 divided by $400,000)).

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§3.69 VI. HOLDING PERIOD

The taxpayer's holding period for the replacement property generally includes the holding period for the relinquished property. IRC §1223(1). Tacking of holding periods is permitted. For tacking to apply, however, the relinquished property must qualify as a capital asset under IRC §1221 or as property held in trade or business under IRC §1231(b). IRC §1223(1); Reg §1.1223-1(a). Although this requirement is similar to the "purpose" requirement of IRC §1031(a) (see §§2.20-2.22), for the relinquished property to qualify as property held in trade or business under IRC §1231(b), it must be held for at least one year before the exchange. In contrast, §1031(a) does not set a minimum holding period. See §2.26.

An exception to the tacking rule applies if the exchange involves the disposition of depreciable real property that is subject to recapture of excess depreciation under IRC §1250(a). If the taxpayer has IRC §1250 gain (*i.e.,* the excess of accelerated depreciation taken over straight-line depreciation), the taxpayer's holding period for ascertaining the proper treatment of that gain begins on the day after the date on which the property was acquired, even if it was acquired in a like-kind exchange. IRC §1250(e)(1)(A). For discussion of depreciation recapture under IRC §1250, see §§3.46-3.50.

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§3.70 VII. EXAMPLES OF CALCULATIONS OF TAXABILITY AND BASIS

The principles set forth in §§3.1-3.69 are best illustrated by examples. The examples in §§3.71-3.75 assume that two-party exchanges are being transacted and that the parties to each exchange are A and B. The examples further assume that the requirements for like-kind exchange treatment have been met. Thus, because the application of IRC §1031 is mandatory (see §1.3), both A and B will receive like-kind exchange treatment in all examples. In each example, the current taxability of the exchange will be ascertained for both A and B as well as their respective bases in the replacement properties acquired in the exchange.

NOTE: In two-party transactions it is possible to evaluate the consequences of IRC §1031 to both parties. In most modern exchanges, the attorney will represent only one party and will consider the consequences to that party. It is not necessary to know the tax consequences to a client's exchange counterparty to properly evaluate consequences to the client, and the attorney will normally want to let the other party's adviser perform such analyses. This is even more true in multiparty and deferred exchanges.

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§3.71 A. Equal Exchange: Parties Neither Receive Nor Give Boot

	A	*B*
(1) Facts:		
Fair market value of relinquished property	$200,000	$200,000
Existing encumbrances	–0–	–0–
Equity (fair market value of relinquished property less existing encumbrances)	200,000	200,000
Cash received (given) to equalize equities	–0–	–0–
Taxpayer's selling expenses	13,000	13,000
Adjusted basis of relinquished property	150,000	125,000
(2) Realized gain:		
Fair market value of replacement property	$200,000	$200,000
Less selling expenses	13,000	13,000
Less adjusted basis	150,000	125,000
Realized gain	$37,000	$62,000
(3) Boot:		
Cash boot received	–0–	–0–
Cash boot given (including sales expenses)	$13,000	$13,000
Mortgage boot received	–0–	–0–
Mortgage boot given	–0–	–0–
(4) Recognized gain:	–0–	–0–
(5) Basis of replacement property:		
Adjusted basis of relinquished property	$150,000	$125,000
Less net boot received	–0–	–0–
Plus gain recognized	–0–	–0–
Plus net boot given	13,000	13,000
Basis of replacement property	$163,000	$138,000
(6) Double check of basis:		
Fair market value of replacement property	$200,000	$200,000
Less unrecognized gain	37,000	62,000
Basis of replacement property	$163,000	$138,000

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§3.72 B. Party A Receives and Party B Gives Cash Boot

	A	*B*
(1) Facts:		
Fair market value of relinquished property	$200,000	$150,000
Existing encumbrances	–0–	–0–
Equity	200,000	150,000
Cash received (given) to equalize equities	50,000	(50,000)
Sales expenses	2,000	1,500
Adjusted basis of relinquished property	140,000	125,000
(2) Realized gain:		
Fair market value of replacement property	$150,000	$200,000
Plus cash received	50,000	–0–
Less cash paid	–0–	50,000
Less selling expenses	2,000	1,500
Less adjusted basis	140,000	125,000
Realized gain	$58,000	$23,500
(3) Boot:		
Cash boot received	$50,000	–0–
Cash boot given (including sales expenses)	2,000	$ 51,500
Mortgage boot received	–0–	–0–
Mortgage boot given	–0–	–0–
(4) Recognized gain:	$48,000	–0–
(5) Basis of replacement property:		
Adjusted basis of relinquished property	$140,000	$125,000
Less net boot received	48,000	–0–
Plus gain recognized	48,000	–0–
Plus net boot given	–0–	51,500
Basis of replacement property	$140,000	$176,500
(6) Double check of basis:		
Fair market value of replacement property	$150,000	$200,000
Less unrecognized gain	10,000	23,500
Basis of replacement property	$140,000	$176,500

This example assumes that cash boot received may be offset by cash boot given in the form of sales expenses paid. See §§3.24-3.28, 3.60.

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§3.73 C. Party B Receives and Party A Gives Mortgage Boot

	A	*B*
(1) Facts:		
Fair market value of relinquished property	$200,000	$250,000
Existing encumbrances	–0–	50,000
Equity	200,000	200,000
Cash received (given) to equalize equities	–0–	–0–
Sales expenses	2,000	2,500
Adjusted basis	90,000	100,000
(2) Realized gain:		
Fair market value of replacement property	$250,000	$200,000
Plus mortgage relief	–0–	50,000
Less mortgage assumed	50,000	–0–
Less sales expenses	2,000	2,500
Less adjusted basis	90,000	100,000
Realized gain	$108,000	$147,500
(3) Boot:		
Cash boot received	–0–	–0–
Cash boot given (including sales expenses)	$2,000	-$2,500
Mortgage boot received	–0–	50,000
Mortgage boot given	50,000	–0–
(4) Recognized gain:	–0–	$47,500
(5) Basis of replacement property:		
Adjusted basis of relinquished property	$90,000	$100,000
Less net boot received	–0–	50,000
Plus net boot given	52,000	2,500
Plus gain recognized	–0–	47,500
Basis of replacement property	$142,000	$100,000
(6) Double check of basis:		
Fair market value of replacement property	$250,000	$200,000
Less unrecognized gain	108,000	100,000
Basis of replacement property	$142,000	$100,000

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§3.74 D. Party B Receives Cash Boot and Gives Mortgage Boot; Party A Receives Mortgage Boot and Gives Cash Boot

	A	*B*
(1) Facts:		
Fair market value of relinquished property	$200,000	$250,000
Existing encumbrances	50,000	–0–
Equity	150,000	250,000
Cash received (given) to equalize equities	(100,000)	100,000
Sales expenses	2,000	2,500
Adjusted basis	100,000	100,000
(2) Realized gain:		
Fair market value of replacement property	$250,000	$200,000
Plus cash received	–0–	100,000
Less cash paid	100,000	–0–
Plus mortgage relief	50,000	–0–
Less mortgage assumed	–0–	50,000
Less sales expenses	2,000	2,500
Less adjusted basis	100,000	100,000
Realized gain	$ 98,000	$147,500
(3) Boot:		
Cash boot received	–0–	$100,000
Cash boot given (including sales expenses)	$102,000	2,500
Mortgage boot received	50,000	–0–
Mortgage boot given	–0–	50,000
(4) Recognized gain:	–0–	$ 97,500
(5) Basis of replacement property:		
Adjusted basis of relinquished property	$100,000	$100,000
Less net boot received	50,000	97,500
Plus gain recognized	–0–	97,500
Plus net boot given	102,000	50,000
Basis of replacement property acquired	$152,000	$150,000
(6) Double check of basis:		
Fair market value of replacement property	$250,000	$200,000
Less unrecognized gain	98,000	50,000
Basis of replacement property	$152,000	$150,000

This example assumes that cash boot received may be offset by cash boot given in the form of sales expenses paid. See §§3.24-3.28, 3.60. Mortgage boot given does not offset cash boot received. *B* could have substantially reduced his or her recognized gain by refinancing or by having *A* retire *A*'s mortgage before the exchange. See §§3.29, 3.54-3.58.

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§3.75 E. Taxpayer Realizes Loss

	A	*B*
(1) Facts:		
Fair market value of relinquished property	$200,000	$190,000
Existing encumbrances	–0–	–0–
Equity	200,000	190,000
Cash received (given) to equalize equities	10,000	(10,000)
Sales expenses	2,000	1,900
Adjusted basis	$200,000	$150,000
(2) Gain or loss realized:		
Fair market value of replacement property	$190,000	$200,000
Plus cash received	+10,000	–0–
Less cash given	–0–	10,000
Less sales expenses	2,000	1,900
Less adjusted basis	200,000	150,000
Realized gain (or loss)	($ 2,000)	$ 38,100
(3) Boot:		
Cash boot received	$10,000	–0–
Cash boot given (including sales expenses)	2,000	$11,900
Mortgage boot received	–0–	–0–
Mortgage boot given	–0–	–0–
(4) Recognized gain (or loss):	–0–	–0–
(5) Basis of replacement property:		
Adjusted basis of property transferred	$200,000	$150,000
Less net boot received	10,000	–0–
Plus net boot given	2,000	11,900
Plus gain recognized	–0–	–0–
Basis of replacement property	$192,000	$161,900
(6) Double check of basis:		
Fair market value of replacement property	$190,000	$200,000
Less unrecognized gain	–0–	38,100
Plus unrecognized loss	2,000	–0–
Basis of replacement property	$192,000	$161,900

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§3.76 VIII. DEPRECIATION ISSUES

For years, the rules governing depreciation of replacement property received in a like-kind exchange have lacked clarity. Beginning in 2000, exchanges of real estate with carryover basis subject to the Modified Accelerated Cost Recovery System (MACRS) were subject to a mandatory "step in the shoes" regime affecting carryover basis, under IRS Notice 2000-4, 2000-1 Cum Bull 313. This required that carryover basis for the replacement property be recovered over the remaining recovery period of the relinquished property, using the same method as used for the relinquished property. This rule raised a number of questions. After a lengthy period of study, on February 27, 2004, the Treasury Department and the Internal Revenue Service issued proposed and temporary regulations under IRC §168. On February 26, 2007, final regulations were adopted in TD 9314, 2007-14 Int Rev Bull 845. The final regulations provide guidance for computing depreciation deductions on MACRS property acquired in transactions subject to IRC §§1031 and 1033. See Reg §1.168(i)-6. The final regulations replace the proposed and temporary regulations with only slight modifications, providing guidance for computing depreciation deductions when both the transferred and the received property in a like-kind exchange or an involuntary conversion transaction are property subject to the MACRS.

In general, the regulations adopt the step-in-the-shoes principle first adopted in Notice 2000-4 for carryover basis while providing more detailed guidance on how to compute replacement property deductions. The essential principle is the distinction drawn between step-in-the-shoes depreciation applicable to carryover basis, labeled "exchanged basis," and "fresh start" depreciation applicable to newly created basis, labeled "excess basis." The final regulations allow an exchanger to treat the sum of the exchanged basis and excess basis of the replacement property as MACRS property if it replaces relinquished property for which the taxpayer made a valid election under IRC §168(f) to exclude from the application of the MACRS. See Reg §1.168(i)-(6)(i)(2).

The final regulations have a retrospective effective date, applying to like-kind exchange transactions when the disposition of relinquished property and the acquisition of replacement property both occur after February 27, 2004. However, if the time of disposition, the time of replacement, or both occurred on or before that date, taxpayers may elect to apply the final regulations or rely on prior IRS guidance.

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§3.76A A. Year of Exchange Depreciation Allowance on Relinquished Property

The regulations provide several rules for depreciation of relinquished property in the year of an exchange or conversion. First, depreciation is not allowed if relinquished property is disposed of in the same year that the property is placed in service. Second, depreciation is not allowed for either replacement or relinquished property in a like-kind exchange or an involuntary conversion if the replacement property is disposed of during the same year that the relinquished property is placed in service. Reg §1.168(i)-6(c)(5).

In the year of exchange, depreciation on the relinquished property is based on the amount of time the property is in service in that year. The first step is to calculate the allowable depreciation deduction for the entire year. The second step is to calculate the fraction of the year the property is in service. The numerator of this fraction is the number of months (include fractions of months) the property was in service during the year, taking into account the convention (mid-month, mid-quarter, or mid-year) previously applied to the relinquished property. The denominator is 12 (months) (except for short taxable years). Reg §1.168(i)-6(c)(5)(i)(A).

If, at the beginning of the year the relinquished property is sold, the remaining recovery period is less than the period between the beginning of the year of sale and the date of the disposition, the depreciation deduction for the year of disposition is equal to the adjusted basis at the beginning of the year. If this rule applies, the exchanged basis (see §3.76B) is zero. Reg §1.168(i)-6(c)(5)(i)(B).

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§3.76B B. Exchanged Basis—Basic Rules

"Exchanged basis" is the lesser of (1) the adjusted basis of the relinquished property or (2) the basis in the replacement property. Reg §1.168(i)-6(b)(7). Exchanged basis is the element of basis that carries over from relinquished to replacement property in a like-kind exchange under IRC §1031(d). It is calculated after the depreciation deductions for the relinquished property in the year of disposition are ascertained.

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§3.76C 1. Conventions

The regulations provide guidance on how to handle depreciation of exchanged basis in circumstances when relinquished and replacement properties in like-kind exchanges or involuntary conversions are subject to different conventions.

- *When the relinquished property or replacement property is mid-month property.* If either the relinquished property or the replacement property is mid-month property, then the exchanged basis must be depreciated using the mid-month convention. This differs for deferred exchanges (discussed in §3.76H). Reg §1.168(i)-6(c)(4)(v)(A).

- *When neither the relinquished property nor the replacement property is mid-month property.* If neither the relinquished property nor the replacement property is mid-month property, then the exchanged basis should be depreciated using the convention that applied to the relinquished property. Reg §1.168(i)-6(c)(4)(v)(B).

- If the relinquished property was placed in service in the year of its disposition and the replacement property was also placed in service in that year, then the applicable convention is determined by the quarter the relinquished property was placed in service.

- If the relinquished property was placed in service in the year of its disposition and the replacement property was placed in service in the subsequent year, then the applicable convention is determined by the quarter the replacement property was placed in service.

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§3.76D 2. Recovery Periods and Depreciation Methods

The rules for depreciable exchanged basis recovery period and depreciation method are based on the original IRS Notice 2000-4, 2000-1 Cum Bull 313, step-in-the-shoes concept with an important caveat: Taxpayers lose the benefit of shorter recovery periods or faster depreciation methods associated with relinquished property when exchanging for replacement property subject to a longer recovery period or less accelerated depreciation method. Basic principles adopted by the regulations are as follows:

- *Recovery period AND depreciation method are the same.* If both the applicable recovery period *and* the depreciation method for the replacement property are the same as the recovery period and method for the relinquished property, the depreciation deduction attributable to depreciable exchanged basis is calculated using the same recovery period and method as the relinquished property. Reg §1.168(i)-6(c)(3)(ii).

- *Recovery period OR depreciation method are the same.* If either the recovery period *or* the depreciation method for the replacement property is the same as the recovery period or method for the relinquished property, the depreciable exchanged basis depreciation deduction is calculated using the recovery period or the method that is the same as the relinquished property. Reg §1.168(i)-6(c)(3)(iii).

- *Recovery period or depreciation method are not the same.* If the recovery period *or* depreciation method for the replacement property is not the same as the recovery period or method for the relinquished property, the following rules apply:

- If the recovery period for the replacement property is *longer* than the period for the relinquished property (*e.g.,* 27.5-year residential real property is exchanged for 39-year nonresidential real property), the depreciation deduction applicable to the exchanged basis is calculated as though the replacement property had originally been placed in service in the same taxable year the relinquished property was placed in service, but using the longer recovery period of the replacement property (Reg §1.168(i)-6(c)(4)(i));

- If the recovery period for the replacement property is *shorter* than the period for the relinquished property (*e.g.,* nonresidential real property is exchanged for residential real property), the depreciation deduction is calculated using the same (*i.e.,* longer) recovery period as that of the relinquished property (Reg §1.168(i)-6(c)(4)(ii));

- If the depreciation method for the replacement property is *less* accelerated than the method for the relinquished property (*e.g.,* a gas station property is exchanged for other nonresidential real property), the depreciation deduction is calculated as though the replacement property had originally been placed in service at the same time as the relinquished property, but using the less accelerated method (Reg §1.168(i)-6(c)(4)(i)(A)); and

- If the depreciation method for the replacement property is *more* accelerated than the method for the relinquished property (*e.g.,* nonresidential property exchanged for a gas station), the depreciation deduction is calculated using the same (*i.e.,* less accelerated) depreciation method as the relinquished property (Reg §1.168(i)-6(c)(4)(iv)(A)).

Thus, if the replacement property has the same or shorter recovery period, or the same or more accelerated depreciation method, the depreciable exchanged basis component of replacement property is depreciated over the remaining recovery period, using the depreciation method and convention of the relinquished property.

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C. Depreciation Allowance on Replacement Property

§3.76E 1. Exchanged Basis

The regulations provide rules to determine the remaining recovery period of the replacement property as well as the depreciation deduction in the year of the exchange. The remaining recovery period for the replacement property is the excess recovery period over the period of time that the replacement property would have been in service had it been placed in service when the relinquished property was placed in service and removed from service at the time of disposition of the relinquished property. This period is determined using the convention that applied to the relinquished property. See §3.76A. The length of time the replacement property would have been in service is determined by using the dates and conventions that apply to the replacement property. Reg §1.168(i)-6(c)(5)(ii)(A).

Calculation of the replacement property depreciation deduction in the year of the exchange is based on a prorata allocation of the deduction to the year of the replacement property acquisition based on the length of that year (*i.e.,* a full 12 months or some shorter period) and the number of months in the year in which the replacement property is in service. This rule is applied to expressly eliminate depreciation deductions relating to periods when no property is owned in a deferred like-kind exchange or an involuntary conversion replacement transaction.

The first step in calculating initial year replacement property depreciable exchanged basis depreciation is to ascertain the applicable recovery period and depreciation method. The second step is to calculate the depreciable exchanged basis as of the beginning of the year, without subtracting the depreciation deduction relating to the relinquished property for that year (provided that the disposition and acquisition of property occur in the same year). The third step is to establish a fraction representing the portion of the initial year in which the replacement property is in service (the "year of acquisition holding period fraction"). The annual depreciation deduction allocable to depreciable exchanged basis is calculated by applying the results of step 1 to the basis resulting from step 2 and then multiplying the result by the year of acquisition holding period fraction. Reg §1.168(i)-6(c)(5)(ii)(B).

NOTE*:* The regulations explicitly provide that land and other nondepreciable property received in an exchange or conversion transaction is not eligible for depreciation. Additionally, if both MACRS property and nondepreciable property are acquired in an exchange or conversion transaction, exchanged basis must first be allocated between the depreciable and nondepreciable property based on the regulations under IRC §1031(d), essentially using a relative fair market value system. Reg §1.168(i)-6(d)(2)(i).

If MACRS depreciable property is acquired as replacement property for land or other nondepreciable property, the newly created MACRS basis in the replacement property attributable to the relinquished nondepreciable property is treated as placed in service in the year of replacement. It is depreciated using the applicable recovery period, method, and convention prescribed in IRC §168 for the specific type of property, *i.e.,* under a "fresh start" method. Reg §1.168(i)-6(d)(2)(ii).

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§3.76F 2. Excess Basis

Excess basis is the excess of the basis in the replacement property (as calculated under IRC §1031(d)) over exchanged basis. Reg §1.168(i)-6(b)(8). Generally, the regulations treat excess basis in replacement MACRS property as newly acquired property that is placed in service in the year of replacement. The depreciation allowance for excess basis is established by using the applicable recovery period, depreciation method, and convention prescribed under IRC §168 for the specific type of property at the time of replacement.

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§3.76G D. Election Not to Apply the Regulations

Taxpayers may elect not to apply the step-in-the-shoes aspect of these regulations and treat the entire basis of the replacement property as being placed in service at the time of replacement. The relinquished property is treated as disposed of at the time of disposition. Reg §1.168(i)-6(i)(1). The election is made in the manner provided for on IRS Form 4562 and its instructions. Reg §1.168(i)-6(j).

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E. Deferred and Reverse Exchanges

§3.76H 1. Deferred Exchanges

In both deferred like-kind exchanges under IRC §1031(a)(3) and in most involuntary conversions under IRC §1033, there is a gap in time between disposition of relinquished property and acquisition of replacement property. The regulations provide that depreciation is not allowable during this period. In addition, when a deferred exchange or involuntary conversion is completed in a year different than the year of relinquished property disposition, the relinquished property year of disposition depreciation is not added back to depreciable exchanged basis when calculating replacement property year of acquisition depreciation. Reg §1.168(i)-6(c)(5)(iv)(A).

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§3.76I 2. Acquisition Before Disposition: "True" Reverse Exchanges

The regulations address the fact that, in an involuntary conversion under IRC §1033, replacement property can be acquired and placed in service before the disposal of the relinquished property in an involuntary conversion and in potentially "pure reverse" like-kind exchanges. The regulations deal with this issue by treating the replacement property as having a "fresh start" purchase price basis during the period from its acquisition to the disposition of relinquished property, coupled with a year of disposition recapture adjustment to prevent double dipping.

If a replacement property is acquired before the disposition of the relinquished property, the unadjusted basis of the replacement property is depreciated under normal principles without reference to the intended relinquished property. When the relinquished property is disposed of, the taxpayer must calculate the exchanged and excess basis of the replacement property and begin to depreciate the exchanged basis in accordance with the rules prescribed in the regulations and described in §§3.76-3.76F. In addition, in the year of disposition of the relinquished property, the taxpayer must include in taxable income (*i.e.,* recapture) the excess of the depreciation allowable on the unadjusted depreciable basis of the replacement property over the depreciation that would be allowable on the excess basis of the replacement property. Thereafter, the taxpayer continues to depreciate the depreciable excess basis of the replacement property. Reg §1.168(i)-6(d)(4).

NOTE: It is unclear whether this treatment could be used in a "true" reverse exchange under IRC §1031. See §5.3. Depreciation issues relating to reverse exchanges using accommodation "parking arrangements" are not addressed in these regulations, nor are depreciation rules relating to qualified intermediaries that acquire and hold property in deferred exchanges. See Reg §1.168(i)-6(c)(5)(iv)(B).

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IX. REPORTING REQUIREMENTS

§3.77 A. Reporting Exchange on Taxpayer's Federal Income Tax Return

Like-kind exchanges are generally reported on Schedule D (for investment property) or IRS Form 4797 (Sales of Business Property) (for trade or business property). IRS Form 8824 (Like-Kind Exchanges) is a supplemental statement that is usually included with Schedule D of an IRS Form 1120 or Form 4797, whichever is appropriate. These forms are filed for the tax year in which the relinquished property is transferred. For exchanges involving related persons, as defined in IRC §1031(f) (see §§2.70-2.83), IRS Form 8824 should also be filed for the two years following the year of the exchange. See the instructions to Schedule D or Form 4797.

The use of Internal Revenue Service forms is mandatory only when required by Treasury Regulations. IRC §6011. The regulations under IRC §1031 do not refer to Schedule D, Form 4797, Form 8824, or any other form. Thus, it is arguable that totally tax-deferred exchanges need not be reported by the taxpayer at all; however, if the tax-deferred status of the transaction is questionable, failing to report the transaction may place the taxpayer at risk of incurring a 20-percent penalty under IRC §6662, as discussed in §3.79. In any event, exchanges that are only partially tax-deferred must be reported—at least to report the recognized gain.

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§3.78 1. Using IRS Form 8824

The instructions to IRS Form 8824 (Like-Kind Exchanges) state that the form is to be used as a supporting statement for like-kind exchanges reported on other forms, including Schedule D and IRS Form 4797. A separate Form 8824 should be used for each exchange. Form 8824 requests certain information about the exchange:

- Descriptions of the properties;
- The date of disposition of the relinquished property;
- The dates of identification and acquisition of the replacement property; and
- Whether the exchange involved direct or indirect transfer of property to or from a related party.

Part II of the form requests more detailed information relating to exchanges involving related parties. Part III concerns computations of realized gain or loss, recognized gain, deferred gain or loss, and basis of like-kind property received. Part IV concerns IRC §1043 conflict-of-interest sales.

Form 8824 is not flexible. Taxpayers who dispose of one relinquished property in the exchange but acquire multiple replacement properties should attach either multiple forms or separate supporting statements. The use of Form 8824 by taxpayers should assist the Internal Revenue Service in tracking the number of like-kind exchanges and provide a record for verifying whether taxpayers have met the time requirements of IRC §1031(a)(3). Failing to file Form 8824, however, should not jeopardize a taxpayer's otherwise valid like-kind exchange.

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§3.79 2. Twenty-Percent Penalty Under IRC §6662

Internal Revenue Code §6662 imposes a penalty for underpayment of tax in specified cases, equal to 20 percent of the amount of the underpayment. The penalty does not apply to an item if the relevant facts are adequately disclosed in the taxpayer's return and there is a reasonable basis for the taxpayer's treatment of the item. IRC §6662(d)(2)(B)(ii). The filing of a complete IRS Form 8824 (see §3.78) should constitute adequate disclosure of relevant facts of the exchange to qualify for this exception to the penalty. Moreover, under IRC §6662(d)(2)(B)(i), the 20-percent accuracy penalty would not apply even if the taxpayer did not complete Form 8824 or otherwise disclose the exchange as long as there is or was substantial authority for the exchange. The latter exception apparently applies even if the exchange is ultimately disallowed. If, however, the exchange is not supported by substantial authority and is ultimately disallowed, the 20-percent accuracy penalty may apply if the taxpayer did not report the exchange. IRC §6662(d)(2)(B)(i). Furthermore, a taxpayer could be subject to the civil fraud penalty under IRC §6663(a) of 75 percent of the portion of the underpayment attributable to fraud if the exchange, coupled with failure to report, constitutes an "intent to evade tax" or an "intent to deceive" within the meaning of IRC §6663.

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§3.80 3. Using IRS Form 1099-S

The person responsible for closing a real property transaction must file an information return (IRS Form 1099-S: "Proceeds From Real Estate Transactions") with the Internal Revenue Service. See IRC §6045; Reg §1.6045-4, discussed in §3.91. In a real property exchange, Form 1099-S is usually filed by an escrow agent or the attorney who prepared the exchange documentation. Schedule D requires the taxpayer to insert on Line 1 the amount included on Form 1099-S, which enables the IRS to match the reporting by the escrow agent or attorney with the reporting by the taxpayer. If the amount on Line 1 is different from the amount in Form 1099-S, the taxpayer should attach a statement explaining the difference.

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B. Reporting Exchange on Taxpayer's State Income Tax Return

§3.81 1. Generally

California reporting requirements are exactly the same as the federal requirements, and California taxpayers reporting a like-kind exchange simply include a copy of IRS Form 8824 with their California state return.

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§3.81A 2. Sale or Exchange of Non-California Property Received in Exchange for California Property

If nonresident taxpayers comply with the Franchise Tax Board's position that California tax is due on recognized gains from disposition of non-California property relating to gains previously realized but unrecognized on California property transfers (see discussion at §3.11A), then California filings will be required for the year of any such disposition. Presumably California will rely on gain calculations provided on the IRS Form 8824 for the year of the exchange of California property for non-California property. At present, it is unclear how such filings will isolate the original California sourced gain from any subsequent gain, or take into account subsequent losses. As this Update goes to press, the FTB has not issued any regulations offering guidance to taxpayers on this matter.

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C. Complying With Special Reporting and Withholding Requirements When Taxpayer or Seller Is "Foreign" Individual, Entity, Trust, or Estate

§3.82 1. Complying With Foreign Investment in Real Property Tax Act (FIRPTA)

If a nonresident alien or a foreign corporation is a party to an exchange, the parties must consider the reporting and withholding requirements of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) (IRC §§861, 871, 882, 897, 6039C, 6652) and related provisions in IRC §1445. Special withholding rules relate to dispositions of real property by domestic partnerships, trusts, or estates to foreign persons who are partners or beneficiaries of such partnerships, trusts, or estates. IRC §1445(e). Although a complete explanation of FIRPTA is beyond the scope of this book, the application of IRC §1445 to like-kind exchanges and penalties for noncompliance are discussed in §§3.83-3.85.

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§3.83 a. Application of FIRPTA

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) applies to a disposition of a "United States real property interest" by a "foreign person." IRC §1445(a). A United States real property interest is

- an interest in real property located in the United States or the Virgin Islands (IRC §897(c)(1)(A)(i)); or
- an interest in a domestic corporation as described in IRC §897(c)(1)(A)(ii).

Generally, a foreign person is a nonresident alien individual, foreign corporation, foreign partnership, foreign trust, or foreign estate. Reg §1.1445-2(b)(2).

Internal Revenue Code §897(e) and regulations promulgated under it provide that the nonrecognition provisions of the Internal Revenue Code apply to the disposition of a United States real property interest by a foreign person only if the United States real property interest is exchanged for a United States real property interest that, immediately after the exchange, would be subject to United States taxation on its subsequent disposition. Temp Reg §1.897-6T(a)(1). Specific rules are provided for mixed exchanges in which both a United States real property interest and other property (including cash) are transferred in exchange for qualifying and nonqualifying property. Temp Reg §1.897-6T(a)(8)(ii).

PRACTICE TIP: An exchange of real property in the United States for real property outside the United States would not qualify for nonrecognition treatment under IRC §1031(a), because such properties are not considered to be of like kind. IRC §1031(h)(1).

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§3.84 b. FIRPTA's Withholding and Reporting Requirements

Internal Revenue Code §1445 and the regulations promulgated under it provide that anyone who acquires a United States real property interest from a foreign person or foreign corporation on or after January 1, 1985, must deduct and withhold a tax in an amount equal to 10 percent of the amount realized on the disposition by the foreign transferor. The amount realized is the sum of the cash paid or to be paid, the fair market value of any other property transferred or to be transferred, the amount of any liability assumed by the transferee, and the amount of any liability subject to which the transferee acquires property. Reg §1.1445-1(g)(5).

Internal Revenue Code §1445(e)(1) also requires withholding of a tax equal to 35 percent (or, to the extent provided in the regulations, 20 percent) of gain realized by a domestic partnership, trust, or estate on the disposition of a United States real property interest to the extent such gain is allocable to

- a foreign person who is a partner or beneficiary of such partnership, trust, or estate; or
- a portion of a trust treated as owned by a foreign person under subpart E of part I of subchapter J of the Internal Revenue Code.

Amounts withheld must generally be reported and paid to the IRS (using Forms 8288 and 8288-A) within 20 days after the date of the transfer of the United States real property interest. Reg §1.1445-1(c). The transferee has a duty to withhold 10 percent of the amount realized (*e.g.,* the sales price), regardless of the amount of cash actually paid by the transferee. Reg §1.1445-1(b)(1). The transferee's failure to deduct and withhold tax as required by IRC §1445 may result in the transferee's being held liable for the payment of the tax and any applicable penalties and interest. Reg §1.1445-1(e)(2).

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§3.85 c. Exceptions to FIRPTA Withholding Requirements; Withholding Certificates

There are a number of exceptions to the withholding provisions of IRC §1445. For like-kind exchanges, no withholding is required if both of the following occur (Reg §1.1445-2(d)(2)(i)):

- The transferor notifies the transferee, in the manner required, that the transferor is not required to recognize any gain or loss on the transfer by operation of a nonrecognition provision of the Internal Revenue Code; and
- The transferee provides a copy of the transferor's notice to the IRS within 20 days after the date of the transfer.

The transferee may not rely on this rule, however, and must withhold the §1445 tax if either (a) the transferor qualifies for only partial nonrecognition or (b) the transferee knows or has reason to know that the transferor is not entitled to the nonrecognition treatment claimed. Reg §1.1445-2(d)(2)(ii). In either circumstance, the transferor or transferee may request a withholding certificate from the IRS under Reg §1.1445-3.

PRACTICE TIP: In a deferred (nonsimultaneous) exchange, the taxpayer may not know whether the exchange will be fully tax-deferred until all replacement property is acquired. Furthermore, application of the boot-offset rules must be considered carefully to ensure that the taxpayer does not unknowingly recognize gain from the exchange. Given the significant liability exposure of transferees under IRC §1445, the safest approach for the transferee is to require the transferor to obtain a withholding certificate from the IRS before closing the transaction.

The transferee's obligation to withhold funds under IRC §1445 may be reduced or eliminated if a withholding certificate is issued by the IRS. Reg §1.1445-3. If either the transferor or the transferee submits an application for a withholding certificate to the IRS on or before the transfer date, the transferee must still withhold 10 percent of the amount realized but need not report or pay to the IRS all or any of the withheld amount until the 20th day after the final determination on the application. Reg §1.1445-1(c)(2). See IRS Form 8288-B. The IRS must act on an application for a withholding certificate within 90 days after its receipt. Reg §1.1445-3(a).

No withholding is required if the transferor is not a foreign person or a foreign corporation. A transferor can provide a certification of nonforeign status signed under penalty of perjury to inform the transferee that withholding is not required. Reg §1.1445-2(b)(2)(i). The transferee is entitled to rely on a transferor's certification unless the transferee either has actual knowledge that the transferor's certification is false or receives notice that the certification is false from the transferor's or transferee's agent. Reg §1.1445-2(b)(4)(iii). A transferee who obtains such a certification must keep that document for 5 years. Reg §1.1445-2(b)(3). See Reg §1.1445-2(b)(2) for the required contents of a certification of nonforeign status.

No withholding is required if an individual transferee is acquiring the United States real property interest for use as the transferee's residence and the amount realized on the transaction is $300,000 or less. Reg §1.1445-2(d)(1). Although a real property interest used as a residence by the *taxpayer* would not qualify under IRC §1031, this exception to FIRPTA might apply in an exchange in which the *buyer* intends to use the relinquished property as a personal residence.

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§3.86 2. Complying With CALFIRPTA

Every transferee of a California real property interest (as defined in IRC §897(c)(1)(A)(i)) is required to withhold 3 1/3 percent of the sales price and remit that amount to the Franchise Tax Board (FTB), subject to numerous exceptions (see §3.87). Rev & T C §18662(e)(2)(A) (often referred to as CALFIRPTA (California Foreign Investment in Real Property Tax Act of 1980)).

Generally, the withholding requirement applies to transfers by individuals, by nonresident partnerships, and by corporations that have no permanent place of business in California. Rev & T C §18662(e)(1). The transferee may delegate this obligation to the real estate escrow person. Rev & T C §18662(e)(6).

The transferor may elect, via a written certification made under penalty of perjury, to have the transferee remit less than the 3 1/3-percent withholding amount, but not less than the imputed tax due on gain that would be recognized under the California personal income tax law (Rev & T C §17000) or corporate tax law (Rev & T C §23001). Rev & T C §18662(e)(2)(B). Statutory changes effective in 2009 increased the assumed tax rate applicable in the case of the recognized gain election to the maximum rate applicable to the taxpayer in question, plus 1 percent or, in the case of S corporations, a tax of either 10.8 percent or 12.8 percent. Rev & T C §§18535-18536 (Stats 2008, ch 305).

The penalty for noncompliance is the greater of $500 or 10 percent of the amount that should have been withheld. Rev & T C §18668(d).

See §3.89 for discussion of FTB filing requirements.

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§3.87 a. Exceptions to CALFIRPTA Withholding Requirements

Exceptions to the withholding requirement include the following (Rev & T C §18662(e)):

- Sales by a corporation having a permanent place of business in California. Rev & T C §§18662(e)(1)(B), 18662(e)(3)(D)(v). A corporation does *not* qualify for this exemption if, immediately after the transfer of title of the real property interest, the corporation
- is not organized and existing under the laws of California;
- has not qualified (as a foreign corporation doing business in California) with the California Secretary of State; *and*
- does not maintain and staff a permanent office in California.
- Transfers in which the total sales price is $100,000 or less. Rev & T C §18662(e)(3)(A).
- Transfers in which the real estate escrow person failed to give written notice of the withholding requirement to the transferee. This exemption does *not* apply in a deferred exchange using a qualified intermediary or accommodator. Rev & T C §18662(e)(3)(B).
- Foreclosure sales (either private or judicial), transfers by deed in lieu of foreclosure, and transfers by a bank acting as a trustee other than under a deed of trust. Rev & T C §18662(e)(3)(C).
- Sales of principal residences (including sales of a California decedent's principal residence). Rev & T C §18662(e)(3)(D)(i).
- Like-kind exchanges under IRC §1031 (subject to limitations, see §3.88). Rev & T C §18662(e)(3)(D)(ii).
- Involuntary conversions under IRC §1033 when the taxpayer will acquire a replacement property. Rev & T C §18662(e)(3)(D)(iii).
- Transactions that result in either a net loss or a net gain not required to be recognized for California income or franchise tax purposes. Rev & T C §18662(e)(3)(D)(iv). This includes dispositions by tax-exempt entities, IRAs, and similar entities when the gain from the sale is exempt from tax.

WARNING: The foregoing bullet list only briefly summarizes the exemptions to the CALFIRPTA withholding requirements. The statutory requirements to qualify for these exemptions are quite complex. Counsel for buyers and other transferees of California real property interests are strongly advised to carefully study the statute before advising their clients on the availability of any of these exemptions.

Special rules apply for withholding in an installment sale. Rev & T C §18662(e)(3)(E).

Dispositions of California real property interests by partnerships and limited liability companies (LLCs) are exempt from withholding. Rev & T C §18662(e)(1)(A)(ii). This exemption is logical because those entities are not subject to tax on gain or loss; instead, the partners or members of these entities are individually liable for the tax on the gain or loss. Thus, the partnership or LLC itself is responsible for withholding on distributions made to its partners or members. It is unclear, however, whether the partnership or LLC (as the transferor) or the partners/members (as the transferees) are responsible for complying with the reporting and withholding requirements.

Under Rev & T C §18662(e)(9), the FTB may prescribe "any requirements necessary for the efficient administration" of the withholding requirements when applied to "de minimus" amounts. If the FTB utilizes this provision, practical procedures may be adopted to deal with transfers of California real property interests resulting in nominal tax liability.

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§3.88 b. Exception for Like-Kind Exchanges

The CALFIRPTA withholding requirements do not apply to certain tax-deferred exchanges under IRC §1031. Rev & T C §18662(e)(3)(D)(ii). In a tax-deferred exchange, the qualified intermediary (QI) is required to withhold and remit to the FTB the applicable amount calculated under Rev & T C §18662(e)(4) only if the transferor/exchanger fails to meet the requirements of IRC §1031(a)(3) (*i.e.,* identify replacement properties within 45 days of disposition and acquire replacement property within 180 days of disposition). As Rev & T C §18662(e)(3)(D)(ii) provides, in part:

No transferee (including for this purpose any intermediary or accommodator in a deferred exchange) is required to withhold any amount under this subdivision if the transferee, in good faith and based on all the information of which he or she has knowledge, relies on a written certificate executed by the transferor, certifying, under penalty of perjury, [that]… [t]he California real property being conveyed is being exchanged, or will be exchanged, for property of like kind (within the meaning of Section 1031 of the Internal Revenue Code), but only to the extent of the amount of the gain not required to be recognized for California income or franchise tax purposes under Section 1031 of the Internal Revenue Code.

[The foregoing] may not apply if an exchange does not qualify for nonrecognition treatment for California income or franchise tax purposes under Section 1031 of the Internal Revenue Code, in whole or in part, due to the failure of the transaction to comply with the provisions of Section 1031(a)(3) of the Internal Revenue Code, relating to the requirement that property be identified and that the exchange be completed not more than 180 days after the transfer of the exchanged property.

QIs, and other real estate escrow persons, may, at their option, remit funds withheld on individual transactions to the FTB on the 20th day following the close of escrow, or remit on a monthly basis, in combination with other transactions closed in the same month. Rev & T C §18662(e)(4)(A).

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§3.89 c. Forms Required by CALFIRPTA

The Franchise Tax Board (FTB) has several forms that must be submitted to comply with CALFIRPTA. For the FTB website where the latest versions of the necessary forms can be downloaded, see Directory. For a website where the FTB publication on "Real Estate Withholding Guidelines" can be obtained, see Directory.

- Form 593, the "Real Estate Withholding Remittance Statement," is completed by the withholding agent (the escrow/title company, accommodator/intermediary, or buyer), and is sent, with the withholding amount, to the FTB.

- Form 593-B, the "Real Estate Withholding Tax Statement," is to be completed by the withholding agent and sent to the seller with a copy of the completed Form 593. It notifies the seller of the amount being withheld in connection with the referenced transaction.

- Form 593-C contains the "Real Estate Withholding Certificate" for individual sellers. It is to be used by sellers who are not entities, or who are not otherwise exempt under Rev & T C §18662(e). The certificate is not required when the exemption for transactions with a sales price of not more than $100,000 (Rev & T C §18662(e)(3)(A)) is available. See Form 593 Instructions.

- Form 593-E, the "Real Estate Withholding—Computation of Estimated Gain or Loss" form, is used by the transferor, including a qualified intermediary or accommodator, to claim an exemption due to a loss or zero gain, or to elect an alternative withholding amount under Rev & T C §18662(e)(2)(B). Transferors are required to certify the accuracy of their responses in Form 593-E under penalty of perjury as required by Rev & T C §18662(e)(2)(B). Form 593-E also contains language as required by Rev & T C §18662(e)(2)(C) that explicitly states that title and escrow agents and exchange accommodators are prohibited from providing legal or accounting advice for purposes of withholding amounts and encourages transferors to consult with a competent tax professional. See Form 593 Instructions.

- For exchanges taking place before 2007, Form 593-L is to be used in conjunction with Form 593-C. Form 593-L provides the manner for computing the estimated gain or loss on the transaction subject to withholding, and the withholding amount (certified by the seller under penalty of perjury). When these forms are used, the withholding agent will compute the amount to be withheld (3 1/3 percent of the gain determined by the seller on Form 593-L) and will complete and file Forms 593 and 593-B with the FTB.

- Form 593-I, the "Real Estate Withholding Installment Sale Agreement," is used if the buyer agrees to withhold on each installment payment instead of the other alternatives. See Rev & T C §18662(e)(3)(E). Only the buyer, who is obligated on the installment payment, can complete the form. The buyer gives the original to the escrow agent, along with a copy of the promissory note and a completed Form 593-B. The escrow agent will withhold the amounts due on the down payment, but the buyer is responsible for withholding on all subsequent installment payments, including the final payment due.

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§3.90 d. Open Issues: Interplay Between IRC §1031 and Rev & T C §§18661-18677

Numerous questions arise in connection with the interplay between IRC §1031 and Rev & T C §§18661-18677. These questions persist despite the addition in 2006 of Rev & T C §18662(e)(2)(B), which allows for a reduced withholding (see discussion in §3.86).

Assume that an individual sells its relinquished property for $100,000 and realizes gain of $40,000 (that is, the taxpayer's adjusted cost basis is $60,000). A secured loan of $65,000 is paid off at closing, and there are $7,000 in closing costs. Net proceeds of $28,000 are delivered to the QI. The following are examples of these unanswered questions.

EXAMPLE 1: If the taxpayer uses only $27,000 of the net proceeds to acquire replacement property, and receives net cash boot of $1,000, is the QI responsible for withholding and remitting to the FTB based on the full net sales price (by application of Rev & T C §18662(e)(2)(B)) or based on $1,000 of gain recognized?

EXAMPLE 2: When the buyer's installment note is payable to the QI, is the buyer's withholding computed on the face amount of the note or on the total purchase price? The FTB has indicated in informal discussions that if all exchange proceeds (cash and installment note payable to the QI) are delivered to a QI, the buyer has no obligation to withhold any amount.

EXAMPLE 3: When the QI receives both cash and the buyer's installment note (with the QI as the payee on the note), there are no note payments during the "exchange period," the QI uses the cash proceeds to acquire replacement property, and the QI distributes the note to the taxpayer, how does the QI get sufficient cash to withhold? And, again, how is the amount that the QI is required to withhold computed?

EXAMPLE 4: When some of the exchange proceeds held by the QI are used in connection with the acquisition of the replacement property for items that are not included in the purchase price (such as loan points, prepaid real property taxes, or security deposits paid to the seller of the replacement property), is the QI responsible for withholding on those disbursed amounts?

EXAMPLE 5: If the exchange takes place on day 1, but the period of time for distribution of the "cash boot" does not occur until day 180, is there an automatic extension of time for the QI to complete and file Form 593-B and remit the withholding amount?

It is anticipated that it will be a while before the FTB provides clarification or the legislature enacts a "clean up" bill to resolve the unanswered questions and conflicts. In the meantime, QIs should err on the side of caution. Counsel should check with the FTB for direction (see Directory for contact information).

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§3.91 D. Filing of Information Return by Person Responsible for Closing Real Estate Transaction

Internal Revenue Code §6045(e) and Reg §1.6045-4 require that certain information concerning sales and exchanges of real property be reported to the Internal Revenue Service by the person responsible for closing the transaction.

Under Reg §1.6045-4(e)(3), the person responsible for closing the transaction usually is one of the following:

- The person listed as the settlement agent if a uniform settlement statement under the Real Estate Settlement Procedures Act of 1974 (12 USC §§2601-2617) is used;
- The person who prepares a closing statement presented to the transferor and transferee in connection with the close of the transaction; or
- Another enumerated person if no closing statement is used or multiple closing statements are used.

In a concurrent exchange, the person responsible for closing the transaction usually is either the escrow agent or the attorney handling the exchange. In a deferred exchange, the person responsible for closing the transaction is usually the attorney preparing the exchange agreement and closing statement.

Transactions subject to these rules must be reported on an information return, IRS Form 1099-S, using magnetic media unless the responsible person files fewer than 250 returns in a calendar year. Reg §1.6045-4(k)(1). A copy of the information return must be furnished to the transferor. Reg §1.6045-4(m)(1).

All covered transactions must be reported, whether or not they are currently taxable. Reg §1.6045-4(b)(1). For example, even though the transferor is entitled to exclude the first $250,000 of gain ($500,000 if the taxpayer is married filing a joint return) from the sale of a principal residence under IRC §121, the transaction still must be reported under IRC §6045(e). See Reg §1.6045-4(r), Examples 2, 4, pertaining to exchanges of real property. Most like-kind exchanges under IRC §1031 are subject to the reporting requirements of §6045(e).

WARNING: The penalty for failing to file a Form 1099-S when required is usually $50 for each return, not to exceed $250,000 per person failing to file. IRC §6721(a)(1), (d). Internal Revenue Code §6045(e)(3) prohibits any real property reporting person to charge any customer separately for complying with that section.

Under Reg §1.6045-4(c)-(d), certain transactions and transferors are exempt from the reporting requirements under IRC §6045(e), including the following:

- Transactions that are not sales or exchanges;
- Transfers in full or partial satisfaction of any indebtedness secured by the property transferred (including a foreclosure, a transfer in lieu of foreclosure, or an abandonment);
- A de minimis transfer in which the total consideration received or to be received is less than $600; and
- Corporate transferors.

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Deferred Exchanges

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§4.1 I. INTRODUCTION

An exchange of property can be either simultaneous or nonsimultaneous. A simultaneous exchange is one in which the relinquished property and the replacement property are transferred concurrently. In a nonsimultaneous exchange, the relinquished property and the replacement property are not transferred concurrently.

A nonsimultaneous exchange is a deferred exchange if a taxpayer first transfers relinquished property and subsequently receives replacement property. A deferred exchange will qualify for like-kind exchange treatment under IRC §1031 if

- it otherwise meets the requirements for a valid simultaneous exchange (see chap 2); and
- it meets the additional statutory and regulatory requirements specifically applicable to deferred exchanges under IRC §1031(a)(3) and Reg §1.1031(k)-1.

A nonsimultaneous exchange is a reverse exchange if a taxpayer first acquires replacement property and later transfers relinquished property. See chap 5 for discussion of reverse exchanges.

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§4.2 A. "Deferred" or "Delayed Status" Exchanges

The regulations define a deferred exchange as an exchange in which, under a written agreement, the taxpayer transfers property held for productive use in a trade or business or for investment and subsequently receives property to be held either for productive use in a trade or business or for investment. See Reg §1.1031(k)-1(a). The key definitional element is that receipt of replacement property occurs after a transfer of relinquished property.

Deferred exchanges are also known as "delayed," or "*Starker,*" exchanges. The term "delayed exchange" was coined before the adoption of Reg §1.1031(k)-1 and is becoming less common. The term "*Starker* exchange" associates these transactions with the seminal case, *Starker v U.S.* (9th Cir 1979) 602 F2d 1341, which established the validity of nonsimultaneous exchanges and ultimately led to the adoption of IRC §1031(a)(3). See §4.7.

To be consistent with the definition in the regulations, this book generally uses "deferred exchange" to refer to a nonsimultaneous exchange that is not a reverse exchange.

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§4.3 B. Is Exchange Simultaneous or Deferred?

An exchange can be simultaneous for purposes of IRC §1031 even if the deeds are not recorded at the same time, because recording is not an essential element in transferring real property. CC §1217; *Warnock v Harlow* (1892) 96 C 298, 31 P 166; *Devereaux v Frazier Mountain Park & Fisheries Co.* (1967) 248 CA2d 323, 56 CR 345. The transferor's delivery of a deed to a transferee is a valid conveyance of real property. CC §1054.

In any event, simultaneous recording is usually a mechanical impossibility. If both deeds will be recorded in the same county, one deed must be recorded first in the county recorder's office. If the properties are located in different counties or in different states, concurrent recordation is very difficult to arrange. The most common way of effecting a "simultaneous" exchange is to arrange for recordation or delivery of the deeds on the same day and to contractually make the transfers of the relinquished property and the replacement property contingent on the simultaneous transfer of title.

Technically, two transfers are nonsimultaneous even if they occur only a few minutes apart. As a practical matter, however, the IRS will probably consider an exchange simultaneous if the transfers occur on the same day unless the taxpayer actually or constructively receives the sale proceeds. See *Carlton v U.S.* (5th Cir 1967) 385 F2d 238. Transfers that do not occur on the same day are generally considered deferred or nonsimultaneous transfers, subject to the time restrictions discussed briefly in §4.4 and in greater depth in §§4.9-4.35.

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§4.4 C. Timing of Deferred Exchanges

For a deferred exchange to qualify under IRC §1031, it must meet the two time requirements in IRC §1031(a)(3):

- The replacement property must be *identified* within 45 days after the relinquished property is transferred; and
- The replacement property must actually be *received* on or before the earlier of (1) 180 days after the date the relinquished property is transferred or (2) the due date of the transferor's tax return for the taxable year in which the relinquished property is transferred, taking into account any extra time allowed by authorized extensions to file the return.

By adopting IRC §1031(a)(3), Congress did not validate all deferred exchanges that satisfy those time restrictions; it simply added additional requirements on identification and receipt of replacement property for taxpayers wishing to qualify under §1031. For detailed discussion of these restrictions, see §§4.9-4.35.

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§4.5 II. HISTORY OF DEFERRED EXCHANGES

Before the landmark case of *Starker v U.S.* (9th Cir 1979) 602 F2d 1341 (see §4.7), the IRS took the position that deferred exchanges did not qualify for like-kind exchange treatment under IRC §1031. This position was based on the premise either that there was no exchange of property or that the property received on transfer of the relinquished property was not property but merely a promise to receive property in the future, which was not like kind with the property transferred.

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A. Judicial Precedent for Deferred Exchanges

§4.6 1. Pre-*Starker* Cases

The deferred exchange concept predated the decision in *Starker v U.S.* (9th Cir 1979) 602 F2d 1341 by several years. Deferred exchanges were approved in cases before *Starker,* both when the replacement property was designated at the time the relinquished property was transferred (see *Redwing Carriers, Inc. v Tomlinson* (5th Cir 1968) 399 F2d 652; *Bennie D. Rutherford,* TC Memo 1978-505) and when the replacement property was not identified at the time of transfer (see *Starker v U.S.* (D Or 1975) 75-1 USTC ¶9443, 35 AFTR2d 1550; *Leo A. Woodbury* (1967) 49 TC 180, acq 1969-2 Cum Bull xxv). None of these cases, however, specifically focused on the concept of a deferred exchange. Instead, pre-*Starker* cases addressed only the nonsimultaneous transfer and receipt of legal title or beneficial or legal ownership.

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§4.7 2. *Starker v U.S.*

Starker v U.S. (9th Cir 1979) 602 F2d 1341 is the landmark case for deferred exchanges under IRC §1031. The facts and transactions that are the subject of the appellate decision actually gave rise to two cases: one involving T.J. Starker (T.J.) and one involving his son and daughter-in-law, Bruce and Elizabeth Starker.

In 1967, the three Starkers agreed to convey to Crown Zellerbach Corporation (CZ) their interests in certain Oregon timberland having an agreed fair market value. CZ agreed to acquire and transfer to the Starkers title to real property that they would designate within 5 years, at a cost up to the amount of the credit for their timberland. CZ retained the option, but not the obligation, to pay the Starkers any remaining credit balance after 5 years in cash, rather than property. The credit amount increased every year at a rate of 6 percent, ostensibly to take into account the increased value of timber growing on the land. CZ's promise to deliver property in the future was unsecured.

Bruce and Elizabeth concluded their portion of the transactions by designating and receiving three parcels of property within 4 months after the transfer of the timberland to CZ. They received nothing else.

Over the next 2 years, CZ acquired 12 parcels of property identified by T.J. and conveyed the property at his direction. Nine of the parcels were conveyed directly to T.J. and two were conveyed to his daughter. In the 12th purchase, the buyer acquired and transferred to T.J. a contract right to acquire property, which local law treated as a beneficial ownership. The property was subject to a life estate, which prevented legal title from passing to T.J. until the life estate expired. CZ never paid any cash to T.J. because all of the exchange value credit was used in the 12 acquisitions.

All three Starkers reported the transactions as IRC §1031 exchanges. The IRS challenged the application of §1031 to defer recognition of realized gain on transfer of the Starker timberland and subsequent receipt of replacement property. The Starkers each paid the assessed taxes and separately sued for refunds. In the case involving Bruce and Elizabeth, the District Court held that their transaction qualified for like-kind exchange treatment under §1031 and that there was no simultaneity requirement under that section. *Starker v U.S.* (D Or 1975) 75-1 USTC ¶9443, 35 AFTR2d 1550. The IRS appealed this decision but later dismissed its appeal. This decision is sometimes referred to as *Starker I*.

The trial judge held that regarding T.J.'s refund claim, nine of the 12 properties would have collateral estoppel coverage because the facts and arguments were so similar to those in *Starker I*. But with respect to the other three properties, the trial judge changed his view, holding that the exchanges did not qualify under §1031, because the properties received were not like in kind to the property transferred, the transfers were not simultaneous, and a contract right to acquire real property was not like in kind to real property itself. *Starker v U.S.* (D Or 1977) 432 F Supp 864. This case is sometimes referred to as *Starker II*.

T.J. appealed *Starker II* to the Ninth Circuit Court of Appeals (602 F2d 1341), which reversed, concluding that, with two exceptions, T.J.'s transactions did qualify for like-kind exchange treatment. With respect to the first nine parcels acquired and transferred to T.J., the Ninth Circuit agreed that the doctrine of collateral estoppel applied because the IRS had already lost a related case (*Starker I*) with similar facts. Nonetheless, there were sufficient distinctions between the *Starker I* facts and those affecting T.J. to permit the court to address the substantive issues involved. With respect to the two properties acquired and transferred to T.J.'s daughter, the court held that like-kind exchange treatment did not apply because no reciprocal exchange had occurred; T.J. had not received any rights to the replacement properties before their transfer to his daughter. 602 F2d at 1350.

Finally, with respect to the 12th transaction (involving a land purchase contract right), the court ruled that the contract right to acquire title to property, which also entitled the buyer to possession, was the equivalent of a fee interest under Reg §1.1031(a)-1(c) and that the property could therefore be the subject of an exchange (602 F2d at 1355):

> [T]itle to real property, like a contract right to purchase real property, is nothing more than a bundle of potential causes of action: for trespass, to quiet title, for interference with quiet enjoyment, and so on. The bundle of rights associated with ownership is obviously not excluded from section 1031; a contractual right to assume the rights of ownership should not, we believe, be treated as any different than the ownership rights themselves.

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B. Legislative Response to *Starker*

§4.8 1. IRC §1031(a)(3)

In *Starker v U.S.* (9th Cir 1979) 602 F2d 1341 (see §4.7; *Starker II* on appeal), the Ninth Circuit invited Congress to clarify the applicability of IRC §1031 to deferred exchanges: "If our holding today adds a degree of uncertainty to this area, Congress can clarify its meaning." 602 F2d at 1356. Five years later, Congress accepted this invitation by enacting IRC §1031(a)(3) in the Tax Reform Act of 1984 (TRA 1984) (Pub L 98-369, 98 Stat 494). After a minor retroactive amendment (effective as if enacted by TRA 1984) in the Tax Reform Act of 1986 (TRA 1986) (Pub L 99-514, 100 Stat 2085), IRC §1031(a)(3) now states:

> (3) *Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property.* For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if
>
> (A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or
>
> (B) such property is received after the earlier of
>
> (i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or
>
> (ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

Accordingly, to qualify a deferred exchange for nonrecognition treatment, the replacement property must be both

- identified within 45 days after the date on which the relinquished property is transferred; and
- acquired within 180 days after the first to occur of (1) the date the relinquished property is transferred to start the exchange or (2) the date that the taxpayer's federal income tax return for the year in which the taxpayer transferred the relinquished property is due, taking into account any extensions of time to file that return.

Both periods begin on the same date; *i.e.,* the 180-day period has 135 days left to run when the 45-day period expires. Reg §1.1031(k)-1(b)(2).

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.9 2. Rationales for Enacting Time Restrictions on Deferred Exchanges

§4.9 2. Rationales for Enacting Time Restrictions on Deferred Exchanges

Congress cited several reasons for enacting IRC §1031(a)(3):

- The taxpayer's lack of realized profit on the transaction (see §4.10);
- The administrative burden of valuing traded property (see §4.11);
- Other administrative burdens (see §4.12); and
- The expanded possibilities for the taxpayer to avoid recognition of gain entirely (see §4.13).

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§4.10 a. Unrealized Profit

The first general justification for nonrecognition treatment has generally been based on the ground that a taxpayer who exchanges like-kind property has not effectively realized a profit on the transaction. See discussion in §1.7. Congress recognized that this rationale applies less to deferred exchanges than to simultaneous exchanges because, to the extent that a taxpayer is able to defer completion of an exchange, the transaction looks less like a like-kind exchange and more like a sale of one property and a later purchase of another. Congress apparently believed this to be particularly true when, as in *Starker v U.S.* (9th Cir 1979) 602 F2d 1341 (*Starker II*), the taxpayer might have received non-like-kind property (cash) at a future date. See H Rep No. 432, 98th Cong, 2d Sess (1984), reprinted in 1984 US Code Cong & Ad News 697, 895.

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§4.11 b. Administrative Burden of Valuing Traded Property

The second general justification for nonrecognition treatment—the administrative burden of valuing property traded for like-kind property (see §1.6)—applies less to deferred exchanges than to simultaneous exchanges, because in deferred exchanges the parties value the relinquished property at a specific dollar amount to calculate the aggregate value of the properties that the taxpayer may receive in the future. H Rep No. 432, 98th Cong, 2d Sess (1984), reprinted in 1984 US Code Cong & Ad News 697, 895. Although this is true for deferred exchanges, in practice it is also true for all three-party and most two-party simultaneous exchanges, in which an exchange value is assigned to each property transferred so that the parties can ascertain whether any adjustments in the form of boot paid or received are necessary. On boot, see §§3.6-3.53.

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§4.12 c. Other Administrative Burdens

Deferred exchanges create certain administrative burdens not created by simultaneous exchanges. For example, the allocation of liabilities and basis among different properties may not be resolved until an exchange is completed, leaving the tax consequences of a multiyear transaction open for an extended period after it is initiated. Further, if a transaction is commenced in one year and not completed until after the statute of limitations on the initial year return has run, the IRS might have limited ability to challenge the characterization or tax consequences of the transaction. Setting time limits on completion of deferred exchanges mitigates these problems. H Rep No. 432, 98th Cong, 2d Sess (1984), reprinted in 1984 US Code Cong & Ad News 697, 897.

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§4.13 d. Possible Avoidance of Recognition of Gain

The interplay among IRC §1031, the installment sale rules of IRC §453, and the stepped-up basis on death under IRC §1014 could significantly expand taxpayers' ability to avoid recognition of gain entirely. If deferred exchanges had no time limit, taxation on disposition of properties could be deferred indefinitely, even if the taxpayer retained the right to receive cash instead of like-kind property. If cash is ultimately received, the installment sale rules permit deferral until its receipt. If like-kind property is received, recognition will be delayed even further. If recognition is delayed until death, the taxpayer's successors could completely avoid recognition of gain for income tax purposes because of the step-up in basis. The fair market value of the replacement property at the date of death would, however, be included in the decedent's estate for estate tax purposes. H Rep No. 432, 98th Cong, 2d Sess (1984), reprinted in 1984 US Code Cong & Ad News 697, 895.

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§4.14 e. Identification Requirements

Strangely, there is virtually no legislative history describing Congress's rationale for the separate identification requirement enacted as IRC §1031(a)(3)(A), compared with the six-month due date of return limit of IRC §1031(a)(3)(B). In fact, Congress apparently viewed the requirement as a relaxation of the initially proposed version of the statute, which would have required identification of replacement property at the time that relinquished property was transferred, in effect requiring a concurrent connection between relinquished and replacement property but allowing a 180-day lag in receipt of the replacement property. This relaxation, permitting identification to occur within 45 days after the relinquished property transfer, was added in the course of the House-Senate Conference on the Tax Reform Act of 1984. H Conf Rep No. 861, 98th Cong, 2d Sess (1984), reprinted in 1984 US Code Cong & Ad News 1445, 1554. Apparently, Congress sought to significantly restrict the flexibility represented by the *Starker II* facts, bringing deferred exchanges into closer conformity with the traditional simultaneous exchange models. Many commentators have claimed that the identification requirement has little or no merit; but the authors believe that it reflects congressional antipathy to the concept of deferred exchanges as open transactions and a congressional desire to rein in taxpayers' freedom to structure these transactions as permitted under other nonrecognition sections, such as IRC §1033 (relating to casualty and condemnation dispositions) and former IRC §1034 (relating to primary residence transfers).

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§4.15 3. Issues Left Unresolved by IRC §1031(a)(3)

The adoption of IRC §1031(a)(3)'s time limits on deferred exchanges created new issues of interpretation but did not alter the fundamental requirement that an exchange of like-kind properties held for a qualified use is required for a taxpayer to benefit from tax deferral under IRC §1031. A taxpayer who receives cash or other non-like-kind property and uses it to purchase like-kind property, even within the periods stated, will not qualify under §1031. H Conf Rep No. 861, 98th Cong, 2d Sess (1984), reprinted in 1984 US Code Cong & Ad News 1445, 1554. Taxpayers and their advisers quickly realized that many, if not most, transactions should not be structured to rely on the buyer's unsecured promise found in *Starker I* and *Starker II*, but they also realized that the statute was silent on what methods could be used to protect taxpayers from default by their exchange partners.

The new time limits raised additional issues, such as the following:

- How were taxpayers supposed to identify replacement property?
- To whom were they to make the identification?
- How specific must the identification be?
- Could property be identified that did not exist at the time of the identification, but that would be created between that time and the time of receipt?
- Could taxpayers identify more property than they expected to receive in the exchange?

Many, but by no means all, of the issues left unresolved after the Tax Reform Acts of 1984 and 1986 were clarified by the final regulations on deferred exchanges under Reg §1.1031(k)-1, issued on April 25, 1991. These regulations address both the procedures and limits applicable to taxpayer compliance with §1031(a)(3) and also the issue of applying the exchange requirement and constructive receipt doctrine to nonsimultaneous transactions.

The remainder of this chapter discusses the final deferred exchange regulations and analyzes the issues that remain open relating to identification, exchange property receipt, and exchange structures that replace the unsecured promise of a relinquished property buyer. Also addressed are regulations governing tax consequences of earnings on funds representing relinquished property sale proceeds during the period between transfer of relinquished property and receipt of replacement property. Planning opportunities and constraints are highlighted throughout.

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III. IDENTIFICATION AND RECEIPT REQUIREMENTS

A. Timing of Identification and Receipt

§4.16 1. Generally

Regulation §1.1031(k)-1(a)-(e) provides detailed rules on the proper method and manner of identifying and receiving replacement property to satisfy the time requirements of IRC §1031(a)(3):

- The period within which the taxpayer must identify the replacement property (identification period) begins on the date on which the taxpayer transfers the relinquished property and ends at midnight on the 45th day after that date (Reg §1.1031(k)-1(b)(2)(i)); and
- The period within which the taxpayer must receive the replacement property (exchange period) also begins on the date on which the taxpayer transfers the relinquished property, but it ends at midnight on the *earlier* of the 180th day after that date or the due date of the taxpayer's income tax return for the taxable year in which the transfer of the relinquished property occurs (taking into account allowed extensions). Reg §1.1031(k)-1(b)(2)(ii), 1.1031(k)-1(b)(3); see §4.8. See also *Raymond St. Laurent,* TC Memo 1996-150.

NOTE: The attorney should emphasize to the taxpayer that the 180-day exchange period begins on the date on which the taxpayer transfers the relinquished property—not on the 45th day after the taxpayer transfers the relinquished property.

Property is transferred when it is disposed of under general tax principles within the meaning of IRC §1001(a). Reg §1.1031(k)-1(b)(2)(iv). The transfer of the benefits and burdens of ownership is generally sufficient to transfer real property. The transfer may be accomplished by execution and delivery of a deed or by execution of a land sale contract. See discussion of *Starker* cases in §4.7. Reg §1.1031(k)-1(b)(2)(iv). The receipt of replacement property is determined under the same general tax principles. Recordation of a deed is not an essential element of a valid transfer of real property. CC §1217. See §4.3.

WARNING: If the 180-day exchange period will end in the taxable year following the year in which the relinquished property is transferred and after the initial due date of the taxpayer's tax return for the year of transfer, the taxpayer must apply for an extension of time to file the prior year's tax return to take full advantage of the 180-day period. For example, a calendar-year individual taxpayer who conveys property after October 17th of a particular year (October 18th if the next year is a leap year) must extend the tax return due date beyond April 15th of the next calendar year to take full advantage of the 180-day period. See Reg §1.1031(k)-1(b)(3); *Raymond St. Laurent,* TC Memo 1996-150; *Orville E. Christensen,* TC Memo 1996-254, aff'd without published opinion sub nom *Christensen* v *Commissioner* (9th Cir 1998) 142 F3d 442.

If the taxpayer fails to identify the replacement property before the end of the identification period, or fails to receive the replacement property before the end of the exchange period, any replacement property received by the taxpayer will be treated as property that is not like kind to the relinquished property, and the taxpayer's gain will not be deferred under IRC §1031. Reg §1.1031(k)-1(b). See also *Raymond St. Laurent, supra*.

In *Smith v Commissioner* (4th Cir 1997) 97-2 USTC ¶50,928, 80 AFTR2d 7778, aff'd without published opinion (4th Cir 1997) 129 F3d 1260, the taxpayer's tax return for the year in question reported that he had identified the replacement property on a specific date that was more than 45 days after disposition of the relinquished property. Although the taxpayer testified that before expiration of the 45-day period he had expressed his interest in acquiring the replacement property, the Tax Court found the weight of the evidence resided with the statement in his tax return, and disallowed tax deferral because of failure to meet the 45-day time period. In *Dobrich v Commissioner* (9th Cir 1999) 188 F3d 512, the Ninth Circuit affirmed, in an unpublished memorandum, the Tax Court's holding (TC Memo 1997-477) that the taxpayers had failed to properly identify replacement property within 45 days. In addition, because the taxpayers backdated documents to make it appear that they had timely identified when they had not, they were

assessed a penalty (under IRC §6663(a)) of 75 percent of the underpaid taxes. See also *Florida Indus. Inv. Corp.,* TC Memo 1999-346, aff'd without published opinion (11th Cir 2001) 252 F3d 440.

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§4.17 2. Effect of Relinquishing Multiple Properties in Same Deferred Exchange

When the taxpayer transfers more than one relinquished property on different dates as part of the same deferred exchange, the identification period and the exchange period are identified by a reference to the earliest date on which any one of the properties is transferred. Reg §1.1031(k)-1(b)(2)(iii). Taxpayers contemplating multiple property transfers must segregate them into different exchanges, or suffer the consequences of the identification and exchange periods starting on the date of the earliest transfer of any asset involved in the exchange. If transfers are found to be part of the same exchange, the taxpayer may violate the identification rules by identifying an excess number of replacement properties (see §§4.22-4.25) or by failing to meet the deadline for identification if the taxpayer counted 45 days after each of several transfers occurring on different dates. Splitting the exchange into multiple exchanges can reduce these problems. For other options to avoid this issue, see §4.34.

The regulations do not indicate when multiple transfers will be considered to be part of the same exchange, nor do they identify when multiple property transactions must be aggregated or may be separated. Exchanges of multiple properties with different parties should not be considered to be part of the same exchange when a separate exchange agreement is used for each parcel of relinquished property. Consequently, the identification period and the exchange period should begin separately for each relinquished property, or alternatively, for each different buyer.

The regulations also do not explain when multiple transactions involving a single property may be separated into different exchanges. For example, if a taxpayer executes two different exchange agreements with the same intermediary, providing for the disposition of undivided interests in one relinquished property at different times, and the buyer of both undivided interests is the same person, it may be difficult to argue successfully that the transactions are not part of the same deferred exchange.

Finally, the regulations do not define what constitutes a single or multiple relinquished property. Generally, properties in different locations that are not contiguous and that can be described separately are likely to be treated as multiple (*e.g.,* two) properties. Two adjacent lots or parcels that are subdivided and can be conveyed and used separately and independently of each other are likely to be deemed multiple properties if they are transferred to different parties; this result is less apparent if a single transferee is involved, and the parcel could be treated as a single property.

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3. Extensions of Time to Identify or Receive Replacement Property

§4.18 a. General Rule: No Extensions

Both the identification period and the exchange period end on the actual date for performance and are not extended under IRC §7503 when the last day falls on a weekend or legal holiday. See supplementary information in TD 8346, 1991-1 Cum Bull 150, 151, citing Rev Rul 83-116, 1983-2 Cum Bull 264.

WARNING: The 180-day exchange period is normally absolute. The Tax Court lacks jurisdiction to make equitable exceptions for hardship or good faith efforts. In one case, cancellation of the sale by the replacement-property seller one day before closing, causing the taxpayer to miss the 180-day exchange period, was no excuse: A good faith attempt to adhere to the statute is not enough. *David A. Knight,* TC Memo 1998-107. No extension is available even if the inability to meet the 180-day requirement is due to the receivership of an intermediary holding all relinquished property proceeds. IRS Letter Ruling 200211016.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.18A b. Federally Declared Disasters (IRC §7508A)

§4.18A b. Federally Declared Disasters (IRC §7508A)

In the wake of the terrorist attacks of September 11, 2001, the IRS and Congress decided to revisit the issue of whether the time limits of IRC §1031(a)(3) could be extended after a disaster. Previously, the IRS had informally taken the position that it was powerless to grant extensions because the limits of §1031(a)(3) were not in the nature of filing requirements but were taxpayer actions serving as a definitional prerequisite to qualification of deferred exchanges under §1031(a). In 1997, however, Congress added IRC §7508A, authorizing the Secretary of the Treasury, in "federally declared disasters" (formerly "presidentially declared disasters") or terrorist or military actions, to grant extensions to affected taxpayers to perform certain acts enumerated in §7508A(a) (previously applicable only to soldiers serving in combat zones).

As originally enacted, §7508A allowed extensions of up to 90 days. In June 2001, Congress amended IRC §7508A(a) to increase the 90 days to 120 days. In 2002, as part of the Victims of Terrorism Tax Relief Act of 2001 (Pub L 107-134, 115 Stat 2433), Congress amended IRC §7508A(a) further to increase the 120 days to 1 year.

As part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub L 107-16, 115 Stat 38,149), IRC §7508(a)(1)(K) was amended to clarify that the types of actions that could give rise to relief include "any other act required or permitted under the internal revenue laws specified by the Secretary" and specifically mentioned §1031(a)(3) as an example of the types of requirements subject to extension of time under these rules.

A "federally declared disaster" is defined in IRC §1033(h)(3) by reference to IRC §165(h)(3)(C). A "terroristic or military action" is defined in IRC §692(c)(2). Treasury Regulation §301.7508A-1(d)(1) defines eight types of affected taxpayers, including any individual whose principal residence (for purposes of §1033(h)(4)) is located in a "covered disaster area," any business entity or sole proprietor whose principal place of business is located in a "covered disaster area," and any individual or entity not located in the covered disaster area but who has records in the disaster area that are necessary to meet a covered filing deadline.

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§4.18B (1) When Postponement Available

Postponements under IRC §7508A are not available simply because a disaster or a terroristic or military action has occurred. The IRS will publish a Notice or issue other guidance (including an IRS News Release) authorizing the postponement. See Rev Proc 2007-56, 2007-34 Cum Bull 388. Such guidance will describe the acts postponed, the duration of the postponement, and the location of the covered disaster area.

The IRS releases updates of time-sensitive acts as necessary, the performance of which may be postponed under §§7508 and 7508A. See Rev Proc 2007-56. When a Notice or other guidance for a particular disaster is published or issued, the guidance generally will refer to the latest update and may provide for a postponement of all the acts listed in the update or the regulations. Alternatively, the guidance may provide that only certain acts listed in the update are postponed based on the time when the disaster occurred, its severity, and other factors.

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§4.18C (2) Periods That May Be Extended

Revenue Procedure 2007-56, which is the latest IRS update of time-sensitive acts, provides special rules for taxpayers undertaking §1031 exchanges. Revenue Procedure 2007-56 §17.02(1) provides that taxpayers covered by a published IRS Notice or News Release following a federally declared disaster or a terroristic or military action may extend the following periods by 120 days or to the last day of the extension period authorized by the IRS, whichever is later:

(1) The last day of the 45-day identification period and the last day of the 180-day exchange period under Regs §1.1031(k)-1(b)(2) (see §4.16); and

(2) The 5-business-day period to enter into a QEAA, the 45-day identification period, the 180-day exchange period, and the 180-day combined time period set forth in §4.02(3)-(6) of Rev Proc 2000-37, 2002 Cum Bull 308. See §5.20.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.18D (3) Requirements for Extension

§4.18D (3) Requirements for Extension

In order to qualify for this relief, the relinquished property must have been transferred on or before the date of the federally declared disaster and the taxpayer must be an "affected taxpayer" as defined in the IRS News Release or other guidance announcing tax relief for the victims of the specific disaster and have difficulty meeting a deadline for any one of the following reasons:

- The relinquished property or the replacement property is located in a covered disaster area as provided in the IRS News Release or other guidance;
- The principal place of business of any party to the transaction is located in the covered disaster area;
- Any party to the transaction or an employee of such a party is killed, injured, or missing as a result of the disaster;
- A document prepared in connection with the exchange or a relevant land record is destroyed, damaged, or lost as a result of the disaster;
- A lender decides not to fund either permanently or temporarily a real estate closing due to the disaster or refuses to fund a loan to the taxpayer because flood, disaster, or other hazard insurance is not available due to the disaster; or
- A title insurance company is not able to provide the required title insurance policy necessary to settle or close a real estate transaction due to the disaster.

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§4.18E c. Transfer of Tobacco Quotas

Transitional relief was made available to taxpayers who transferred tobacco quotas to the USDA and could not make timely arrangements for a like-kind exchange. If the taxpayer applied by June 17, 2005, to enter into a contract with the USDA for payments, the date on which the taxpayer transfers a quota was deemed to be September 16, 2005. To qualify for this transitional relief, the taxpayer who received a payment must have remitted the amount of the payment to a qualified intermediary within 5 business days of the later of the date the exchange agreement is entered into or the date the owner payment is received by the taxpayer. See §2.46A for further discussion of tobacco tax quotas.

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B. Identification of Replacement Property

§4.19 1. Significance of IRC §1031(a)(3)(A)

As described in §4.14, IRC §1031(a)(3)(A) sets up an identification hurdle in a deferred exchange that must be cleared within 45 days after the taxpayer transfers the relinquished property. The issue of identification is moot when all replacement property in an exchange is received before the end of the applicable identification period, because replacement property that the taxpayer receives before the end of the 45-day identification period is automatically treated as properly identified. Reg §1.1031(k)-1(c)(1). Identification separate from acquisition thus becomes an issue only when (and to the extent that) a taxpayer wants to complete acquisition of replacement properties after the identification period expires.

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§4.20 2. Methods of Identification

A taxpayer may properly identify replacement property by designating it as replacement property in a written agreement to exchange properties signed by all parties to the exchange before the end of the identification period. Reg §1.1031(k)-1(c)(2), (k)-1(c)(7), Example 2(iii). An amendment to an exchange agreement executed before the end of the identification period would satisfy this requirement, and the regulations do not require that this form of identification be sent or otherwise independently delivered to another party. The written agreement between the parties or the amendment to the exchange agreement must adequately describe the replacement property. Reg §1.1031(k)-1(c)(3). See §4.21. The taxpayer is not, however, obligated to have a binding contract to acquire the replacement property at the time of identification. The regulations require that the property must be "designated as replacement" in the identification; therefore, it does not appear that a contract to purchase property that makes no mention of the property's role in the taxpayer-buyer's exchange would satisfy the requirement on its own.

Replacement property is also properly identified if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent to the person obligated to transfer the replacement property to the taxpayer (*e.g.,* to the seller of the replacement property), even if that person is a disqualified person under Reg §1.1031(k)-1(k), or to anyone else involved in the exchange (*e.g.,* an intermediary, an escrow agent, or a title company), other than the taxpayer or a disqualified person under Reg §1.1031(k)-1(k), before the end of the identification period. Reg §1.1031(k)-1(c)(2), (k)-1(k). See §4.65 for the definition of "disqualified person," which includes (1) agents, (2) family members, or (3) corporations, trusts, or partnerships in which the taxpayer has a 10 percent or larger interest. Thus, if the only person to whom written identification is sent is a disqualified person, the transaction will qualify for tax deferral under IRC §1031(a)(3) only if that person is the one who is obligated to transfer the replacement property to the taxpayer. Reg §§1.1031(k)-1(c)(2), 1.1031(k)-1(c)(7), 1.1031(k)-1(c)(7), Example 2(i)-(ii).

Taxpayers must report the date of replacement property identification on IRS Form 8824, which reports a like-kind exchange on their federal income returns for the year of the relinquished property transfer.

WARNING: The taxpayer has the burden of proof to show timely identification. For example, in *Smith v Commissioner* (4th Cir 1997) 97-2 USTC ¶50,928, 80 AFTR2d 7778, aff'd without published opinion (4th Cir 1997) 129 F3d 1260, the Tax Court weighed the taxpayer's testimony against the statement in his tax return, and, relying on the return, disallowed tax deferral because of his failure to meet the 45-day time period. Appropriate identification of the replacement property is an area vulnerable to tax fraud; some taxpayers are tempted to backdate documents or otherwise dishonestly allege that identification was made within the 45-day period. Such actions may be crimes. See IRC §§7201, 7207. In *Dobrich v Commissioner* (9th Cir 1999) 188 F3d 512, the Ninth Circuit affirmed, in an unpublished memorandum, the Tax Court's holding in *David Dobrich,* TC Memo 1997-477, aff'd (9th Cir 1999) 99-2 USTC ¶50,826, which imposed, under IRC §6663(a), a penalty of 75 percent of the underpayment of taxes against taxpayers who backdate documents to make it appear that they had timely identified replacement property. See §4.16.

PRACTICE TIP: Because the IRS is likely to scrutinize taxpayers' documentation that identification was properly made within the identification period, the attorney should carefully monitor the client's manner and timing of identification to avoid potential disqualification of the exchange, imposition of penalties, and criminal sanctions. Evidence of compliance with the requirements should be supplied, *e.g.,* the postmarked envelope containing the identification letter, a certified or registered receipt, a receipt from a messenger or courier, a witness to delivery of the identification document, or notarized signatures to a contract containing identification.

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§4.21 3. Description of Replacement Property

Because the identification requirement was intended to limit taxpayers' flexibility, the effectiveness of the rule would be vitiated if taxpayers could create flexibility by using very broad or generic property descriptions. Although the regulations require no particular wording or special IRS form to describe the replacement property being identified, they do require that replacement property be unambiguously described in a written document or agreement. Reg §1.1031(k)-1(c)(3).

Generally, real property is unambiguously described if it is given a legal description, street address, or distinguishable name (*e.g.,* the Mayfair Apartment Building). The drafter of the description should be as specific about the identity of the replacement property as possible. For example, a description such as the Pacific Heights Apartment Building, 100 Gold Rush Street, San Francisco, California, should be sufficient. It may be more difficult to identify unimproved real property. For example, "10 acres of unimproved real property on the northeast corner of Main Street and Center Boulevard in Marin County, California" should be sufficient as long as it is unambiguous. A reference to "unimproved land in Hood County, with a fair market value not to exceed $100,000" would not be sufficient, because it is ambiguous. See Reg §1.1031(k)-1(c)(7), Example 3. Whenever possible, the assessor's parcel numbers should be used to describe unimproved or rural land.

Generally, personal property is unambiguously described if it is described by a specific description of the particular type of property. For example, a truck is unambiguously described if it is described by a specific make, model, and year (*e.g.,* 2002 Ford Explorer). Reg §1.1031(k)-1(c)(3). It may not be necessary to separately describe personal property, however, if it is incidental to real property in a multiple property exchange. See discussion of the incidental property rule under Reg §1.1031(k)-1(c)(5) in §4.27.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.22 4. Designation of Multiple and Alternative Replacement Properties

§4.22 4. Designation of Multiple and Alternative Replacement Properties

A taxpayer intending to acquire multiple replacement properties in a single exchange may identify as many replacement properties as desired, subject to the conditions and restrictions in Reg §1.1031(k)-1(c) and described below. If all properly identified replacement properties are acquired, their number or value will be irrelevant to whether the identification requirement of IRC §1031(a)(3) has been successfully met. If the taxpayer does not acquire all identified replacement properties, the limits on alternative property identification will be relevant.

A taxpayer may identify more than one replacement property even if the taxpayer does not intend to acquire them all. Reg §1.1031(k)-1(c)(4). This approach is known as designation of alternative replacement properties. Before the deferred exchange regulations were issued, practitioners were uncertain about whether taxpayers could identify more properties than they intended to acquire. See, *e.g., Ravenswood Group v Fairmont Assocs.* (SD NY 1990) 736 F Supp 1285 (district court suggested that only five properties may be designated). This issue was resolved in the regulations, which provide three options for making a valid designation of alternative replacement properties:

- The "three-property" rule (identification of alternative properties is valid if the taxpayer designates no more than three alternative properties relating to the same exchange). Reg §1.1031(k)-1(c)(4)(i)(A), (k)-1(c)(7), Example 4. See §4.23.
- The "200-percent" rule (identification of alternative properties is valid if the value of all designated replacement properties does not exceed 200 percent of the value of all relinquished property in the same exchange). Reg §1.1031(k)-1(c)(4)(i)(B). See §4.24.
- The "95-percent" rule (identification of alternative properties is valid if the taxpayer timely receives at least 95 percent of the value of all the identified replacement properties before the end of the exchange period). Reg §1.1031(k)-1(c)(4)(ii)(B). See §4.25.

The taxpayer must meet the criteria of at least one of these rules for the identification of alternative replacement properties to be valid. Because replacement property must be properly identified to be like-kind to relinquished property, compliance with these rules is essential. The three-property rule is the simplest from the taxpayer's standpoint because it does not depend on the fair market value of the properties.

WARNING: The results will be devastating if the taxpayer identifies multiple replacement properties in a manner that does not comply with one of these three rules. The taxpayer will be treated as if *no* like-kind replacement property had been identified (Reg §1.1031(k)-1(c)(4)(ii)), except if, and to the extent that, the taxpayer actually receives any replacement property before the end of the identification period (Reg §1.1031(k)-1(c)(1), (k)-1(c)(4)(ii)(A)).

If a written document specifies a properly limited set of alternative properties as the ultimate replacement property, the taxpayer may orally inform the intermediary or other party to the exchange of which replacement properties the taxpayer wishes to receive as part of the exchange. Reg §1.1031(k)-1(c)(7), Examples 4-5, (k)-1(d)(2), Example 1.

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§4.23 a. Three-Property Rule

Identification of alternative replacement properties is valid if the taxpayer identifies no more than three alternative replacement properties as part of the same deferred exchange, regardless of the values of the relinquished or replacement properties. Reg §1.1031(k)-1(c)(4)(i)(A), (k)-1(c)(7), Example 4. The taxpayer need not have entered into a binding contract to purchase any of the identified replacement properties at the time of identification.

The three-property rule limits the identification of alternative replacement properties to three, regardless of the number of relinquished properties transferred as part of the "same" deferred exchange.

PRACTICE TIP: If a taxpayer transfers five properties in the same exchange, only three replacement properties may be identified under this rule; but if a taxpayer is able to separate the transfer of the relinquished properties so that the transaction is not treated as the same deferred exchange, the taxpayer may identify up to three properties for each relinquished property.

Under the three-property rule, the taxpayer need not state the fair market value of any of the replacement properties or the terms on which the taxpayer would be willing to acquire one or more of them. Further, the taxpayer need not state any order of preference or priority as to which alternative property the taxpayer prefers to acquire. The taxpayer is required, however, to receive the same or substantially the same property as one or more of those that were identified. Reg §1.1031(k)-1(d)(1)(ii). See §4.29.

As with relinquished property (see §4.17), what constitutes a single property for purposes of the three-property rule is not entirely clear. For example, it is unclear whether unimproved property subdivided into multiple parcels, or an apartment building or a commercial building, operated as a single rental building, that has been subdivided into multiple condominium parcels, constitutes a single replacement property. The authors believe that the sensible approach is to treat contiguous property owned by a single seller as a single property, and condominium or apartment units operated as a single rental building or project as a single property, but no guidance has been issued addressing this issue.

WARNING: The draconian results of over-identification suggest that extreme caution be used in analyzing whether contiguous property is treated as a single property or multiple properties under the three-property rule.

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§4.24 b. 200-Percent Rule

When the taxpayer identifies more than three alternative replacement properties in connection with the same deferred exchange, the identification is valid as long as the aggregate fair market value of all replacement properties that remain identified at the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties in the exchange on the date or dates on which the taxpayer transferred the relinquished properties. Reg §1.1031(k)-1(c)(4)(i)(B).

EXAMPLE: If a taxpayer transfers two parcels of relinquished property with an aggregate fair market value of $100,000, the taxpayer may identify any number of replacement properties as long as the aggregate fair market value of all the identified replacement properties as of the end of the identification period does not exceed $200,000. See Reg §1.1031(k)-1(c)(7), Example 5.

No guidance currently exists on how a taxpayer establishes the identified properties' fair market value for purposes of this rule, particularly the value of properties that the taxpayer does not ultimately acquire. Therefore, when the 200-percent rule is used, it may be advisable, though not mandatory, for a taxpayer to have either a binding contract to purchase or an appraisal completed for each identified replacement property before the identification period ends in order to be certain that the replacement properties' total fair market value does not exceed 200 percent of the relinquished property's value. This rule focuses on the properties' fair market value (Reg §1.1031(k)-1(m)); encumbrances and relative equities in the replacement and relinquished properties are disregarded. Although the IRS debated using a rule based on the equity in the identified properties, it concluded that such a rule would be too difficult to apply, especially because taxpayers have so much control over the equity of replacement properties.

Compliance with the 200-percent rule is more complex and uncertain than is compliance with the three-property rule (see §4.23). Taxpayers should state the fair market value of each replacement property in their identification notices and be prepared to support their estimates with contemporaneous third party evidence such as appraisals.

WARNING: If the replacement properties are not subject to binding purchase contracts when the identification period ends, the taxpayer runs the risk that the IRS might not accept an appraiser's valuation. If the IRS claims a higher valuation of an identified property, it may assert that the identification did not meet the 200-percent rule. There is no evidence to date, however, that the IRS is inclined to make such claims, at least when there is no evidence of fraud.

Another difficult issue could arise if an identified replacement property is appraised at a certain value at the end of the identification period, but the taxpayer must later pay a greater purchase price because a binding contract was not in effect at that time. Because the relevant valuation date is the end of the identification period, an accurate appraisal should constitute sufficient proof of compliance with the 200-percent rule. The actual purchase price paid should not be conclusive evidence of fair market value, because a buyer could pay more for a certain property than anyone else would pay, solely for subjective reasons. In an appreciating market, a taxpayer could pay more for replacement property at the end of the exchange period than the fair market value specified for that property at the end of the identification period and still satisfy the 200-percent rule.

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§4.25 c. 95-Percent Rule

A perfectly valid simultaneous exchange could involve a taxpayer transferring a single relinquished property and acquiring more than three replacement properties whose aggregate value exceeds 200 percent of the value of the relinquished property. The drafters of the deferred exchange regulations recognized that some taxpayers might want to complete such exchanges as deferred exchanges and should be allowed to do so. Accordingly, the 95-percent rule was adopted as a safety valve. Identification of alternative replacement properties is valid even if the taxpayer fails to meet either the three-property rule (see §4.23) or the 200-percent rule (see §4.24), as long as the taxpayer receives at least 95 percent of the aggregate fair market value of all identified replacement properties before the end of the exchange period. Reg §1.1031(k)-1(c)(4)(ii)(B).

EXAMPLE: A taxpayer transfers relinquished property with a fair market value of $1 million and identifies four replacement properties with fair market values of $1 million, $1 million, $900,000, and $100,000, respectively, for a total of $3 million. The taxpayer acquires the first three replacement properties with aggregate fair market values of $2,900,000 but does not acquire the fourth replacement property. Because more than three properties were identified, the taxpayer does not satisfy the three-property rule. Because the aggregate fair market value of the four identified replacement properties is 300 percent of the fair market value of the relinquished property, the taxpayer does not satisfy the 200-percent rule. The 95-percent rule is satisfied, however, because the taxpayer received at least 95 percent of the aggregate fair market value of all identified replacement properties before the end of the exchange period ($2,900,000 divided by $3,000,000 = 96.67 percent).

Under the 95-percent rule, the fair market value of each identified replacement property is ascertained as of the earlier of the date on which the property is received by the taxpayer or the last day of the exchange period. Reg §1.1031(k)-1(c)(4)(ii)(B). Note the differences in this date and the date relevant for valuation under the 200-percent rule, which is the last day of the identification period.

WARNING: The 95-percent rule leaves little room for error and should be used only when acquisition of sufficient property is virtually certain. If a taxpayer fails both the three-property and 200-percent rules, acquisition of properties representing 94 percent of all identified properties will result in a fully taxable exchange.

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§4.26 5. Property Received During Identification Period

Properties received during the identification period are included in computing whether property identified as alternative replacement property at the end of the identification period satisfies the three-property, 200-percent, and 95-percent rules (see §§4.23-4.25).

EXAMPLE: If the 200-percent rule is being followed and one property worth 25 percent of the value of the relinquished property is received before the end of the 45-day identification period, the taxpayer may identify two additional properties of any value (under the three-property rule; see §4.23) or more than two other properties if the total fair market value of those other replacement properties does not exceed 175 percent of the fair market value of the relinquished property (under the 200-percent rule; see §4.24). If three properties with an aggregate fair market value equal to 150 percent of the relinquished property's fair market value are acquired during the identification period, the taxpayer may identify additional replacement properties only if their aggregate fair market value does not exceed 50 percent of the relinquished property's fair market value. See Reg §1.1031(k)-1(c)(4)(iii).

Under the 95-percent rule (see §4.25), the value of properties acquired during the identification period are included in both the numerator and the denominator of the properties acquired; the denominator will include the value of all properties identified (regardless of whether or not acquired), and the resulting percentage must be at least 95 percent. Reg §1.1031(k)-1(c)(4)(i)(B), (c)(4)(ii)(B).

EXAMPLE: A taxpayer transfers a relinquished property with a fair market value of $1 million and acquires during the identification period three replacement properties with an aggregate fair market value of $3 million. The taxpayer identifies four additional replacement properties with an aggregate fair market value of $2 million. Thus, the aggregate fair market value of all identified replacement properties is $5 million. The identification of any additional properties beyond the three properties received during the identification period violates the three-property rule and the 200-percent rule. The 95-percent rule, however, is satisfied if the taxpayer receives any number of the identified additional replacement properties during the exchange period and the aggregate fair market value of all properties received, including the three acquired during the identification period, is at least $4,750,000 (95 percent of $5 million).

It is important to remember, however, that properties received during the identification period are not subject to disqualification as "like-kind" even if properties received thereafter are ineligible for like-kind treatment owing to violation of the identification rules.

EXAMPLE: Taxpayer transfers relinquished property worth $100,000 with $10,000 basis and receives replacement property worth $50,000 before the end of the identification period. Taxpayer identifies four additional properties whose value is $40,000 each and ultimately acquires three of these properties. Taxpayer is treated as identifying five properties of aggregate $210,000 value and thus fails both the three-property and 200-percent rules. Taxpayer acquired less than 95 percent of value of identified properties ($170,000/$210,000 = 81 percent). Result: Taxpayer's $50,000 property qualifies (subsequent to all other requirements) and taxpayer has deferred $40,000 of $90,000 realized gain.

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§4.27 6. Incidental Property

Property whose use is merely incidental to the operation of a more valuable item of property is disregarded for identification purposes. For this purpose "incidental property" refers to property transferred, together with a larger item of property in standard commercial transactions, having an aggregate fair market value not exceeding 15 percent of the value of the larger property to which it relates. Reg §1.1031(k)-1(c)(5)(i).

EXAMPLE: If furniture, laundry machines, and miscellaneous personal property worth no more than $150,000 will be purchased with an apartment building worth at least $1 million, under the incidental property rule the items of personal property need not be separately identified (15 percent of $1 million = $150,000). Identification of the apartment building consistent with Reg §1.1031(k)-1(c)(3) is sufficient even if no reference is made to the personal property. Reg §1.1031(k)-1(c)(5)(ii), Example 2.

The incidental property rule is relevant only to ascertaining whether identification is properly made for purposes of the time requirements of IRC §1031(a)(3). Reg §1.1031(k)-1(c)(5)(i). If personal property (even of nominal value) will be exchanged along with real property, the exchange is considered to be a multiple property exchange and must be reported under the allocation rules governing multiple property exchanges, regardless of the number or value of the properties involved. Gain may be recognized if the taxpayer does not acquire sufficient replacement personal property in an exchange involving both real and personal property, or if the boot-offset rules affecting multiple property exchanges are not satisfied. Reg §1.1031(j)-1. See §§3.36-3.42.

WARNING: The limited scope of the incidental property rule is frequently misunderstood. The rule does not change the fact that personal property is not like in kind to real property. Attorneys should make their clients aware of the consequences of a multiple property exchange in any real estate transaction involving disposition or acquisition of personal property, regardless of whether such property must be separately identified for purposes of IRC §1031(a)(3)(A).

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§4.28 7. Revoking Identification

Compliance with the rules on identifying replacement properties is determined at the end of the 45-day identification period. Reg §1.1031(k)-1(c)(6). During the identification period, a taxpayer may identify too many properties or properties of too high a value to qualify under the three-property rule (see §4.23) or the 200 percent rule (see §4.24). Even when the taxpayer does not intend to rely on the 95 percent rule (see §4.25), this fact will have no bearing on qualification for tax deferral under IRC §1031 as long as the taxpayer revokes the identifications to the extent necessary to bring properties remaining identified as possible replacements, including those acquired during the identification period, within the three-property or 200 percent rule limits before the end of the identification period. Reg §1.1031(k)-1(c)(6).

The revocation must be in writing and made in the same manner as the replacement properties were identified. Reg §1.1031(k)-1(c)(6), (c)(7), Example 6. Thus, if identification was a part of an exchange agreement between multiple parties, all parties should sign an amendment to the agreement, modifying the identified properties. If identification was given by written notice from the taxpayer to another party to the exchange, such as a qualified intermediary, the revocation should be made by similar notice. Oral revocations of identification are invalid. Reg §1.1031(k)-1(c)(7), Example 7.

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§4.29 C. Receipt of Identified Replacement Property

A taxpayer must receive the identified replacement property before the end of the applicable exchange period. The replacement property received must be the same or substantially the same property as identified. This requirement applies to each identified replacement property. Reg §1.1031(k)-1(d)(1). Without this requirement, the identification requirement would be meaningless.

What is considered to be substantially the same, however, is not at all clear from the regulations. Compare Examples 3-4 of Reg §1.1031(k)-1(d)(2). In Example 3, a taxpayer identifies a barn on two acres of land with a fair market value of $250,000. The taxpayer subsequently receives the barn and its underlying land together valued at $187,500 (75 percent of $250,000) but does not receive the remaining land. The regulations assert that the barn and the underlying land differ in basic nature or character from the identified real property as a whole and thus are not considered to be substantially the same property as identified. If the taxpayer had separately identified the barn and underlying land as one property and the remaining land as a second property (because they had separate legal descriptions), the result would have been different.

In Example 4, a taxpayer identifies two acres of unimproved land valued at $250,000 and receives only 1.5 acres (75 percent) of the identified property, which has a fair market value of $187,500 (75 percent of the fair market value of the identified replacement property). The regulations state that the taxpayer is considered to have received substantially the same property as identified.

The effect of the "substantially the same" requirement raises questions in several different contexts:

- Is the regulations' 75-percent test a "bright line" test when dealing with fungible acreage, or would 74 percent or 60 percent also be treated as substantially the same?
- How does this concept apply to leasehold estates of 30 years or more, which are equivalent to fee interests under Reg §1.1031(a)-1(c): *i.e.,* will a 50-year lease be treated as being substantially the same as a 30-year lease?
- How does the concept apply to fractional interests in real estate: *i.e.,* will a 90-percent undivided tenant-in-common interest be treated the same as a fee interest? What about a 60-percent tenancy-in-common interest? What happens when a 50-percent individual interest is identified but a 35-percent interest is received?
- How will property constructed during the period between identification and receipt be tested to analyze whether it is substantially the same?

Of these issues, the regulations address only the topic of property under construction. See §4.30. For answers to the other questions, taxpayers and their advisers are for the moment left entirely to their own devices.

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§4.30 D. Property Under Construction

Taxpayers sometimes transfer relinquished property intending to apply relinquished property equity toward acquiring unimproved land and constructing improvements on the land while still qualifying for like-kind exchange treatment under IRC §1031. Taxpayers may also acquire property that is already improved and wish to apply the relinquished property proceeds to expand the improvements. Regulation §1.1031(k)-1(e)(1) provides that an exchange will not be disqualified under §1031 simply because the replacement property is not in existence or is being produced at the time the property is identified as replacement property. For these purposes, the terms "produced" and "production" have the same meanings as stated in IRC §263A(g)(1) and its regulations, which include "construct, build, install, manufacture, develop, or improve." Construction occurring *after* the taxpayer receives the replacement property, however, does not qualify as replacement property under IRC §1031.

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§4.31 1. Identification

How does a taxpayer identify property that does not exist on the date of identification? If the replacement real property has not yet been built, the regulations state that the identification requirement is satisfied if the taxpayer provides a legal description of the underlying land and as much detail on construction of the improvements as is practicable when the identification is made. Reg §1.1031(k)-1(e)(2).

PRACTICE TIP: Attorneys should advise clients to be as specific as possible when describing future improvements in a like-kind exchange identification. This could include reference to detailed plans and specifications for new buildings. However, if such detailed plans do not exist, or might be subject to change, it is probably permissible to describe the characteristics of projected improvements, such as size of building (square feet), type of construction (frame, tilt-up, steel frame), general use (office, warehouse, multifamily residential), scale (1-story, 10-story, campus, etc.). See discussion in §4.32 on scope of permitted deviation from identified improvements.

For purposes of the 200-percent rule (see §4.24) and the incidental property rule (see §4.27), the fair market value of replacement property that is to be produced is its estimated fair market value as of the date on which the taxpayer expects to receive it. Reg §1.1031(k)-1(e)(2)(ii).

NOTE: This rule differs from the normal valuation rule, which establishes value at the end of the identification period. Reg §1.1031(k)-1(c)(4)(i)(B). See §4.24.

If a portion of the value of the replacement property will be produced after the identification period ends, the taxpayer would be safest in relying on the three-property rule unless the future expenditure amount is reasonably certain. Further, it is unclear whether the IRS will use construction cost or fair market value as the correct measure. For example, land and improvements costing $100,000 could be worth $120,000 on completion and the IRS could use the higher figure. Because valid identification under both the 200-percent rule (see §4.24) and the incidental property rule (see §4.27) may require an appraisal or a budget to establish the value of the property to be built, identification of property to be produced is less likely to qualify under those rules. Further guidance from the IRS may be necessary to analyze whether improvements are properly described, because it is unclear whether generic descriptions of the type of building, sketches, or even building plans are necessary.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.32 2. Receipt

§4.32 2. Receipt

When the replacement property is to be produced and does not exist when identified, the taxpayer must still receive replacement property that is substantially the same property as identified. Reg §1.1031(k)-1(d)(1)(ii). Under the regulations, when the identified replacement property is property to be produced, normal production changes are not taken into account. If, however, substantial changes are made in the property to be produced compared with the property as it was identified, the replacement property received will not be considered to be substantially the same as identified. Reg §1.1031(k)-1(e)(3)(i).

WARNING: These rules may place the taxpayer in an awkward position. Conservative tax practice requires the taxpayer to provide as much detail as possible about the construction to make sure that the property to be produced is properly identified. Too much detail, however, could result in the taxpayer's not receiving substantially the same property as that identified if changes are made during construction, or could discourage a taxpayer from making economically sound decisions to change plans during construction.

PRACTICE TIP: In an exchange involving property to be built, the taxpayer should time the construction project to ensure that the improvements can be sufficiently described by the end of the identification period and the construction will be sufficiently complete by the end of the exchange period. Unambiguously describing the land and generally describing the improvements should suffice. For example, if the improvements are described as a 10,000-square-foot industrial building with tilt-up concrete walls, and the taxpayer builds at least a 7500-square-foot building with concrete block walls, the replacement property should be considered substantially the same property as identified, based on the usual or typical production changes exception found in the regulations. Reg §1.1031(k)-1(d)(2), Examples 3-4.

The regulations create a major distinction between personal and real property under construction that is not completed when received by a taxpayer. Personal property that is to be produced must be completed by the time of receipt by the taxpayer, or it will not be treated as substantially the same as the identified property and thus will not qualify as like-kind replacement property. Reg §1.1031(k)-1(e)(3)(ii).

Real property is given clearly preferential treatment. Under Reg §1.1031(k)-1(e)(3)(iii), real property improvements that are not completed before the end of the exchange period will still be considered substantially the same as the property identified if

- it would have been considered substantially the same property as identified had it been completed when it was received by the taxpayer; and
- when received, the property constitutes real property under local law.

For example, building materials or components delivered to a jobsite but not installed would not be considered real property under California law, and their value could not be included in ascertaining the extent to which the replacement property is substantially the same as the property identified. CC §§658, 662-663.

The same treatment applies to the value of construction services rendered after the taxpayer's receipt of property. In that situation, the taxpayer is receiving services, not like-kind property, and any portion of the replacement property not yet produced will not be treated as like-kind property. Reg §1.1031(k)-1(e)(4).

Thus, only the portion of the replacement property improvements that is complete within the exchange period will qualify for the exchange. See Reg §1.1031(k)-1(e)(5).

EXAMPLE: A taxpayer transfers relinquished property to an intermediary, who receives $100,000 from the sale of the property to a third party, and under the exchange agreement is obligated to use all the proceeds to build improvements on an identified replacement property. The intermediary uses $50,000 of the proceeds to buy unimproved replacement property designated by the taxpayer and begins construction of improvements estimated to cost $50,000. Before the end of the exchange period, the intermediary transfers to the taxpayer the replacement property, partially improved with a building ($20,000 of improvements are installed on the building),

and the following additional items: (a) $10,000 in the form of a credit for prepaying the remaining amount due to the construction contractor, who then finishes the job, and (b) $20,000 of building materials located at the jobsite but not yet installed. The taxpayer would be treated as receiving $30,000 of nonqualifying property on completion of the exchange: $20,000 of personal property (the uninstalled building materials) and $10,000 relating to the contractor's services, which are treated as production services under Reg §1.1031(k)-1(e)(4). This example assumes that the replacement property received would have been substantially the same property as identified had construction been complete when the taxpayer received the replacement property.

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E. Extending Time Limits of IRC §1031(a)(3)

§4.33 1. Lease With Option to Purchase

Because both the identification period and the exchange period begin on the date of transfer of the taxpayer's relinquished property, the best way to extend these periods is not to let them commence. Simply postponing a sale of the relinquished property is the clearest means of doing so. Often, however, a buyer may need to take possession of the property or may insist on obtaining a clear legal right to acquire the property on fixed terms. In this event, the most direct approach to extending the time restrictions of IRC §1031(a)(3) is to grant the buyer a lease with an option to purchase and set the option exercise far enough into the future to satisfy the taxpayer's need for more time to identify or acquire replacement properties. A simple option, independent of a lease, may also work when a buyer does not need possession of the property, as when a developer acquires unimproved land.

As long as the taxpayer does not transfer the benefits and burdens of ownership through the lease or the option to purchase, a subsequent exchange of the leased or optioned property should not be jeopardized. See, *e.g.,* IRS Letter Ruling 8118023. For the IRS view on factors relevant to determining whether a lease of equipment constitutes a sale, see Rev Rul 55-540, 1955-2 Cum Bull 39. These factors focus on the economics of a leasing arrangement and look to whether rent payments by a lessee are consistent with a commercially reasonable relationship between the landlord and the tenant regarding the benefits and burdens of asset ownership.

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§4.34 2. Avoiding Treatment as Same Exchange

Although no existing authority provides concrete examples of how to do so, taxpayers may be able to avoid aggregation of transfers involving multiple properties by separating the disposition transactions as much as possible, using different escrow agents, sale agreements, exchange agreements, intermediaries, exchange structures, and buyers, and otherwise creating clear distinctions between the transfers.

By structuring multiple relinquished property dispositions into separate transactions, the taxpayer retains the flexibility of having separate identification and exchange periods for each property. For example, if two relinquished properties are separately disposed of, each property will have its own 45-day identification and 180-day exchange period. If an identified replacement property from the first sale falls through, but the taxpayer still desires to acquire that property, it may be later identified in a second relinquished property disposition that has remaining time on its own 45-day identification period.

Nevertheless, the IRS may still aggregate into one deferred exchange any series of dispositions that are part of an integrated, interrelated, or interdependent set of transfers as the same deferred exchange. Reg §1.1031(j)-1. See §4.17.

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§4.35 3. Build-to-Suit Transactions

If the taxpayer intends to use exchange equity to build or improve replacement real property, the attorney should consider several planning opportunities. As noted in §4.32, construction that takes place after the taxpayer receives the replacement property does not qualify as replacement property. If a substantial amount of the construction to be performed might not be completed before the end of the 180-day exchange period, the taxpayer should consider taking one of the following steps:

- Require the seller of the replacement property to begin construction before the taxpayer transfers the relinquished property. The taxpayer may find it necessary to advance funds to the seller to pay for the construction with the advance being treated either as a loan or as additional deposit against the purchase price.
- Postpone transfer of the relinquished property until the construction on the replacement property is certain to be completed within the next 180 days.
- Advance funds to an intermediary or accommodator for the purchase of replacement property and begin construction of new or additional improvements before the taxpayer transfers the relinquished property to the intermediary or transferee. See discussion of reverse exchanges and parking arrangements in chap 5. To the extent that construction is not complete and the intermediary continues to hold net proceeds, the return of those proceeds to the taxpayer will be taxable as boot under IRC §1031(b) even if the taxpayer ultimately uses the proceeds to finish the improvements.

In summary, to avoid the economic and tax risks associated with exchanges of property under construction, the taxpayer should ensure that its exchange equity will be spent on construction within the exchange period. See IRS Letter Rulings 9428007, 9413006.

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IV. CONSTRUCTIVE RECEIPT AND REGULATIONS' SAFE HARBORS

§4.36 A. Doctrine of Constructive Receipt

Courts have consistently held that a transaction will be treated as a sale and not an exchange if the taxpayer actually receives the proceeds from the disposition of the relinquished property. See, *e.g., Carlton v U.S.* (5th Cir 1967) 385 F2d 238; *Swaim v U.S.* (ND Tex 1979) 79-2 USTC ¶9462, 45 AFTR2d 1276, aff'd (5th Cir 1981) 651 F2d 1066. Even if the taxpayer does not actually receive cash proceeds from the disposition of the relinquished property, the exchange will not qualify under IRC §1031 if the taxpayer is treated as having constructively received the proceeds. See, *e.g., Halpern v U.S.* (ND Ga 1968) 286 F Supp 255. If the taxpayer actually or constructively receives some but not all of the cash proceeds, the exchange may still satisfy §1031, but the proceeds received are taxed as boot under IRC §1031(b). See §§3.6, 3.12-3.13, 3.22-3.29.

The doctrine of constructive receipt derives from IRC §451. Regulation §1.451-2 provides in part:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Thus, a crucial question in every deferred exchange is whether the taxpayer's control over the proceeds from the disposition of relinquished property is substantially limited or restricted. The courts have generally applied the constructive receipt doctrine to invalidate ostensible exchanges when the taxpayer has the ability to receive or control the proceeds from the disposition, even if the taxpayer does not actually receive those proceeds. See, *e.g., Maxwell v U.S.* (SD Fla 1988) 88-2 USTC ¶9560, 62 AFTR2d 5406, discussed in §4.41.

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B. Actual or Constructive Receipt Outside Regulations' Safe Harbors

§4.37 1. General Principles

The deferred exchange regulations clearly state that, to qualify as a deferred exchange, a transaction must be an exchange and not a sale followed by a purchase. Reg §1.1031(k)-1(a). The exchange will not qualify under IRC §1031 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 like-kind replacement property, even if the taxpayer ultimately receives like-kind replacement property. Reg §1.1031(k)-1(a), (k)-1(f)(1).

Regulation §1.1031(k)-1(f)(2) incorporates general tax rules and existing case law on actual and constructive receipt. See §§4.15, 4.38-4.43. Under §1.1031(k)-1(f)(2), the general rules of actual and constructive receipt are applied without regard to the taxpayer's method of accounting:

- The taxpayer is treated as being in actual receipt of money or property at the time the taxpayer actually receives the money or property or receives the economic benefit of the money or property; and
- The taxpayer is treated as being in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw on it at any time or after notice of intention to draw. If the taxpayer's control of money or property is substantially limited or restricted, the taxpayer is in constructive receipt of the money or property at the time the limitations or restrictions lapse, expire, or are waived.

The regulations also state that the actual or constructive receipt of money or property by an agent of the taxpayer (as determined under general legal principles) is considered to be actual or constructive receipt by the taxpayer. See §§2.53, 2.62, 4.15, 4.38-4.43.

Regulation §1.1031(k)-1(g) provides several safe harbors that shield taxpayers from assertions that the taxpayer is in actual or constructive receipt of money or other property for purposes of IRC §1031. TD 8346, 1991-1 Cum Bull 150, 152; IRS Letter Ruling 200130001. A detailed discussion of these safe harbors is found in §§4.44-4.69. A safe harbor is a set of requirements promulgated by the IRS that, if followed, will protect a taxpayer from challenge on specific grounds; here, the safe harbors are available to protect against an IRS challenge that there was constructive receipt of exchange proceeds. Although taxpayers are not automatically deemed in constructive receipt of relinquished property sale proceeds if they fail to adhere to the safe harbor requirements, conservative practice warrants compliance with them. This contrasts with the rules on identification and receipt of replacement properties in Reg §1.1031(k)-1(b)-(c), which are applied as binding interpretations of the Internal Revenue Code. The importance of the deferred exchange safe harbors and the consequences of failure to meet their requirements, however, have meaning only if the attorney understands the principles applicable in their absence. If a taxpayer does not qualify for one of the safe harbors in Reg §1.1031(k)-1(g), the ample body of case law on the constructive receipt doctrine for like-kind exchanges will apply. Sections 4.38-4.43 discuss this body of law.

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§4.38 2. Deferred Exchange Structures and the Problem of Constructive Receipt

In a deferred exchange, the taxpayer transfers the relinquished property and, instead of immediately receiving replacement property, receives an exchange credit from the transferee. The amount of the exchange credit is generally the fair market value of the relinquished property less the debt assumed by the transferee or the liabilities to which the relinquished property was subject and less expenses of the exchange. This credit is generally equal to the net funds that the taxpayer would have received on a sale of the relinquished property after paying off all liens. The practical problem that planners have addressed since the first deferred exchange was arranged is how to (1) assure the relinquished property transferor (*i.e.,* the taxpayer) that the transferee will actually acquire and transfer replacement property to the transferor at the agreed future date and on the agreed terms, but (2) avoid actual or constructive receipt of sales proceeds by the taxpayer. Historically, those who have structured deferred exchanges have taken two basic approaches in limiting the taxpayer's receipt of non-like-kind property:

- In the cooperating buyer approach, the buyer of the relinquished property retains possession and control of funds representing the exchange credit but is obligated to purchase replacement properties and transfer them to the taxpayer in completion of the exchange. See §4.39.
- In the cooperating intermediary approach, the buyer of the relinquished property pays the purchase price to an independent third party agent or intermediary who later uses the funds to purchase the replacement properties and transfer them to the taxpayer. See §§4.40-4.42. On the benefits and risks of these approaches, see §§4.39-4.43.

An inverse relationship typically exists between the tax risk of constructive receipt and the economic risk that the transferee or intermediary will fail to meet its contractual obligation to purchase and transfer replacement property to the taxpayer. The more control that the taxpayer has over the proceeds, the less likely that a cooperating party will fail to complete the exchange, but the more likely that a court or IRS will find constructive receipt. Conversely, the less control that the taxpayer has over the proceeds, the greater the economic risk that a cooperating party will fail to complete the exchange, but the less likely that the IRS or a court will find constructive receipt.

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§4.39 a. Cooperating Buyer Approach

The cooperating buyer approach resembles the structure approved in *Starker v U.S.* (9th Cir 1979) 602 F2d 1341. In the *Starker* cases (discussed in §4.7), the buyer of the relinquished properties, Crown Zellerbach Corporation (CZ), held the proceeds in its own name in the form of exchange value credits. The Starkers allowed CZ to retain control and use of the proceeds until they designated properties for CZ to purchase. The taxpayers essentially relied on CZ's unsecured promise to purchase replacement property and transfer it to them. No court has held a taxpayer to be in constructive receipt of amounts owed under an unsecured contractual promise in any reported case on like-kind exchanges or installment sales.

The disadvantage of the cooperating buyer approach is that the taxpayer must rely on the solvency and good faith of the relinquished property buyer for future performance. The Starkers were apparently willing to do so because of CZ's size and reputation. Most buyers, however, are substantially less creditworthy than CZ, and even large and seemingly substantial corporations are not immune to financial difficulties, as the General Motors bankruptcy filing in 2009 has aptly demonstrated. Thus, the question arises whether the obligation of the buyer of the relinquished property (to purchase replacement property and convey it to the taxpayer) may be secured. Regulation §1.1031(k)-1(g)(2) provides a safe harbor from constructive receipt for certain security or guaranty arrangements in both the cooperating buyer and cooperating intermediary contexts. See §§4.45-4.48. These arrangements give the taxpayer substantial latitude to require security for the transferee's obligation. If the safe harbors are not available, then arrangements used to secure a cooperating buyer's performance might be subject to challenge resulting in the taxpayer's constructive receipt of boot.

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§4.40 b. Cooperating Intermediary Approach

Under the cooperating intermediary approach, a third party intermediary receives the net sales proceeds owed the taxpayer on sale of the relinquished property and ultimately uses those proceeds or equivalent funds to purchase replacement property for the taxpayer. If the intermediary is solvent and reliable, the economic risk of the transaction is probably less than under the cooperating buyer approach.

NOTE: This chapter uses the term "cooperating intermediary" to refer to any third party who directly or indirectly substitutes for a replacement property buyer or the taxpayer's exchange counterparty, regardless of whether that intermediary is "qualified" under the rules established by Reg §1.1031(k)-1(g). The role as exchange counterparty is a crucial aspect of the intermediary's function because this role allows an exchange to occur.

As with the security devices applicable to cooperating buyer structures, the deferred exchange regulations adopt a set of guidelines constituting safe harbors for cooperating intermediary structures, sanctioning the use of escrows, trusts, and qualified intermediaries. See §§4.41-4.42. Failure to satisfy the safe harbor requirements is not fatal to an exchange, however, because taxpayers are not automatically deemed to be in constructive receipt of relinquished property sale proceeds if the safe harbor requirements are not met. Attorneys should be cautious, however, about planning transactions that do not fall within one or more of the safe harbors.

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§4.41 (1) Escrow and Trust Arrangements

Exchange escrows and exchange trusts are two common means of securing the obligations of a cooperating intermediary in a deferred exchange. Typically, the escrow holder or trustee receives and holds cash proceeds from sale of a relinquished property and then applies the proceeds toward purchase of replacement property by a cooperating buyer. In California, the escrow holder is the dual agent for both parties until the escrow conditions are satisfied. At that time, the escrow holder becomes the agent for the seller regarding the proceeds and the agent for the buyer regarding the deed. *Shreeves v Pearson* (1924) 194 C 699, 707, 230 P 448; *Claussen v First Am. Title Guar. Co.* (1986) 186 CA3d 429, 435, 230 CR 749.

Because an escrow agent is the agent of the taxpayer/seller, funds that are held by the escrow agent postclosing are deemed to be constructively received by the taxpayer unless the taxpayer is denied access to and control over the funds. The IRS and the courts have been consistent in disallowing exchange transactions under IRC §1031 if the taxpayer could theoretically control the funds after sale of the relinquished property. Thus, the mere use of an escrow to hold relinquished property sale proceeds will *not* prevent a taxpayer from being deemed in constructive receipt of the proceeds. In several cases, exchange treatment was disallowed even though the taxpayer relied in good faith on bad advice on how to structure the exchange to qualify under IRC §1031.

For example, in *Byron Wayne Meadows,* TC Memo 1981-417, the taxpayer followed the advice of a real estate broker by selling the relinquished property and directing the escrow holder to wire the proceeds directly to an escrow account with a title company for the purchase of replacement property. The court held that the transaction constituted a sale followed by a purchase of another property. The fact that the taxpayer was misled by the broker did not help the taxpayer avoid recognition of gain. Although the taxpayer never actually received the net sales proceeds, the escrow agent's receipt of the proceeds at the taxpayer's direction was sufficient for a finding that the taxpayer constructively received the proceeds.

Similarly, in *Stuart L. Gibson,* TC Memo 1982-342, the taxpayer sold the relinquished property on May 1, 1976, and purchased replacement property 3 months later. Although the cash was transferred directly from the sale escrow to the acquisition escrow, the court again held that the transaction constituted a sale followed by a reinvestment, because the court found that the taxpayer controlled the funds once they were in escrow. See also *Dollie H. Click* (1982) 78 TC 225; *Antonio D'Onofrio,* TC Memo 1983-632; *Joyce M. Allen,* TC Memo 1982-188.

Although reliance on bad advice may not protect a taxpayer from characterization of the transaction as a sale and reinvestment, it may protect the taxpayer from penalties. When the taxpayer in *Robert G. Young,* TC Memo 1985-221, received a check for the net settlement proceeds and later transferred it directly to the sellers of the replacement property, the court characterized the transaction as a sale and reinvestment. Because of the taxpayer's lack of formal schooling, his reliance on two attorneys and a real estate broker, and the formalistic distinction between a sale and reinvestment and an exchange under IRC §1031, the court did not impose the negligence penalty.

Complete control over trusts used as vehicles to exchange property will also result in a finding of constructive receipt. In *Joanne H. Greene,* TC Memo 1991-403, the court found the taxpayer to have constructively received the sale proceeds because the taxpayer had complete, unfettered control over two "*Starker* trusts" (see §4.52).

For another example of the courts' reluctance to uphold IRC §1031 treatment when the taxpayer theoretically controlled sales proceeds, see *Maxwell v U.S.* (SD Fla 1988) 88-2 USTC ¶9560, 62 AFTR2d 5406. In *Maxwell,* the court denied §1031 treatment of an attempted exchange because the sales proceeds were placed in escrow and held under an escrow agreement that the court found not to be bulletproof. Even though the taxpayers received replacement real property, they could have demanded the funds instead. See also *John M. Rogers* (1965) 44 TC 126, aff'd per curiam (9th Cir 1967) 377 F2d 534.

PRACTICE TIP: An escrow that does not qualify for the safe harbor under Reg §1.1031(k)-1(g)(3) (see §4.44) must incorporate substantial restrictions on the taxpayer's access to funds and require participation of the relinquished property buyer or a cooperating intermediary to avoid constructive receipt.

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§4.42 (2) Independence of Intermediary

If the taxpayer uses a cooperating intermediary (whether serving as escrow holder, trustee, or a substitute for a cooperating buyer), a further question arises: Must the intermediary be independent of the taxpayer? In a number of cases decided before the adoption of Reg §1.1031(k)-1, the courts held that the intermediary need not be independent, but cannot be the taxpayer's agent. See *Biggs v Commissioner* (5th Cir 1980) 632 F2d 1171 (intermediary was corporation, 90 percent of which was owned by taxpayer's attorney); *Mays v Campbell* (ND Tex 1965) 246 F Supp 375 (exchange between taxpayer and corporation owned 90 percent by taxpayer and his two sons); *Leslie Q. Coupe* (1969) 52 TC 394, acq in result 1970-2 Cum Bull xix (intermediary was taxpayer's attorney); *Hubert Rutland,* TC Memo 1977-8 (intermediary was corporation controlled by taxpayer). For a more recent case, see *Fred L. Fredericks,* TC Memo 1994-27 (intermediary was corporation wholly owned by taxpayer). See also §2.62.

The basic premise in these cases is that the intermediary or other party to the exchange must act as a principal in the exchange rather than solely as an agent of the taxpayer. This premise dates as far back as 1935, to the Board of Tax Appeals decision in *Mercantile Trust Co.* (1935) 32 BTA 82.

Internal Revenue Code §1031(f) restricts, but does not prohibit, exchanges between taxpayers and a related person. When an exchange occurs between a taxpayer and a related person (defined in IRC §1031(f)(3) as "any person bearing a relationship to the taxpayer described in [IRC §§]267(b) or 707(b)(1)"), the taxpayer must hold the replacement property and the related person must hold the relinquished property for at least 2 years after the last transfer that was part of the exchange, unless an applicable exception applies. Otherwise, the taxpayer must recognize the deferred gain from the relinquished property when the subsequent disposition occurs. IRC §1031(f). Thus, if the intermediary is related to the taxpayer, the exchange is not automatically disallowed, but the 2-year holding period may apply. For detailed discussion of the related person rules, see §§2.70-2.83.

NOTE: The related person rules of IRC §1031(f) should not be confused with the disqualified person rules of Reg §1.1031(k)-1(k), which limit the types of persons and entities who can act as qualified escrow holders, trustees, and intermediaries under the regulations. See §§1.47, 4.65-4.67.

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§4.43 3. Constructive Receipt in Other Contexts

Authorities applying IRC §§451 (general rule for including items in gross income in taxable year of receipt) and 453 (installment method of reporting income) may be relevant to analyzing whether a taxpayer constructively received funds in a like-kind exchange. Particularly useful are authorities that address the consequences of placing funds in escrow for certain purposes, subject to disbursement only on satisfaction of certain specified conditions.

In several cases, the escrow holder was held to be acting as an agent of the other party—rather than the taxpayer—when the escrow holder received the funds. Consequently, the taxpayer was held not to be in constructive receipt of the funds. See *Williams v U.S.* (5th Cir 1955) 219 F2d 523 (escrow arrangement was self-imposed limitation on right to take and dispose of funds under predecessor statutes to IRC §§451, 453). See also *Arnwine v Commissioner* (5th Cir 1983) 696 F2d 1102; *Warren v U.S.* (5th Cir 1980) 613 F2d 591; *Kenneth D. Herndon,* TC Memo 1986-230.

In *Reed v Commissioner* (1st Cir 1983) 723 F2d 138, the court held that the use of an escrow arrangement was effective to shift income recognition by the taxpayer for purposes of IRC §451 when three conditions were satisfied:

- The escrow arrangement was part of a bona fide arm's-length agreement between the purchaser and seller, calling for deferred payment;
- The seller received no present beneficial interest from the funds while they were in escrow (*e.g.,* interest earned on the funds); and
- The escrow holder was not acting under the exclusive authority of the taxpayer.

The court determined that both parties (not just the taxpayer) had imposed substantial restrictions on access to the impounded funds, preventing constructive receipt by the taxpayer. See also *Busby v U.S.* (5th Cir 1982) 679 F2d 48; *Charles L. Vaughn* (1986) 87 TC 164; *Fred M. Stiles* (1978) 69 TC 558, acq 1978-2 Cum Bull 3.

The three-part test in *Reed v Commissioner, supra,* is difficult to satisfy in most deferred exchanges because the escrow holder is holding the funds at the request of and under the exclusive authority of the taxpayer rather than for the benefit of, or subject to control by, the buyer of the relinquished property. Unless the facts (rather than merely a recitation in the contract without legal or economic substance) can support that the escrow holder held the funds for the benefit of, or subject to control by, the buyer of the relinquished property, a court may find that the impound of the funds was a self-imposed limitation directed by the taxpayer. See *Maxwell v U.S.* (SD Fla 1988) 88-2 USTC ¶9560, 62 AFTR2d 5406.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.44 C. Regulations' Safe Harbors for Avoiding Actual or Constructive Receipt

§4.44 C. Regulations' Safe Harbors for Avoiding Actual or Constructive Receipt

The regulations contain four provisions establishing safe harbors, which are intended to insulate taxpayers from actually or constructively receiving cash boot in a deferred exchange. Reg §1.1031(k)-1(g)(1). These safe harbors include the following:

- Definition of a set of permissible arrangements creating security for performance of exchange obligations by a cooperating buyer or a cooperating intermediary (Reg §1.1031(k)-1(g)(2); see §§4.45-4.48);
- Definition of the elements of permissible (qualified) escrow accounts and trusts established to secure performance by a cooperating buyer or a cooperating intermediary (Reg §1.1031(k)-1(g)(3); see §§4.49-4.52);
- Definition of the criteria for use of a cooperating intermediary, termed a "qualified" intermediary, who will not be considered to be the taxpayer's agent when holding money or other property derived from a relinquished property sale (Reg §1.1031(k)-1(g)(4); see §§4.53-4.57D); and
- Authorization for a taxpayer's receipt of time-value benefit from its relinquished property equity in the form of interest on a "growth factor" (Reg §1.1031(k)-1(g)(5), (k)-1(h); see §§4.58-4.62).

A taxpayer is permitted to use more than one safe harbor concurrently (*i.e.,* a qualified escrow and a qualified intermediary; Reg §1.1031(k)-1(g)(1)), but an exchange will not automatically satisfy IRC §1031 simply because one or more of the safe harbor structures is used. All of the other requirements of §1031 must be satisfied, such as the like-kind, identification, and receipt of replacement property requirements. Conversely, a taxpayer's failure to use one or more of the safe harbors does not mean that the exchange will be disqualified but simply that the taxpayer-favorable presumptions established by compliance with the safe harbor are lost.

The integrity and financial stability of its exchange counterparties are the taxpayer's best protection against being considered in actual or constructive receipt of the exchange proceeds. Even so, the taxpayer often has several overriding concerns:

- Will the exchange fail to qualify under IRC §1031?
- Will the cooperating intermediary or buyer abscond with the funds or refuse to cooperate?
- Will the cooperating intermediary or buyer die or become bankrupt or unable to perform because a third party placed a lien or claim on the funds to be used to purchase the replacement property for the taxpayer?

The taxpayer's first concern will not be eliminated by the use of one or more of the safe harbors, except to the extent that the taxpayer is protected from an IRS assertion that the taxpayer is in constructive receipt of the exchange proceeds.

The taxpayer's second concern may be eliminated by a security or guaranty arrangement, qualified escrow account, or qualified trust, which should prevent the intermediary or buyer from absconding with the exchange funds or otherwise refusing to perform.

The use of a corporate intermediary will eliminate the risks posed by the possible death or disability of the intermediary.

NOTE: An attorney should carefully consider whether there are ever circumstances when an individual should serve as intermediary. In the authors' opinion, these would be rare.

The taxpayer's third concern may be addressed by using the security devices permitted under the security or guaranty arrangement safe harbor, which should give the taxpayer priority against third party claimants if a lien or claim is placed on the exchange proceeds. There are no assured means of protection from claims against the intermediary's assets, however. This problem is inherent in exchanges in which the exchange proceeds become part of the intermediary's assets. Use of a qualified escrow or qualified trust segregates exchange assets from an exchange buyer's or exchange intermediary's other assets. In this situation, use of a trust is probably a better approach because assets held in the trust are not subject to enforcement of a money judgment obtained against a beneficiary before the date the beneficiary is entitled to receive funds from its trust. Prob C §15301. In several bankruptcy proceedings

involving insolvent intermediaries, the absence of an express escrow or trust arrangement has resulted in classification of exchangers as unsecured creditors of an intermediary. See, *e.g., Millard Refrigerated Servs. v LandAmerica 1031 Exch. Servs., Inc.* (*In re LandAmerica Fin. Group)* (Bankr ED Va Apr. 15, 2009, No. 08-35994-KRH) 2009 Bankr Lexis 940.

The use of a permitted security device may also protect the taxpayer in the event of the bankruptcy of the intermediary or transferee. The filing of a bankruptcy petition by or against the intermediary or buyer could, however, subject the relinquished property, the exchange proceeds, or the replacement property to a preference claim under Bankr C §547 (11 USC §547).

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§4.45 1. Security and Guaranty Arrangements

The regulations permit the taxpayer to obtain security for, or a third party guaranty of, the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer without the taxpayer's being considered in constructive receipt of nonqualifying property. Regulation §1.1031(k)-1(g)(2)(i) allows the following forms of security:

- Mortgage or deed of trust (see §4.46);
- Other security interest in property (other than cash or a cash equivalent);
- Third party guaranty (see §4.47); and
- Conforming standby letter of credit (see §4.48).

The safe harbor for security or guaranty arrangements concerns securing the obligation of the taxpayer's transferee. Although Reg §1.1031(k)-1(g)(2) does not directly mention an intermediary, an exchange using a qualified intermediary should have the benefits of this safe harbor even if the taxpayer transfers the relinquished property to the ultimate transferee by a direct deed. See §§2.62-2.64. Even when direct deeds are used, the intermediary has the contractual obligation to acquire the relinquished property from, and transfer replacement property to, the taxpayer. Thus, the intermediary should still be considered the taxpayer's transferee for purposes of this safe harbor. Once a taxpayer has an immediate ability or unrestricted right to receive money or other property under the security or guaranty arrangement, the protection afforded by this component of the safe harbor ceases to apply. Reg §1.1031(k)-1(g)(2)(ii).

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§4.46 a. Mortgage or Deed of Trust Against Relinquished Property

The taxpayer is permitted to receive a security interest in the relinquished property in the form of a mortgage or deed of trust executed by the transferee. Such an instrument would secure the transferee's obligation to spend a specific amount of money to purchase replacement property for the taxpayer.

A performance deed of trust against the relinquished property may also be received to secure the obligation of the taxpayer's transferee. This type of deed of trust does not secure a promise to pay money, but instead secures the relinquished property buyer's promise to purchase the replacement property and convey it to the taxpayer.

One problem with using mortgages or deeds of trust taken from a cooperating buyer is that the taxpayer is providing 100 percent financing of its equity to the buyer, who may ultimately be unable or unwilling to acquire the replacement property for the taxpayer, leaving the taxpayer to foreclose on the deed of trust but lose its exchange. Another problem is the buyer's potential reluctance to encumber the relinquished property, because the encumbrance would restrict the buyer's ability to refinance or sell it. Even if the buyer is willing to execute a performance deed of trust, that deed of trust would be subordinate to any existing deeds of trust and may become subordinate to any new deeds of trust given when the buyer acquires the relinquished property. In that situation, the taxpayer will be secured only to the extent of the buyer's equity in the relinquished property. Furthermore, the taxpayer may be unable to nonjudicially foreclose under the power of sale provision in the performance deed of trust without a fixed sum or a liquidated damages clause in the deed of trust or exchange agreement. CC §2924c; 4 Miller & Starr, California Real Estate §§10.183, 10.186-10.191, 10.195-10.197 (3d ed 2000).

As a practical matter, a security device such as a mortgage or deed of trust will not provide the taxpayer with liquid proceeds to acquire replacement property if the transferee defaults.

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§4.47 b. Third Party Guaranty

Another means of securing funds held by the buyer of the relinquished property is to obtain a third party guaranty of the buyer's obligations. As a practical matter, it may be difficult to obtain such a guaranty when the buyer of the relinquished property is simply accommodating the taxpayer in the exchange. Further, a guaranty is only as good as the guarantor. Although a third party guarantor may be more reliable or creditworthy than a transferee, the taxpayer still must enforce the guaranty through legal channels—a process unlikely to be completed within 180 days. To address this problem, taxpayers may use a standby letter of credit, which is in essence a form of bank guaranty. See §4.48.

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§4.48 c. Standby Letter of Credit

The use of a standby letter of credit to secure a cooperating buyer or cooperating intermediary's exchange obligations must comply with Reg §15A.453-1(b)(3)(iii). The letter of credit may not be drawn on in the absence of a default of the transferee's obligation to transfer like-kind replacement property to the taxpayer. Under Reg §15A.453-1(b)(3)(iii), the standby letter of credit must be a nonnegotiable, nontransferable letter of credit that serves as a guaranty of the obligation secured by the instrument. To permit the acquisition of the replacement property if the taxpayer's transferee defaults, the letter of credit should be structured to require the financial institution or person issuing it to disburse proceeds directly to the escrow for the replacement property purchase or to the seller of the replacement property for the intermediary's benefit. Payment of money directly to the taxpayer would result in actual receipt of cash, invalidating the exchange even if the taxpayer uses those funds to purchase replacement property. Reg §1.1031(k)-1(f)(2).

The letter of credit should be structured to require the taxpayer or the intermediary to give notice to the issuing financial institution sufficiently before the exchange period expires to ensure that the institution will disburse the proceeds of the letter of credit so that the replacement property can be timely acquired and satisfy IRC §1031 if the taxpayer's transferee defaults on its obligation. Under IRS Letter Ruling 9141018 a standby letter of credit meets the safe harbor requirements unless it is, or may be, unconditionally drawn on by any party during the exchange period. The ruling should have clarified that the letter of credit may be drawn against before expiration of the exchange period if the transferee defaults, as long as the funds are not available to the taxpayer.

NOTE: The regulations prohibit use of an irrevocable letter of credit as a security device. This prohibition is based on the notion that a security interest in cash constitutes constructive receipt of the cash. An irrevocable letter of credit is a cash equivalent because the party to whom it is issued can unilaterally present the letter for payment to the issuing financial institution at any time before its expiration.

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§4.49 2. Qualified Escrow Accounts and Qualified Trusts

To ensure that the relinquished property transferee acquires the replacement property to complete a deferred exchange, the taxpayer may wish to require that cash be set aside for this purpose. In light of recent qualified intermediary failures, this may be advisable. The regulations provide a safe harbor that permits cash or a cash equivalent to be held in an escrow account or a trust account that is dedicated to funding the replacement property purchase without the taxpayer's being in constructive receipt of those funds as long as the escrow or trust meets certain requirements. Reg §1.1031(k)-1(g)(3). See §§4.50-4.52.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.50 a. Definitions

§4.50 a. Definitions

Under the escrow or trust account safe harbor, the concepts of "qualified" escrow account and "qualified" trust are created. Reg §1.1031(k)-1(g)(3)(i).

A qualified escrow account is an escrow account in which funds or other non-like-kind properties are held by an escrow holder as agent for parties to the account and in which

- the escrow holder is neither the taxpayer nor a disqualified person as defined in Reg §1.1031(k)-1(k) (see §4.65) (Reg §1.1031(k)-1(g)(3)(ii)(A)); and
- the escrow agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account, except as provided in Reg §1.1031(k)-1(g)(6) (see §4.63) (Reg §1.1031(k)-1(g)(3)(ii)(B)).

A qualified trust is a trust in which funds or other non-like-kind properties are held by a trustee and in which

- the trustee is neither the taxpayer nor a disqualified person as defined in Reg §1.1031(k)-1(k) (see §4.65) (the relationship between the taxpayer and the trustee created by the qualified trust is disregarded) (Reg §1.1031(k)-1(g)(3)(iii)(A)); and
- the trust agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held by the trustee, except as provided in Reg §1.1031(k)-1(g)(6) (see §4.63) (Reg §1.1031(k)-1(g)(3)(iii)(B)).

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.51 b. Limitations

§4.51 b. Limitations

The qualified escrow and qualified trust safe harbor ceases to apply when the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in a qualified escrow or trust account. Rights conferred on the taxpayer under state law to terminate or dismiss the escrow holder of a qualified escrow account or the trustee of a qualified trust (and thus receive funds), however, are disregarded for this purpose. Reg §1.1031(k)-1(g)(3)(iv).

Although a taxpayer may receive money or other property directly from a party to the exchange (see §4.55), the taxpayer may not receive money or other property from a qualified escrow account or a qualified trust before the end of the exchange period without invalidating the safe harbor. Reg §1.1031(k)-1(g)(3)(v).

WARNING: The use of a qualified escrow or trust account does not affect IRC §1031's requirement that the transaction be an exchange. Reg §1.1031(k)-1(a). This safe harbor does not permit a taxpayer to sell relinquished property, direct the exchange proceeds to a qualified escrow account or a qualified trust, and then direct those proceeds to purchase replacement property. The sole purpose of a qualified escrow or qualified trust is to secure the obligation of the taxpayer's transferee (or intermediary) to transfer replacement property to the taxpayer. If the taxpayer's transferee is not obligated to purchase replacement property and transfer it to the taxpayer to complete the exchange, the exchange requirement under §1031 will not be met. See Reg §1.1031(k)-1(g)(8), Example 1, for an illustration of a qualified escrow account used to secure the obligation of the taxpayer's transferee to transfer replacement property to the taxpayer.

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§4.52 c. Use of Trusts

The real estate industry began using the term *Starker* trust to mean the use of any trust in a like-kind exchange after the ruling in *Starker v U.S.* (9th Cir 1979) 602 F2d 1341, which permitted a nonsimultaneous exchange. See §4.7. Because neither *Starker I* nor *Starker II* had anything to do with a trust, the term is a misnomer.

The IRS first issued a letter ruling in 1979 approving use of a trust (see IRS Letter Ruling 7938087), but that ruling was later suspended and then revoked (see IRS Letter Ruling 8046122).

Although a trust may now be used to secure the obligation of the taxpayer's transferee in a deferred exchange, the structure of such a qualified trust remains unclear. Regulation §1.1031(k)-1(g)(3)(iii) discusses who may act as trustee and beneficiary, but the regulations lack any examples that feature a trust.

Specifically, the regulations are unclear about whether the taxpayer may be a beneficiary under a qualified trust. It would make no sense if this were impossible; current practice is to make both the taxpayer and the cooperating buyer or intermediary trust beneficiaries. Presumably, the transferee or qualified intermediary (QI) is the trustor because the trust corpus is supplied by that party. However, it may be preferable to have the relinquished property buyer be the trustor because funds would not have passed through the intermediary's hands; this might be a better method to avoid adverse consequences of an intermediary's bankruptcy filing. The trustee may not be the taxpayer or a disqualified person, although the relationship between the taxpayer and the trustee created by the qualified trust will not be considered in ascertaining whether the trustee is independent of the taxpayer. Reg §1.1031(k)-1(g)(3)(iii)(A).

PRACTICE TIP: The trust agreement must incorporate the restrictions stated in Reg §1.1031(k)-1(g)(6) to avoid the taxpayer's being in constructive receipt of the cash or cash equivalent. Reg §1.1031(k)-1(g)(3)(ii)(B). Attorneys using qualified trust arrangements should proceed cautiously in light of the lack of guidance on the use of this particular mechanism. Nonetheless, the use of a qualified trust in conjunction with a QI probably offers the best protection against risk created by an intermediary's bankruptcy or a third party lien on its assets and frequently operates in tandem with the QI structure.

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3. Qualified Intermediaries

§4.53 a. Requirements for Application of Safe Harbor

Before the deferred-exchange regulations were adopted, taxpayers had no assurance that a cooperating intermediary would not be treated as the taxpayer's agent (which could result in the taxpayer's constructive receipt of exchange proceeds or failure to actually "exchange" property and thus disqualify the exchange). Regulation §1.1031(k)-1(g)(4) provides a safe harbor allowing a taxpayer to use a qualified intermediary (QI) to facilitate an exchange.

The IRS will not treat a QI as the taxpayer's agent if two requirements are satisfied (Reg §1.1031(k)-1(g)(4)(iii)):

- The QI is not the taxpayer or a disqualified person (as defined in Reg §1.1031(k)-1(k); see §4.65); and
- Before the transfer of relinquished property, the QI enters into a written exchange agreement with the taxpayer and, under the agreement, performs the following functions: acquires the relinquished property from the taxpayer, transfers the relinquished property to the ultimate transferee (buyer), acquires the replacement property, and transfers the replacement property to the taxpayer (Reg §1.1031(k)-1(g)(4)(iii)(B)).

WARNING: The written exchange agreement between the taxpayer and the QI must be in place before the transfer of relinquished property and cannot be created after the fact, even if all funds from sale of the relinquished property are received by the QI.

The regulations appear to encourage the use of qualified intermediaries. See Reg §1.1031(k)-1(g)(8), Examples 3-4. Example 3 notes that the safe harbor is satisfied regardless of whether the intermediary is considered, under general tax principles, to have acquired title or beneficial ownership of the properties. Reg §1.1031(k)-1(g)(8), Example 3(ii). Example 4 shares most of Example 3's facts but shows the effect of an assignment of rights by the relinquished property transferee, the replacement property transferor, or both. If the assignment is done properly, no harm is done to the exchange transaction. Reg §1.1031(k)-1(g)(8), Example 4.

The intermediary is treated as acquiring and transferring property for purposes of Reg §1.1031(k)-1(g)(4)(iii)(B) and thus is treated as the taxpayer's exchange counterparty if the intermediary does any of the following (Reg §1.1031(k)-1(g)(4)(iv)):

- Acquires and transfers legal title to the property;
- Enters into an agreement with a person other than the taxpayer to transfer the relinquished property to that person, and the relinquished property is then in fact transferred to that person under the agreement; or
- Enters into an agreement with the owner of the replacement property to transfer that property to the taxpayer, and the replacement property is then in fact transferred to the taxpayer under the agreement.

Under the alternatives in the second and third bullets above, direct deeding is permitted (because legal title need not be transferred through the intermediary) if interdependent obligations exist in the exchange agreement. Reg §1.1031(k)-1(g)(8), Examples 3-4. On the use of direct deeds, see §§2.62-2.64.

To satisfy the qualified intermediary safe harbor, the QI must have a relationship with the taxpayer, as transferee of the relinquished property, and with the seller of the replacement property.

PRACTICE TIP: This relationship is usually created by an assignment of contract rights from the taxpayer to the QI. When a contract to sell the relinquished property has been created between the taxpayer and the buyer, the taxpayer's rights to receive sale proceeds are assigned to the QI before closing. When a contract between the taxpayer and the seller of replacement property has been created, the taxpayer's purchase right is assigned. See Reg §1.1031(k)-1(g)(8), Example 5.

A QI may also be able to perform other functions without being deemed the taxpayer's agent. For example, in two 1998 letter rulings, an entity who was a qualified intermediary under the safe harbor regulation was not disqualified because it acquired nonqualifying properties for the taxpayer. The limited activities of this entity in acquiring such

nonqualifying properties constituted routine financial or trust services (Reg §1.1031(k)-1(k)(2)(ii)). IRS Letter Rulings 9826033, 9812013 (sister rulings). In so-called "program exchanges," the QI (or affiliates under common control) may perform a variety of functions. See §§4.73A-4.73I.

The QI must acquire and transfer both the relinquished property and the replacement property. See Reg §1.1031(k)-1(g)(4)(iii)(B). Thus, the requirements of this safe harbor would not be satisfied in three-party exchanges. See §1.40. Although a three-party exchange may satisfy the requirements of IRC §1031 under existing case law, neither a cooperating buyer nor a cooperating seller would technically satisfy all requirements to act as a QI.

WARNING: Resignation or replacement of a QI during the course of a deferred exchange (*i.e.,* after transfer of relinquished property but before acquisition of replacement property), could jeopardize availability of the safe harbor because no single party would have undertaken all acts required of a QI. Although the IRS has ruled that the change of a QI's tax status from disregarded entity to regarded entity does not cause the safe harbor to be lost, the scope of this ruling probably cannot be extended to outright substitution of the QI in the middle of an exchange. See IRS Letter Ruling 200908005.

As with the qualified escrow and qualified trust safe harbors, QI status terminates when the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the QI. For this purpose, rights conferred on the taxpayer under state law to terminate or dismiss the QI are disregarded. Reg §1.1031(k)-1(g)(4)(vi). However, the agreement between the taxpayer and the QI must contain the restrictions of Reg §1.1031(k)-1(g)(6) to limit the taxpayer's right to receive cash in lieu of property. See §4.63. Reg §1.1031(k)-1(g)(4)(ii).

The QI safe harbor is also available for simultaneous transfers of like-kind properties. Reg §1.1031(b)-2. Use of a QI in multiparty simultaneous exchanges can often be advantageous, because it avoids any need for a taxpayer to obtain exchange cooperation from the relinquished property's buyer or the replacement property's seller, other than consenting to assignments of the taxpayer's rights under the respective purchase and sale agreements for the properties.

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§4.54 b. Effect of Satisfaction of Safe Harbor

Compliance with the qualified intermediary safe harbor means only that the determination of whether a taxpayer is in actual or constructive receipt of money or other property will be made as if the qualified intermediary (QI) were not the taxpayer's agent. Thus, even when a QI is used, an exchange may be disallowed on the ground that the taxpayer actually or constructively received money or other property. For example, a poorly drafted exchange agreement allowing the taxpayer access to exchange funds by failing to properly recite the limitations of Reg §1.1031(k)-1(g)(6) could disqualify the exchange, because loss of the safe harbor is likely to create a presumption that the QI is the taxpayer's agent.

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§4.55 c. Receipt of Money or Other Property by Taxpayer

A taxpayer is permitted to receive money or other property directly from a party to the transaction without affecting the qualified intermediary safe harbor, although such receipt will create boot in the exchange. The protection of the safe harbor will be lost, however, if the taxpayer receives money or other property from the qualified intermediary (QI) before the end of the exchange period. Reg §1.1031(k)-1(g)(4)(vii). See Reg §1.1031(k)-1(g)(8), Example 1 (taxpayer permitted to receive $10,000 from transferee of relinquished property before exchange completed). Thus, the QI's release of cash to the taxpayer will result in loss of the QI safe harbor, even if the taxpayer is willing to report the receipt of cash as boot under IRC §1031(b), which could disqualify the entire exchange on the ground that the QI is the taxpayer's agent.

If the taxpayer must receive a portion of the net sales proceeds before the exchange is completed, the cash should be disbursed at closing directly from the buyer of the relinquished property or from the closing or settlement agent and should never be placed into the hands or control of the QI. Reg §1.1031(k)-1(g)(4)(vii). See §§4.37-4.43 on deferred exchanges outside the safe harbors.

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§4.56 d. Assignment of Rights to Intermediary

When the qualified intermediary will not take title to relinquished or replacement property, it can still be treated as acquiring and transferring these properties if it becomes a party to the contracts providing for the transfers. The qualified intermediary (QI) may be a party to these agreements or may be assigned the taxpayer's rights under agreements to sell relinquished property or to purchase replacement property, if all parties to the agreements are notified in writing of the assignment on or before the date of the relevant property transfer. Reg §1.1031(k)-1(g)(4)(v). On method and form of assignment, see §§6.6-6.8. This procedure permits the taxpayer to enter into real property purchase and sale agreements directly with the buyer of the relinquished property and the seller of the replacement property and then assign those agreements to the QI to consummate the exchange. When contract assignment is used, it is crucial that all parties to each agreement either affirmatively consent to or be notified of the assignment in writing on or before the date of the relevant transfer of property. The regulations do not specifically require a novation and substitution of a new contract in place of the old. See CC §§1530-1531.

The QI's failure to enter into an agreement with the buyer of relinquished property or seller of replacement property or failure to notify the buyer of the assignment will jeopardize the QI safe harbor unless the intermediary actually acquires title to the property. See Reg §1.1031(k)-1(g)(8), Example 5.

In IRS Letter Ruling 200130001 the IRS disallowed nonrecognition treatment in a real estate exchange because of the taxpayers' failure to provide notice of QI contract assignments to the relinquished property buyers or to the replacement property sellers.

The IRS has approved use of electronic signatures and electronically transmitted documents in connection with transmission of notices between a taxpayer and a QI in a personal property exchange program. IRS Letter Ruling 200236026.

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§4.57 e. Taxation of Qualified Intermediaries

Qualified intermediaries are normally organized as corporations taxable under Part 1, Chapter C, of the Internal Revenue Code (IRC §§301-385). Sometimes they will elect taxation under Chapter S of the Code (IRC §§1361-1379). A discussion of alternative forms of organization and of the tax consequences of the alternatives is beyond the scope of this book. See Selecting & Forming Business Entities (2d ed Cal CEB 2007).

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§4.57A (1) Basic Source of Qualified Intermediary Income

Qualified intermediaries (QIs) usually derive income from two basic sources: fees for services, and interest income from funds held on deposit that derive from sale of relinquished properties. Each constitutes ordinary income to the QI, taxable at rates applicable to business corporations. Against this income, the QI may deduct business expenses, including interest owed to exchangers under applicable exchange agreements. When all interest earned on accounts in the name of the QI is owed to the exchanger, zero net interest income will result. Any difference between what is earned and what is owed will create positive income.

NOTE: A major problem for QIs could arise if they adopt the cash method of accounting. In exchanges that are not completed within the same taxable year, the QI will receive income from interest credited by depository institutions in the first year but will not pay interest to the exchanger until the second year. Because the deduction for the interest paid will not accrue until the payment is made, a positive income item will result in the first year, which will not be offset until the subsequent year. Because of this problem, a QI is generally advised to adopt the accrual method of accounting, which allows a ratable deduction of interest owed to an exchanger as it accrues in the first year even though the interest is not payable until the second year of an exchange that straddles tax years.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.57B (2) Treatment of Deferred Exchange Funds Held by Qualified Intermediary: Deemed Loan

§4.57B (2) Treatment of Deferred Exchange Funds Held by Qualified Intermediary: Deemed Loan

In 2008, the IRS issued final regulations under IRC §468B(g), as well as companion provisions under IRC §7872 (TD 9413, 2008-34 Int Rev Bull 404), addressing the tax treatment of income earned on escrow accounts, trusts, and other funds held by qualified intermediaries (QIs) as well as by escrow holders, trustees, and other parties during deferred like-kind exchanges of property. These provisions apply to exchanges initiated after October 7, 2008. The regulations responded to an IRS perception that taxpayers were improperly accelerating the deduction of exchange expenditures by allowing QIs to retain interest earned on exchange funds as a form of compensation rather than receiving the interest and paying it over as a fee, which would be capitalized into the cost of replacement property. Under these rules, deferred exchange funds held by a QI pursuant to an escrow agreement, trust agreement, or exchange agreement are treated as a loan from the exchanger to the QI unless all earnings on the funds are allocable to the exchanger. Reg §1.468B-6(c)(1).

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.57C (a) Test of Forgone Interest

§4.57C (a) Test of Forgone Interest

If a loan, then the arrangement is considered a compensatory loan under IRC §7872 (Reg §1.7872-16(c)) and, unless an exception applies, is tested to determine whether there is "forgone interest." IRC §7872(e)(2). If no exception applies and there is forgone interest, (1) the qualified intermediary (QI) is deemed to pay this to the exchanger, (2) the exchanger is required to recognize the amount of forgone interest as income in the year it accrues, (3) the exchanger treats the amount as a fee paid to the QI, and (4) the QI has compensation income in the same amount. The exchanger would ordinarily capitalize the amount of the fee into the cost of the replacement property in the exchange.

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§4.57D (b) Exceptions to Deemed Loan Rules

The final regulations under IRC §468B(g) contain significant exceptions intended to limit the "deemed loan" effect to large deferred exchanges. These exceptions include a de minimis rule that excludes transactions when the exchanger's relinquished property sales proceeds are less than $2 million and the duration of the arrangement is 6 months or less. Reg §1.7872-5(b)(16). The regulations also adopt a special applicable federal rate (AFR) as a testing rate to determine whether there is forgone interest. The AFR is equal to an investment rate on a 13-week (generally, 91-day) Treasury bill. Reg §1.7872-16(d).

The regulations attempt to place qualified intermediaries (QIs) owned or controlled by banks or other depository institutions on a level playing field with non-bank-owned QIs insofar as determining whether interest earned on exchange funds is being paid to taxpayers. When exchange funds are held with a depository institution in an account (including a sub-account) that is separately identified with a taxpayer's name and identification number, then only the earnings of this account are treated as earnings attributable to the exchange funds. If all earnings from this account are paid to the taxpayer, then no additional interest is imputed. Reg §§1.468B-6(c)(2)(ii)(A), 1.468B-6(e), Example 6.

These carve-outs may allow QIs to continue to earn interest on deposits from the sale of relinquished property as one of their primary revenue sources without exchangers having to recognize income due to "forgone interest" other than in large transactions involving more than $2 million in relinquished property proceeds. For further discussion, see §4.60. For discussion of background to regulations under IRC §§468B(g) and 7872, see Alton & Weller, *Treatment of Section 1031 Exchange Intermediaries as Borrowers Under New Prop. Reg. 1.468B-6,* 104 J Tax 338 (June 2006).

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4. Interest and Growth Factors

§4.58 a. Taxpayer May Earn Interest

As part of a deferred exchange, a taxpayer may receive (1) interest earned on money held in escrow or trust (or by a qualified intermediary) or (2) a growth factor. Reg §1.1031(k)-1(g)(5). The term "growth factor" arose from its use by the taxpayer in *Starker v U.S.* (9th Cir 1979) 602 F2d 1341, discussed in §4.7. In *Starker,* the parties had agreed on a maximum exchange period of 5 years. The agreement required the buyer/intermediary to add to the taxpayer's exchange credit a growth factor equal to 6 percent of the balance. Because the relinquished property was timberland, the taxpayer contended that the growth factor compensated him for the growth of the timber on the property. The court pointed out, however, that the taxpayer was entitled to receive the additional 6 percent regardless of the fate of the timber. The court disregarded the growth factor label and characterized the money as interest, which was taxable to the taxpayer. 602 F2d at 1356.

Before adoption of the deferred-exchange regulations, it was unclear how the IRS would treat the taxation of interest or growth factors reinvested by an intermediary in replacement property. A common concern was that a taxpayer's receipt of the time value benefit of relinquished property sale proceeds through receipt of interest on those proceeds could lead the IRS to assert that the taxpayer was in constructive receipt of the sales proceeds. The IRS addressed this concern in the deferred exchange regulations by providing that the determination of whether the taxpayer is in actual or constructive receipt of money or other property will be made without regard to whether the taxpayer is, or may be, entitled to receive any interest or growth factor as part of the deferred exchange. Reg §1.1031(k)-1(g)(5). This principle applies, however, only if the taxpayer's rights to receive interest or a growth factor are expressly limited as stated in Reg §1.1031(k)-1(g)(6). See §4.63.

PRACTICE TIP: To protect the taxpayer from being held in constructive receipt of the net sales proceeds, the attorney should combine the safe harbor permitting receipt of interest or a growth factor with one or more of the other structural constructive receipt safe harbors. Compliance with the safe harbor for interest and growth factors alone will generally be insufficient to protect the taxpayer from a finding of constructive receipt, except in a buyer-cooperating deferred exchange.

The agreement between the taxpayer and the qualified intermediary may identify, by name, the account that holds the exchange proceeds, including the tax identification number associated with the account. As long as (1) the agreement affecting the exchange limits the taxpayer's right to receive, pledge, borrow, or otherwise obtain the benefits of any money or other property as provided in Reg §1.1031(k)-1(g)(6)(ii) or (iii) (see §4.63) and (2) the exchange otherwise complies with the safe harbor requirements of Reg §1.1031(k)-1(g)(2), (3), or (4), then the use of the taxpayer's name and identification number on the account should be disregarded in determining whether the taxpayer is in actual or constructive receipt of money or other property that is not like-kind to the relinquished property.

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§4.59 b. When Taxpayer May Receive Interest

Despite the ongoing accrual of interest, the taxpayer may not receive the interest or growth factor until completion of the exchange or the lapse of specific time periods in Reg §1.1031(k)-1(g)(6). Reg §1.1031(k)-1(g)(5). On completion of the exchange or lapse of the other specific time periods allowed under Reg §1.1031(k)-1(g)(6), any interest earned on the exchange funds or any growth factor may be transferred to the taxpayer. See §4.63.

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§4.60 c. Income Tax Treatment

The regulations clarify that an interest or growth factor credited to a taxpayer is treated as interest income. Reg §1.1031(k)-1(h)(2). It is thus not "boot" in the exchange. To qualify for the interest and growth factor safe harbor, the taxpayer's entitlement to the money or other property received must be a function of the length of time that elapsed between the transfer of the relinquished property and the receipt of the replacement property. Reg §1.1031(k)-1(h)(1). This amount will be taxable as interest to the taxpayer, according to the taxpayer's method of accounting, regardless of whether it is paid to the taxpayer in cash or invested in replacement property (including like-kind property). Reg §1.1031(k)-1(h)(2). A cash method taxpayer is not required to include that amount in income until it is actually received.

WARNING: Taxpayers cannot avoid the characterization of growth factors as interest by increasing the exchange equity credit according to the length of time it takes the taxpayer to locate replacement property.

In 2008, the IRS issued final regulations under IRC §468B-6 that provide the requirements for reporting income from IRC §1031 qualified escrow accounts, qualified trusts, or any other type of account in which a qualified intermediary (QI) holds exchange proceeds in connection with a deferred exchange under IRC §1031(a)(3). In general, the regulations treat the assets of a qualified escrow account, qualified trust, or any other account established in connection with a deferred exchange under IRC §1031(a)(3) as owned by the taxpayer, *i.e.,* the party that transfers the relinquished property. Thus, unless an exception applies, the taxpayer is taxable on the "forgone interest" income earned on these assets. Reg §§1.1031(k)-1(g)(3), (k)-1(h)(2); 1.468B-6. Notably, the regulations contain a de minimis exception that excludes transactions when the exchanger's relinquished property sales proceeds are less than $2 million and the duration of the arrangement is 6 months or less. Reg §1.7872-5(b)(16). The regulations also adopt a special AFR testing rate to determine whether there is "forgone interest." The AFR is equal to an investment rate on a 13-week (generally, 91-day) Treasury bill. Reg 1.7872-16(d). See §§4.57B-4.57D.

The holder of funds in connection with a deferred exchange under IRC §1031(a)(3) must report the income of the escrow account or trust on Form 1099 to the extent that the information-reporting provisions of the Internal Revenue Code otherwise require the filing of that form. Reg §1.468B-6(d).

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§4.61 d. Minimizing Taxpayer's Taxable Interest Income

Although the interest and growth factor safe harbor permits the taxpayer to receive interest without jeopardizing the exchange, the taxpayer may still wish to allow the qualified intermediary (QI) or transferee to retain the interest as all or a portion of its fee for facilitating the exchange, as long as the taxpayer is not deemed to be in receipt of "forgone interest" under IRC §§468B(g) and 7872 and the regulations promulgated thereunder. See §§4.57B-4.57D, 4.60. For example, if the taxpayer's relinquished property sales proceeds are less than $2 million and the duration of the arrangement is 6 months or less, thus qualifying under the de minimis exception for "forgone interest" under Reg. §1.7872-5(b)(16), the taxpayer may choose to allow the QI to retain the earnings on the exchange proceeds as a portion of the QI's fee. In doing so, the taxpayer may avoid one level of taxation. If the taxpayer whose exchange qualifies under the de minimis exception for "forgone interest" under Reg §1.7872-5(b)(16) is nevertheless paid all of the interest on completion of the exchange transaction, that interest will be taxable to the taxpayer. Separate payment to the QI of its fee will not be currently deductible but will likely be capitalized under general tax principles. IRC §263; Rev Rul 72-456, 1972-2 Cum Bull 468. In this circumstance, if the QI retains the interest as its fee, the taxpayer will not have interest income. In either situation, the QI will report the same amount as its fee, whether the QI is paid directly or by retaining the interest.

If no exception for "forgone interest" is applicable, then the taxpayer may be required to recognize gain on income earned on exchange proceeds irrespective of whether those earnings are actually paid to the taxpayer. See §4.60.

Another approach to potentially minimizing the taxpayer's taxable interest income if one of the exceptions to "forgone interest" under IRC §§468B(g) and 7872 applies is to have the QI use interest earned on exchange funds to pay closing costs and other transactional expenses. When all earnings on exchange proceeds are credited to the taxpayer and there is thus no deemed loan from the taxpayer to the QI, payment of transactional expenses by the QI is treated as if the funds were first distributed to the taxpayer and then paid by the taxpayer to the recipient. Reg §1.468B-6(c)(2)(ii)(C).

However, if the taxpayer is not required to report the interest received as income as a result of the application of one of the exceptions for "forgone interest," such as the de minimis exception under Reg §1.7872-5(b)(16), payment of transactional expenses from earnings on exchange proceeds may result in the QI being required to recognize income on the interest earned, offset by a deduction for expenses paid. The taxpayer would not receive a corresponding basis increase for the closing costs and other transactional expenses paid by the QI, but the taxpayer would have effectively paid transactional expenses in its exchange with pre-tax dollars.

PRACTICE TIP: The attorney should ensure that the agreement between the taxpayer and the QI properly covers the amount and payment terms for the QI's fee and clearly identifies who is entitled to any interest earned on the exchange proceeds. If the QI is going to retain all or a portion of the interest earned on exchange proceeds or if the QI is to going to pay transactional expenses from interest earned on exchange proceeds, the attorney should explore whether an exception (such as the de minimis exception under Reg §1.7872-5(b)(16)) applies to ensure that the taxpayer does not have to recognize taxable gain on earnings that it does not directly receive.

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§4.62 e. Penalties

Penalties paid under an exchange agreement provision for delayed closing of an exchange are not considered to be interest. In *Joseph W. Kaempfer, Jr.,* TC Memo 1992-19, the court held that a taxpayer was not entitled to deduct as interest an amount paid under an exchange agreement for each day the closing was delayed. Because the exchange agreement provided for a simultaneous rather than a deferred exchange, the amount given up by the other party could not be characterized as interest under IRC §163.

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§4.63 5. Additional Restrictions on Safe Harbors

The safe harbors for qualified escrow accounts, qualified trusts, qualified intermediaries, and interest and growth factors all require that restrictions be imposed on the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period, except in specific circumstances. Reg §1.1031(k)-1(g)(6)(i). These restrictions may lapse only if any of the following occurs (Reg §1.1031(k)-1(g)(6)(ii)-(iii)):

- After the end of the identification period, the taxpayer has not identified any replacement property;
- After the end of the identification period, the taxpayer has identified replacement property and receives all the identified property to which the taxpayer is entitled under the exchange agreement; or
- A material and substantial contingency occurs that (a) relates to the exchange, (b) is provided for in writing, and (c) is beyond the control of the taxpayer or a disqualified person (as defined in Reg §1.1031(k)-1(k)), other than the person obligated to transfer the replacement property to the taxpayer.

The protection against constructive receipt afforded by the safe harbors will not be available if these "(g)(6)" restrictions are not imposed on the taxpayer, even if the taxpayer never actually receives, pledges, borrows, or otherwise obtains the benefits of money or other property. Reg §1.1031(k)-1(g)(6)(i), (k)-1(g)(8), Example 2(ii). See *Michael Hillyer,* TC Memo 1996-214. Thus, each exchange agreement should contain language that meets the requirements of Reg §1.1031(k)-1(g)(6), unless a compelling reason exists to waive the benefits of the safe harbor protections of Reg §1.1031(k)-1(g)(2)-(5).

The safe harbors will not be jeopardized if the qualified intermediary (QI) is obligated to transfer any remaining exchange funds to the taxpayer after completion of the exchange (described in Reg §1.1031(k)-1(g)(6)(iii)(A) as the taxpayer's receipt of all the replacement property to which the taxpayer is entitled under the exchange agreement).

To meet the exceptions in Reg §1.1031(k)-1(g)(6)(ii)-(iii), taxpayers must define conditions beyond their control as marking the completion of an exchange. This exception is very narrow, available only when an extraneous condition, such as receipt of zoning approval, is described. In IRS Letter Ruling 200027028, the IRS addressed the scope of this exception. A QI proposed to amend its standard exchange agreement, entitling the taxpayer to receive exchange funds before the end of the exchange period if the taxpayer did either of the following:

- Identified three replacement properties and acquired two but was unable to acquire the third after negotiating with the seller in good faith; or
- Identified a single replacement property but, after the close of the identification period and after negotiating in good faith with the seller of the identified replacement property, was unable to acquire the property.

The IRS determined, after referring to Reg §1.1031(k)-1(g)(8), Example 2, that the proposed amendment did not meet the exceptions in Reg §1.1031(k)-1(g)(6)(ii)-(iii), because the amendment could apply to any situation in which the taxpayer, after good faith bargaining, could not acquire one or more of the identified replacement properties. The circumstances described were not beyond the taxpayer's control, nor did they constitute a material and substantial contingency. See Weller, *Early Distributions From 1031 Exchange Accounts—Another Look at a Strange New Ruling*, 93 J Tax'n 73 (Aug. 2000).

PRACTICE TIP: When a taxpayer identifies three properties but only intends to acquire one, the parties should be able to provide in the exchange agreement or written identification that a QI may release any funds remaining after the single permitted replacement property is acquired.

In *M. Michael Stewart,* TC Summary Opinion 2006-37, the Tax Court concluded that a taxpayer who obtains a distribution of exchange proceeds from a QI before the end of the 180-day exchange period is not entitled to IRC §1031 recognition despite the reinvestment of the proceeds in like-kind property before the termination of the 180-day exchange period. Intent to exchange property and qualify for nonrecognition treatment is not sufficient to satisfy §1031.

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§4.64 6. Prorations and Closing Costs Are Disregarded in Applying Safe Harbors

When the proposed regulations on deferred exchanges were published, several commentators requested clarification on the effect of escrow prorations and closing costs on the issue of constructive receipt. If prorations and closing costs (when treated as credits to the taxpayer) were treated as amounts received by the taxpayer, then the safe harbors could be adversely affected. The IRS resolved this issue in the final regulations by providing that the taxpayer's receipt of or right to receive proration items (*e.g.,* rents) and closing costs will be disregarded for purposes of applying the constructive receipt safe harbor. Reg §1.1031(k)-1(g)(7).

Closing costs are defined in the regulations as transactional items that relate to the disposition of the relinquished property or to the acquisition of the replacement property. They appear in the typical closing statement as the responsibility, under local standards, of a buyer or seller (*e.g.,* commissions, prorated taxes, recording or transfer taxes, and title company fees). Reg §1.1031(k)-1(g)(7)(ii). In California, the local standards should be established by general escrow practice in the region where the disposition of the relinquished property or acquisition of the replacement property occurs. To date, no published authority expands on the scope of what items constitute typical closing statement items under local standards.

Although these prorations will not interfere with safe harbor use, the amount of prorations credited to the taxpayer on disposition of the relinquished property may still constitute cash boot under IRC §1031(b). See §3.13.

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§4.65 7. Disqualified Persons

Certain parties under the control of or related to the taxpayer are restricted from serving as qualified escrow agents, trustees, or intermediaries for purposes of the safe harbors. The regulations refer to those parties as "disqualified persons." See Reg §1.1031(k)-1(k).

Although the Internal Revenue Code is replete with definitions of "related parties" and "related persons," the deferred exchange regulations do not incorporate one of these definitions. Reg §1.1031(k)-1(k)(1)-(4) defines a disqualified person for purposes of satisfying the safe harbors for like-kind exchanges as follows:

- Anyone who is the taxpayer's agent at the time of the transaction;
- Anyone who bears a relationship to the taxpayer described in either IRC §267(b) or §707(b) (determined by substituting 10 percent for 50 percent in each place it appears in those sections); and
- Anyone who bears a relationship with an agent of the taxpayer described in either IRC §267(b) or §707(b) (determined by substituting 10 percent for 50 percent in each place it appears in those sections).

Thus, disqualified persons include the following:

- The taxpayer's agents at the time of the transaction (Reg §1.1031(k)-1(k)(2); see §4.66);
- Family members, including ancestors, descendants, and siblings, but not in-laws or cousins (Reg §1.1031(k)-1(k)(3));
- Corporations in which the taxpayer has more than a 10-percent interest (Reg §1.1031(k)-1(k)(3));
- Trusts of which the taxpayer is both fiduciary and grantor or is both fiduciary and beneficiary (Reg §1.1031(k)-1(k)(3));
- Partnerships in which the taxpayer has at least a 10-percent interest (Reg §1.1031(k)-1(k)(3));
- Corporations in which an agent of the taxpayer has more than a 10-percent interest (Reg §1.1031(k)-1(k)(4)); and
- Trusts or partnerships in which an agent of the taxpayer has more than a 10-percent interest (Reg §1.1031(k)-1(k)(4)).

NOTE: This list is not exclusive but does include some of the more common examples of disqualified persons. See Reg §1.1031(k)-1(k); IRC §§267(b), 707(b).

In published guidance, the IRS has taken a literal approach when applying Reg §1.1031(k)-1(k)(1)-(4) to determine whether a qualified intermediary (QI) is a disqualified person. In Letter Ruling 200724007, the IRS held that a QI organized as a limited liability company could have members that were disqualified persons under Reg §1.1031(k)-1(k)(1)-(4) (as regards certain taxpayers) using the QI's services without the QI itself being deemed a disqualified person with respect to those taxpayers. The ruling specified that no limited liability company member could own more than a 5-percent capital or profits interest in a QI unless a special waiver to ensure that member was not a disqualified person was obtained. Letter Ruling 200724007 also held that the QI could pay commissions to members, including disqualified persons, for obtaining new exchange clients without being considered a disqualified person under Reg §1.1031(k)-1(k)(1)-(4).

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§4.66 a. Who Is Agent of Taxpayer?

Regulation §1.1031(k)-1(k)(2) provides that the agent of the taxpayer at the time of the transaction is a disqualified person. The regulation adds that persons who have 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 are considered agents of the taxpayer for purposes of the disqualified person definition. The regulations do not clarify whether those persons (the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker) are the only persons who can be considered agents for purposes of Reg §1.1031(k)-1(k)(2), or whether these persons are specified because they are the only agents to whom the 2-year rule applies. Thus, persons other than those specified could be considered agents of the taxpayer and disqualified persons for purposes of the safe harbors.

In determining whether a person is the taxpayer's agent, the regulations direct that the following services be ignored (Reg §1.1031(k)-1(k)(2)(i)-(ii)):

- Services for the taxpayer with respect to exchanges of property intended to qualify under IRC §1031; and
- Routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.

NOTE: A 2002 modification to the regulations relaxed this restriction for banks by providing that banks or subsidiaries of bank holding company consolidated groups with investment banking or brokerage group members will not be disqualified persons solely because of the investment banking or brokerage activities of the group on behalf of the taxpayer. See Reg §1.1031(k)-1(k)(4). This modification was made at the request of certain bank-owned qualified intermediaries that wanted assurance that they could serve exchange clients that were also customers of the parent bank's investment banking division. See §4.67A.

EXAMPLE: Attorneys who have performed only exchange-related services for the taxpayer, or who have performed other types of legal services no more recently than 2 years before the first disposition of the relinquished property, will not be considered disqualified persons. The scope of the "exchange related" services exceptions remains unclear. For example, does legal representation in connection with creation of a real estate purchase agreement for property acquired in a like-kind exchange constitute "exchange-related" services? The answer to this is unknown.

In IRS Letter Ruling 200338001 the IRS determined that an intermediary LLC whose manager and sole member is an LLC is not a disqualified person. The sole member of the intermediary LLC was Manager LLC, which was managed by the taxpayers' law firm. All of the individual attorneys in the law firm, including the taxpayers' son, were also individual managers of the Manager LLC. A single-member LLC was formed to serve as an intermediary ("Intermediary LLC"). The law firm had provided legal services to the taxpayers within the past 2 years. Intermediary LLC was wholly owned by a party unrelated to the taxpayers and who did not provide services to the taxpayers or otherwise act as the taxpayers' agent.

The IRS determined, however, that neither the law firm nor the taxpayers' son nor the Manager LLC owned an interest, directly or indirectly, in Intermediary LLC. Therefore, even though all three were disqualified persons, Intermediary LLC was not a disqualified person.

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§4.67 b. Attorneys as Owners of Corporate Intermediaries

The intermediaries in deferred exchanges are often corporations, and their shareholders are often attorneys. An attorney who has rendered legal advice to a taxpayer within the past 2 years on matters other than exchanges is a disqualified person. Even if the attorney is a disqualified person, however, a corporate intermediary in which the attorney is a shareholder would not be a disqualified person if the attorney owns 10 percent or less of the corporation. Moreover, the attorney's management position in the corporation does not disqualify the corporate intermediary. See Reg §1.1031(k)-1(k)(5), Example 3. Thus, an attorney who performs more than exchange-related services for clients should arrange for an independent person to own the stock in a corporate intermediary (but may still retain the position of director and officer of the corporation) to avoid jeopardizing the safe harbors. See IRS Letter Ruling 9232030 (member of law firm permitted to act as intermediary when law firm had not acted as taxpayer's attorney for past 2 years and rendered only exchange-related services).

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§4.67A c. Qualified Intermediaries Owned by Financial Institutions

Under Reg §1.1031(k)-1(k)(2)(i)-(ii), routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company are ignored in determining if a person is an agent of the taxpayer.

In IRS Letter Ruling 200630005, the Internal Revenue Service stated that a finance company that has a primary business of providing lending services, in addition to holding real property for investments, but that holds no customer deposits, is not an agent of an exchanger who used the services of the finance company's affiliated exchange company. Although the finance company could potentially provide clients of its own affiliated exchange company with replacement property options, the sale, or offering for sale, of properties owned by the finance company to a customer does not cause the finance company or the qualified intermediary (QI) to be considered an agent of the exchanger for purposes of Reg §1.1031(k)-1(k)(2), as long as the finance company does not act as a real estate broker or agent.

A pair of nearly identical rulings clarifies the types of services that can be performed by affiliates of a bank-owned QI and by the QI itself without resulting in the QI being deemed a disqualified person under Reg §1.1031(k)-1(k)(1). See §§4.65-4.66. IRS Letter Rulings 200803003 and 200803014 involved QIs that were wholly owned members of bank-controlled groups. Through other subsidiaries, the banks provided investment advisory, brokerage, private planning, insurance, trust, and retail banking services. In some instances, these subsidiaries would provide these services to customers who used the QI's exchange services. The rulings seem to indicate that the banks' QI subsidiaries would provide some retail banking services in addition to exchange intermediary services.

The IRS ruled that the provision of these types of services would not result in the QI being deemed a disqualified person under Treas Reg §1.1031(k)-1(k)(1). Applying the factors put forth by the Supreme Court in *National Carbide Corp. v Commissioner* (1949) 336 US 422, 93 L Ed 779, 69 S Ct 726, the IRS held that insurance services did not create an agency relationship between the bank subsidiary and the exchanger under Reg §1.1031(k)-1(k)(2). See §4.66. The provision of trust services by an affiliate of the QI, including principal and income accounting, fiduciary income tax services, distribution and valuation services, charitable trust services, bill payment, probate related services, and discretionary investment and asset management services, did not create an agency relationship but rather constituted routine trust services that are not taken into account when determining whether the QI is a disqualified person under Reg §1.1031(k)-1(k)(2)(i)-(ii). Furthermore, the provision of routine banking services by an affiliate or by the QI, including consumer and small business lending, home financing, margin lending and other extensions of credit, retirement and custodial services, check writing, direct deposit, online bill payment, and fee-refunded ATM transactions, also did not create an agency relationship and are not taken into account when determining whether the QI is a disqualified person under Reg §1.1031(k)-1(k)(2)(i)-(ii). Finally, the fact that the QI subsidiary was a member of a controlled group that includes an investment banker or broker did not disqualify the QI from performing exchange intermediary services to investment clients under Reg §1.1031(k)-1(k)(4)(ii). See §4.66.

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§4.68 8. Joint Signature Accounts

Under Reg §1.1031(k)-1(f)(2), the taxpayer is not in constructive receipt of money or property if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Some taxpayers wish to impound the exchange proceeds in a bank account in which the taxpayer (or the taxpayer's designee) and the intermediary or the transferee of the relinquished property are joint signatories. The signatures of both parties are required for withdrawals from such accounts. This device should be permitted if the joint signature account is established as part of an otherwise valid qualified escrow, qualified trust, or qualified intermediary arrangement.

A joint signature account substantially restricts the taxpayer's control of the funds because the taxpayer controls only whether a disbursement may be made and not the receipt of funds. The IRS may contend, however, that the taxpayer has enough control over the funds to have constructively received them. To date, the IRS has shown no inclination to take this position, and in light of Reg §1.468B-6 (see §4.60), it does not appear that this will change in the immediate future. Joint signature accounts have been specifically approved for use in repetitive like-kind exchange programs. Rev Proc 2003-39. See §4.73F.

The taxpayer and either the transferee of the relinquished property or the intermediary may be parties to an escrow in which the net sales proceeds are deposited to secure the obligation of the taxpayer's transferee or the obligation of the intermediary to transfer replacement property to the taxpayer, if the escrow arrangement satisfies the qualified escrow account safe harbor of Reg §1.1031(k)-1(g)(3). See §§4.49-4.52. That safe harbor allows a third party escrow holder to have signature authority over the disbursement of funds subject to the terms of a written escrow agreement. It does not grant the taxpayer signature authority on a joint bank account but only allows the taxpayer to authorize the escrow holder to disburse the funds. See Reg §1.1031(k)-1(g)(8), Example 2. The joint signature account cards provided by most banks probably do not constitute an escrow agreement that would satisfy the qualified escrow account safe harbor; they certainly do not contain the conditions that Reg §1.1031(k)-1(g)(6) requires. Thus a joint signature account may protect an exchanger from qualified intermediary (QI) theft of exchange funds but may not offer protection from a QI bankruptcy or creditor claims.

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§4.68A 9. State Regulation of Qualified Intermediaries

In response to a number of high-profile failures of qualified intermediaries (QI), several states—including California, Nevada, Washington, and Idaho—have enacted, or are considering enacting, rules regulating QIs that operate within their borders. These rules are designed to protect exchangers from QI failure or malfeasance.

California has enacted a set of laws that provide for insurance and investment standards for QIs doing business in California and that prohibit QIs from engaging in certain bad acts. Fin C §§51000-51015. In enacting these rules, the legislative intent was clearly set out (Stats 2008, ch 708, §1):

> The Legislature finds and declares that there are no statutory requirements for persons that facilitate like-kind exchanges pursuant to Section 1031 of the Internal Revenue Code and associated regulations of the United States Department of the Treasury. The purpose of this act is to create a statutory framework that provides consumer protections to those who entrust money or property to persons acting as exchange facilitators and to ensure that persons acting as exchange facilitators adhere to specified rules when they act in that capacity with respect to like-kind exchanges.

QIs doing business in California must do at least one the following (Fin C §51003):

- Maintain a minimum fidelity bond of $1 million;
- Deposit cash, securities, or a letter of credit for at least $1 million; or
- Use a qualified escrow account or trust for each exchange (see §4.49).

QIs doing business in California must also maintain errors and omissions insurance of at least $250,000 or deposit cash, securities, or a letter of credit in that amount. Fin C §51007.

A QI is considered as doing business in California if any of the following are true (Fin C §51000(b)(1)):

- The relinquished property is located in California;
- The exchange accommodation titleholder holds title to property in California (in a reverse exchange as prescribed by Rev Proc 2000-37; see §5.18); or
- The QI maintains an office in California or advertises its services to exchangers located in California.

Perhaps most importantly, California law provides that QIs doing business in the state "have the responsibility to act as a custodian for all exchange funds" and to invest those funds in investments that meet a "prudent investor standard." This standard is violated if relinquished property exchange proceeds are commingled with operating accounts, are loaned to an affiliate of the QI (other than for bank-owned QIs), or are invested in a manner that creates risk of illiquidity or fails to preserve principal for the exchanger. Fin C §51009.

The California statutes are set to expire (*i.e.,* sunset) on January 1, 2014. Fin C §51015.

For more thorough discussion of security of exchange funds and efforts to regulate QIs, see Marques and Weller, *Security of Funds in 1031 Like-Kind Exchanges,* Journal of Passthrough Entities (Jan.-Feb. 2009).

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§4.69 10. Effective Date

The regulations governing deferred exchanges apply to transfers of property made by a taxpayer after June 9, 1991. In addition, a transfer of property made by a taxpayer after May 15, 1990, but before June 10, 1991, is treated as complying with IRC §1031(a)(3) and the regulations if the deferred exchange satisfies either the final regulations or the proposed regulations published May 16, 1990. Reg §1.1031(k)-1(o). The application of the qualified intermediary safe harbor to simultaneous exchanges applies to transfers of property made by taxpayers after June 9, 1991. Reg §1.1031(b)-2(b).

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D. Coordination of IRC §453 With Deferred Exchanges

§4.70 1. Boot May Be Reported on Installment Method

Regulation §1.1031(k)-1(j)(2) coordinates the installment sale rules under IRC §453 with the regulations governing deferred exchanges under IRC §1031. Generally, this regulation provides that the taxpayer's use of a qualified escrow account, qualified trust, or qualified intermediary (QI) will not by itself result in the taxpayer's having received a payment under the installment sale rules of IRC §453 and Temp Reg §15A.453-1(b)(3)(i). Consequently, when a transfer of relinquished property occurs in one year and the taxpayer ultimately receives boot in the subsequent year through a qualified escrow or trust distribution or an exchange credit payment from a QI, it is treated as an installment sale.

Under Reg §1.1031(k)-1(j)(2)(i), if the obligation of the taxpayer's transferee to transfer replacement property to the taxpayer is or may be secured by cash or a cash equivalent held in a qualified escrow account or a qualified trust, the fact that the obligation is secured in this way will be disregarded in determining whether the taxpayer has received a payment for purposes of the installment sale rules. Thus, the cash or cash equivalent is usually not considered a payment in the year of sale. This result mitigates the effect of Temp Reg §15A.453-1(b)(3)(i), which provides that receipt of evidence of indebtedness that is secured directly or indirectly by cash or a cash equivalent is treated as the receipt of payment. An amendment to Temp Reg §15A.453-1(b)(3)(i) now acknowledges the special rule in Reg §1.1031(k)-1(j)(2)(i).

Also, if a taxpayer structures an exchange using a QI, the determination of whether the taxpayer has received a payment for purposes of the installment sale rules will be made as if the QI were not the taxpayer's agent. Reg §1.1031(k)-1(j)(2)(ii).

The existence of a qualified escrow account, qualified trust, or QI is disregarded for purposes of the installment sale rules until the earlier of the following (Reg §1.1031(k)-1(j)(2)(i)-(ii)):

- The time that the safe harbor would otherwise cease to apply under IRC §1031 (*i.e.,* when the taxpayer has the immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the funds held in the qualified escrow account or qualified trust or held by the QI); or
- The end of the 180-day exchange period.

EXAMPLE: A calendar year taxpayer enters into a deferred exchange agreement with a QI on October 1, 2002, transferring a property worth $100,000 to a buyer on that date. The taxpayer fails to complete the exchange by the end of the exchange period. The taxpayer may receive the exchange funds from the QI after the end of the exchange period (March 2003) and report the exchange as an installment sale with a payment received in 2003.

A taxpayer who does not elect out-of-installment sale treatment must apply the installment method to qualifying transactions, including a receipt of boot from a QI in the subsequent tax year. IRC §453(d)(1). A taxpayer may elect out-of-installment sale treatment by reporting the full amount of gain on the tax return for the year in which the installment sale or exchange occurs. IRC §453(d)(2); Reg §15A.453-1(d)(3). An election of out-of-installment sale treatment may only be revoked with IRS consent. IRC §453(d)(3).

In a situation involving boot received from a QI in a subsequent tax year as a result of a failed §1031 exchange, the IRS allowed a taxpayer to revoke an inadvertently made election out of the installment method. In granting the reprieve, the IRS seemed to rely on the fact that the taxpayer's accountant failed to recognize that the transaction qualified for installment sale treatment. IRS Letter Ruling 200813019.

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§4.71 2. Qualification for Installment Treatment: Bona Fide Intent to Exchange

To qualify for the special rules under Reg §1.1031(k)-1(j)(2)(ii), the taxpayer must have a bona fide intent to enter into a deferred exchange at the beginning of the exchange period. A taxpayer will be treated as having a bona fide intent only if it is reasonable to believe, based on all the facts and circumstances as of the beginning of the exchange period, that replacement property will be acquired before the end of the exchange period. Reg §1.1031(k)-1(j)(2)(iv). See Reg §1.1031(k)-1(j)(2)(vi), Examples 5-6, for examples of taxpayers with the requisite bona fide intent.

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§4.72 3. Limitations

A failed or terminated exchange results in full recognition of gain from the disposition of the relinquished property as if the property were sold. Under Reg §1.1031(k)-1(j) taxpayers may postpone the recognition of gain in a failed or terminated exchange to the extent of the exchange funds received in the year after the transfer of the relinquished property if the taxpayer had a bona fide intent to enter into an exchange. See §4.71. An issue arises, however, if the amount of gain to be recognized exceeds the amount of the exchange funds, usually when the taxpayer's relinquished property was subject to a mortgage in excess of basis. In that situation, it is unclear whether the gain from the debt relief is postponed to the subsequent year or recognized in the year of disposition of the relinquished property. If the exchange had been completed as intended, the debt relief would be entirely avoided by a taxpayer who satisfied the boot-offset rules. See §§3.12-3.14, 3.19-3.21. If a like-kind exchange had never been initiated, however, the gain from the debt relief would be taxed in the year of the sale of the relinquished property under the general rules for installment sales. Temp Reg §15A.453-1(b)(3)(i).

Moreover, the exceptions for receipt of payment under Reg §1.1031(k)-1(j)(2)(i)-(ii) do not apply if the relinquished property is property that is not held for productive use in a trade or business or for investment, or is property described in IRC §1031(a)(2) (*e.g.,* stock in trade, property held primarily for sale, stocks, bonds, partnership interests). Reg §1.1031(k)-1(j)(2)(iv).

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§4.73 4. Installment Notes Received in Deferred Exchanges

Regulation §1.1031(k)-1(j) also addresses certain consequences of receipt of a promissory note from the relinquished property buyer. As discussed in §4.70, such a note is reportable under the installment method in IRC §453(f)(6). Before issuance of the regulations, it was unclear whether the buyer would be treated as the taxpayer's transferee, a prerequisite for treatment of the buyer's note as an installment obligation, or whether the intermediary would be treated as the transferee. Regulation §1.1031(k)-1(j) provides that, if the taxpayer receives an evidence of indebtedness of the transferee of the qualified intermediary (QI) (*e.g.,* a promissory note from the buyer of the relinquished property), such receipt will be treated as receipt of an evidence of indebtedness of a person acquiring the property from the taxpayer for purposes of IRC §453 and Temp Reg §15A.453-1(b)(3)(i). Thus, the taxpayer may receive a note directly from the ultimate transferee of the relinquished property and still qualify for installment sale reporting under IRC §453, despite the rule that the taxpayer must receive the note from the person acquiring the property in order to qualify for installment reporting. IRC §453(f)(3). This rule applies to simultaneous exchanges (under Reg §1.1031(b)-2(b)) and deferred (nonsimultaneous) exchanges (under Reg §1.1031(k)-1(j)(2)(iii)). See §4.70.

In a quite liberal approach to this area, the regulations also provide that, in a deferred exchange using a QI, the QI is considered to be the taxpayer's transferee even if the taxpayer transfers legal title to the relinquished property directly to the ultimate buyer by use of a direct deed. Reg §1.1031(k)-1(g)(4)(iv)(C); Reg §1.1031(k)-1(g)(8), Example 4. Regulation §1.1031(k)-1(j)(2)(vi), Example 4, illustrates the taxpayer's receipt of replacement property and the installment obligation of the ultimate transferee in the year following the year in which the relinquished property was transferred. The taxpayer's receipt of the installment obligation may be reported on the installment method under IRC §453. Although the example does not state whether the transferee's note is payable to the taxpayer or the QI, either alternative should be permissible on the basis of Reg §1.1031(k)-1(j)(2)(ii). Further, in Example 4, the installment obligation is delivered to the taxpayer in the subsequent year along with the replacement property. Although this situation is not specifically covered by the regulations, the taxpayer should be entitled to receive the installment obligation either concurrently with the transfer of the relinquished property to the transferee or at the end of the exchange period. See Reg §1.1031(k)-1(g)(8), Example 4 (buyer pays $10,000 directly to taxpayer and $90,000 to QI concurrently with transfer of relinquished property to buyer).

Regulation §1.1031(k)-1(j)(2) applies to transfers of property made by a taxpayer on or after April 20, 1994.

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V. PERSONAL PROPERTY EXCHANGE PROGRAMS

§4.73A A. Generally

Taxpayers have utilized IRC §1031 to defer recognition of gain when large numbers of personal property assets, such as cars or trucks, are being sold and purchased as part of an ongoing business such as vehicle leasing. It is beyond the scope of this book to describe in detail the various issues specific to these forms of transactions, but typically these issues relate to the application of the safe harbors from constructive receipt contained in Reg §1.1031(k)-1(g) to arrangements involving overlay of a qualified intermediary (QI) and qualified escrow structure onto existing business procedures for sales and purchases of assets. In a series of letter rulings, the IRS has evidenced a generally flexible attitude toward structures adopted by taxpayers to reconcile their business practices with the requirements of the constructive receipt safe harbor. See IRS Letter Rulings 200242009, 200241013, 200241016, 200240049, 200236026, 200109022. Of particular note for real estate transactions is the IRS's approval of the use of electronic signatures and e-mail transmission of notices between a taxpayer and QI in connection with assignments of purchase and sale contracts and identification of replacement property. See IRS Letter Ruling 200236026.

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B. Ongoing Tangible Personal Property Exchange Programs

§4.73B 1. Overview

Owner and lessors of large fleets of vehicles, construction equipment, and other similar tangible personal property (such as car rental companies, and bank lease-finance companies) engage on an ongoing basis in tax-deferred exchanges. For instance, the car that one might lease is owned by a bank; when the lease is over, the bank sells the car and acquires another car. Usually the bank structures these two transactions as a tax-deferred exchange. These transactions are not, however, done one-by-one; they are done large scale, with hundreds of vehicles (or other tangible personal property) being sold and purchased each month, in an organized trading "program," generally under a master exchange agreement, and with one intermediary handling all of the exchanges. Questions have arisen about how to apply the various "safe harbor" requirements to these organized, ongoing, repetitive, tax-deferred exchange programs.

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§4.73C 2. Rev Proc 2003-39: Safe Harbors for LKE Programs

Revenue Procedure 2003-39 provides a safe harbor for LKE (like-kind exchange) Programs. On its face, this revenue procedure applies only to an ongoing program that involves multiple exchanges of 100 or more properties (LKE Programs) that have all of the following characteristics:

- The taxpayer regularly and routinely enters into agreements to sell tangible personal property and to purchase tangible personal property;
- The taxpayer uses a single, unrelated intermediary to accomplish the exchanges in the LKE Program;
- The master exchange agreement expressly limits the taxpayer's right to receive or otherwise obtain the benefit of the money or other property held by the intermediary;
- In the master exchange agreement, the taxpayer assigns to the intermediary the taxpayer's rights (but not necessarily its obligations) in some or all of the taxpayer's existing and future agreements to sell relinquished property and to purchase replacement property;
- The taxpayer gives written notice of the assignment to the other party (seller or buyer, as the case may be);
- The taxpayer complies with the identification requirements by (1) implementing a process that identifies potential replacement properties before the end of the identification period for the relinquished property or group of properties that it is disposing of in the exchange or (2) receiving replacement properties before the end of the 45-day identification period or (3) a combination of (1) and (2);
- The taxpayer implements a process for collecting, holding, and disbursing funds (which may include the use of a joint account between the taxpayer and intermediary, or third party accounts for their joint benefit) to ensure that the intermediary has control over the proceeds from the sale of the relinquished property;
- The relinquished properties and replacement properties are "matched" to determine gain recognized (if any) and to determine the basis of the replacement properties; and
- The taxpayer will recognize gain or loss on the disposition of relinquished properties that are not matched with replacement properties; the taxpayer will have a cost basis on replacement properties received but not matched with replacement properties.

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§4.73D 3. Multiple Ongoing LKE Programs

When the taxpayer conducts multiple ongoing LKE Programs, there has been a question whether these are all treated as one exchange, or whether the taxpayer can break them into multiple exchanges (and if so, where is the dividing line). Revenue Procedure 2003-39 makes it clear that the taxpayer is allowed to treat multiple LKE Programs as separate exchanges, and in such case, each LKE Program must meet the safe harbor requirements enumerated in §4.73C. The failure of any LKE Program to meet the safe harbor requirements, or to otherwise satisfy IRC §1031, will not adversely affect any other LKE Program that the taxpayer is consummating, as long as such other LKE Program does satisfy the requirements described in §§4.73E-4.73I.

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§4.73E a. Identifying Replacement Properties; Netting of Funds

Particularly favorable to taxpayers using LKE Programs is the liberalizing of the timing for the matching of replacement properties with relinquished properties. Under Rev Proc 2003-39, replacement property received within the 45-day identification period or otherwise identified in compliance with Reg 1.1031(k)-1(c) is deemed to have been properly identified as long as it is "matched" with relinquished property before the due date (including extensions) of the taxpayer's tax return. This means that the matching can occur long after expiration of the applicable identification period, as long as the matched sale and purchase transactions occur less than 46 days apart.

The LKE Program also may allow the taxpayer to "net" amounts owed by the taxpayer to a buyer against the sales price of the relinquished property as long as the master exchange agreement provides for, and the taxpayer complies with, the requirement that funds equal to the full amount of sales proceeds from relinquished property are transferred to or for the benefit of the intermediary by the beginning of the next business day. Similar "netting" on the acquisition of replacement property is allowed, if the amount owed by the seller of replacement property to the taxpayer is netted against the purchase price to be paid, so that the intermediary transfers to the taxpayer the amount owed by the seller, resulting in the intermediary's expending the full amount of the purchase price for the replacement property.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.73F b. Flow of Funds and Constructive Receipt

§4.73F b. Flow of Funds and Constructive Receipt

Issues involving flow of funds are also complicated in LKE Programs. Revenue Procedure 2003-39 has also liberalized the treatment of funds, thus providing the taxpayer with more control without violating the "constructive receipt" restrictions of IRC §1031.

The taxpayer will not be deemed to be in constructive receipt of money or other property as the result of processing a check or other negotiable instrument made payable to a person other than the taxpayer if

- that instrument has not been endorsed by the payee;
- the payee is not a disqualified person; and
- the instrument is forwarded to the intermediary, or to its account, or to a joint account of taxpayer and intermediary, or a third party account held for the benefit of both taxpayer and intermediary.

A joint account held in the name of (or for the benefit of) the taxpayer and intermediary will not cause constructive receipt if it is used to collect, hold, or disburse proceeds from the sale of relinquished property for the benefit of the intermediary. The account agreement must state that (1) the intermediary's authorization is required to transfer relinquished property proceeds out of the account and (2) the taxpayer's right to receive, pledge, borrow, or otherwise obtain the benefits of proceeds from the sale of relinquished property is restricted as required under Reg 1.1031(k)-1(g)(6). The joint account may be used for other purposes, as long as the taxpayer's rights do not violate Reg 1.1031(k)-1(g)(6) and the intermediary has the right to control the funds.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.73G c. Taxpayer as Lender to Purchaser of Relinquished Property; Taxpayer as Lessor of Purchased Relinquished Property

§4.73G c. Taxpayer as Lender to Purchaser of Relinquished Property; Taxpayer as Lessor of Purchased Relinquished Property

If a taxpayer who engages in an LKE program lends money to a buyer to finance the buyer's purchase of the relinquished property, the taxpayer's receipt of the buyer's note will not be treated as actual or constructive receipt of money or other property if the following conditions are met:

- The taxpayer makes similar loans in the ordinary course of its business;
- The buyer is not obligated to use the taxpayer's financing;
- The loan terms are at market rate; and
- The taxpayer, under the written master exchange agreement, promptly transfers to or for the benefit of the intermediary an amount equal to the loan proceeds plus interest at market rate for the period from the date of the loan to the date of transfer of loan proceeds to the intermediary.

If the taxpayer is the lessor of the relinquished property being purchased by the buyer-lessee, the receipt of the lease security deposit will not be treated as actual or constructive receipt of money or other property if, pursuant to the written master exchange agreement, the taxpayer promptly transfers to or for the benefit of the intermediary an amount equal to the security deposit plus interest at market rate for the period from the date of the sale of the relinquished property to the date of transfer of the security deposit to the intermediary.

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§4.73H d. Status of Qualified Intermediary

A party will not fail to be a qualified intermediary (QI) merely because (1) it is assigned taxpayer's rights to sell relinquished properties or receives funds from these sales that ultimately are not matched with or are not applied to replacement properties under the taxpayer's LKE Program or (2) it is assigned taxpayer's rights to acquire or pays funds that are used to acquire replacement properties that ultimately are not matched with relinquished properties under the taxpayer's LKE Program. This allows the QI to participate in nonexchange transactions without becoming a disqualified person.

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§4.73I e. Assignment Safe Harbor

The assignment, in the master exchange agreement, by the taxpayer to the intermediary of the taxpayer's rights in some or all of its existing or future agreements to sell relinquished property or to purchase replacement property, and the taxpayer's written notice of the assignment to the other party to each agreement to sell relinquished property or to purchase replacement property by the date of each relevant transfer, will satisfy the requirements of Reg 1.1031(k)-1(g)(4)(v).

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§4.73J 4. Implications of Rev Proc 2003-39 for Exchanges Generally

A number of aspects of the safe harbors for LKE Programs have potential application to exchanges generally. Funds netting, use of joint qualified intermediary-exchanger bank accounts, and participation in nonexchange transactions may be examples that should apply for all IRC §1031 purposes. To date, however, no published guidance supports this conclusion.

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§4.74 VI. REAL PROPERTY EXCHANGE AGREEMENT

The form in §§4.75-4.103 is designed for real property transactions in which the exchanger owns 100 percent of the relinquished property, and will own 100 percent of the replacement property. This form will need to be modified if

- the properties being exchanged are personal property, rather than real property (see §§2.48-2.49 for requirements of personal property exchanges), or
- the exchanger's ownership interest is less than 100 percent.

Although the form applies to simultaneous exchanges, because the vast majority of IRC §1031 transactions are structured as deferred or delayed exchanges, the form anticipates and addresses the issues arising in a nonsimultaneous exchange. See §§4.2-4.4. This form is intended to meet the safe harbor requirements for using a qualified intermediary (QI) to facilitate the exchange. Reg §1.1031(k)-1(g)(4)(iii). See §§4.53-4.57D for general discussion of role and requirements of QIs.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.75 A. Form: Title and Introductory Paragraph

§4.75 A. Form: Title and Introductory Paragraph

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4.75-1 Title and introductory paragraph

REAL PROPERTY EXCHANGE AGREEMENT

THIS REAL PROPERTY EXCHANGE AGREEMENT (the Agreement) is made and entered into as of _ _[*date*]_ _**, by and between**_ _[*name*]_ _**, a** _ _[*type of entity*]_ _ _ _[*if more than one exchanger, add name and type of entity of additional exchangers*]_ _ **(**_ _[*together*]_ _ **Exchanger) and** _ _[*name*]_ _**, a** _ _[*type of entity*]_ _ **as the Qualified Intermediary (QI).**

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§4.76 B. Form: Recitals

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.75-4.103.

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4.76-1 Recitals

This Agreement is made and entered into with reference to the following facts:

A. Exchanger is the present fee owner of that certain real property defined in _ _[*e.g., Section 1.17*]_ _ as the Relinquished Property.

B. Exchanger desires to make a qualified tax-deferred exchange of Exchanger's interest in the Relinquished Property for other property or properties of like kind in accordance with Internal Revenue Code §1031, the Treasury Regulations promulgated under that section, and corresponding provisions of state tax legislation.

C. Exchanger has entered into a written Sale Contract with Buyer by which Exchanger has agreed to convey and Buyer has agreed to acquire Exchanger's interest in the Relinquished Property on the terms and conditions set forth in the Sale Contract.

D. QI is willing to act as a qualified intermediary, as that term is defined in Regulation §1.1031(k)-1(g)(4), in connection with Exchanger's exchange.

NOW, THEREFORE, in consideration of the mutual covenants, conditions, and agreements set forth in this Agreement, Exchanger and QI each agree as follows:

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.77 C. Form: Definitions

§4.77 C. Form: Definitions

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4.77-1 Definitions

1. Definitions. Whenever used in this Agreement, the following terms have the following meanings:

1.1 "Acquisition Credit" has the meaning provided in _ _[*e.g., Section 7.6.2*]_ _ of this Agreement.

1.2 "Buyer" means _ _[*name*]_ _.

1.3 "Closing Agent" means _ _[*name*]_ _, whose address is _ _[*address*]_ _, Facsimile No.: _ _[*number*]_ _.

1.4 "Code" means the Internal Revenue Code of 1986, as amended from time to time.

1.5 "Dispute" has the meaning provided in _ _[*e.g., Section 3.4*]_ _ of this Agreement.

1.6 "Exchanger" means the party whose name and status are stated in the preface to this Agreement, and whose address is _ _[*address*]_ _, Facsimile No.: _ _[*number*]_ _.

1.7 "Exchange Credit" has the meaning provided in _ _[*e.g., Section 3.1*]_ _ of this Agreement.

1.8 "Exchange Period" means the one-hundred-eighty- (180-) day period beginning on the date of transfer of Exchanger's interest in the Relinquished Property, to QI or, at QI's direction, to the Buyer, as set forth in the Sale Contract.

1.9 "Exchange Value" means the gross purchase price to be paid by Buyer for the Relinquished Property.

1.10 "Forum State" means the State of _ _[*name*]_ _.

1.11 "Hazardous Materials" has the meaning provided in _ _[*e.g., Section 9.2*]_ _ of this Agreement.

1.12 "Identification Period" means the 45-day period beginning on the date of transfer of Exchanger's interest in the Relinquished Property to QI, or at QI's direction, to the Buyer.

1.13 "QI" means _ _[*name*]_ _, a _ _[*legal entity*]_ _.

1.14 "QI's Fee" means $_ _[*dollar amount*]_ _.

1.15 "Purchase Note" has the meaning provided in _ _[*e.g., Section 7.3.2*]_ _ of this Agreement.

1.16 "Regulations" means the Treasury Regulations promulgated with respect to the Code.

1.17 "Relinquished Property" means that certain _ _[*real/real and associated personal*]_ _ property _ _[*located at/commonly known as*]_ _ _ _[*name*]_ _ in _ _[*City*]_ _ _ _[*County*]_ _, _ _[*State*]_ _ more particularly described on _ _[*e.g., Exhibit A*]_ _ to this Agreement.

1.18 "Replacement Property" means the like-kind property or properties to be identified by Exchanger and acquired by QI for transfer to Exchanger in connection with the like-kind exchange provided for in this Agreement.

1.19 "Sale Contract" means the written agreement between Exchanger and Buyer dated _ _[*date*]_ _.

1.20 "Seller" means the party or parties from whom QI is to acquire any Replacement Property for transfer to Exchanger under this Agreement.

1.21 "Yield" has the meaning provided in _ _[*e.g., Section 7.6.3*]_ _ of this Agreement.

Comment: See §§4.8, 4.16-4.18 for discussion of the 180-day time limit to complete the exchange described in section 1.8 of the form. See §§4.8, 4.14 for discussion of the 45-day identification period requirement described in section 1.12 of the form.

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§4.78 D. Form: Exchange of Properties

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4.78-1 Exchange of properties

2. Exchange of Properties. Exchanger agrees to transfer Exchanger's interest in the Relinquished Property to QI in consideration of, and in exchange for, the transfer by QI to Exchanger of Replacement Property under _ _[*e.g., Section 7*]_ _ of this Agreement. QI agrees to transfer Exchanger's interest in the Relinquished Property to Buyer in a sale transaction and to acquire the Replacement Property from the Seller of the Replacement Property in a purchase transaction in furtherance of the exchange described in this Agreement.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.79 E. Form: Terms for Acquisition of Relinquished Property

§4.79 E. Form: Terms for Acquisition of Relinquished Property

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4.79-1 Terms for acquisition of the relinquished property

3. Terms for Acquisition of the Relinquished Property.

3.1 Exchange Credit. QI will initially credit Exchanger in exchange for receipt of the Relinquished Property an amount (Exchange Credit) equal to the Exchange Value, less all of the following amounts:

3.1.1 All costs and prorations described in _ _[*e.g., Section 4*]_ _ of this Agreement, which are charged to QI on account of the sale of Exchanger's interest in the Relinquished Property to Buyer;

3.1.2 The amount of all principal and accrued interest on any obligation secured by Exchanger's interest in the Relinquished Property as of the transfer date of Exchanger's interest in the Relinquished Property, including any prepayment penalty associated with this obligation, and the amount of any due and payable real property taxes and assessments that are a lien on Exchanger's interest in the Relinquished Property at the time of such transfer;

3.1.3 Any amount of the net proceeds that Closing Agent or Buyer distribute to Exchanger on the disposition of Exchanger's interest in the Relinquished Property; and

3.1.4 QI's Fee.

3.2 Adjustments to Exchange Credit. The Exchange Credit will be adjusted under _ _[*e.g., Section 7.6*]_ _ of this Agreement.

3.3 Assignment and Assumption of Sale Contract.

3.3.1 Exchanger transfers, assigns, and delegates to QI all of Exchanger's right, title, and interest in the Sale Contract, and QI accepts such assignment.

3.3.2 At the time this Agreement becomes effective, Exchanger will cause any deposit that has been made under the Sale Contract and released to Exchanger to be delivered to QI and will advise both Buyer and Closing Agent of this assignment.

3.3.3 All representations, covenants, and warranties, express or implied, made by Exchanger or Buyer with respect to the transfer of Exchanger's interest in the Relinquished Property and the transactions contemplated by the Sale Contract and this Agreement will survive the transfer of Exchanger's interest in the Relinquished Property by Exchanger to QI and by QI to Buyer. All rights, remedies, liabilities, and obligations arising therefrom will be deemed to be assigned and delegated by QI to Exchanger and assumed by Exchanger effective simultaneously with the closing of the sale of the Relinquished Property to Buyer.

3.3.4 The assignment and assumption provided in this _ _[*e.g., Section 3.3*]_ _ is null and void if Buyer or its assignee does not acquire title to Exchanger's interest in the Relinquished Property because of the Buyer's or assignee's breach or if either fails to waive any contingencies or if there is a failure of any condition precedent to the obligations of either Exchanger or Buyer to perform the Sale Contract.

3.4 Legal Dispute. If a legal dispute or claim of liability, cost, or expense arises under the Sale Contract before transfer of Exchanger's interest in the Relinquished Property to Buyer (a Dispute), this Agreement (except for this subsection and _ _[*e.g., Sections 9, 12, and 13*]_ _ of this Agreement), may at QI's sole

discretion be rescinded. If QI elects to rescind this Agreement, then the unamended Sale Contract will be reinstated as between Exchanger and Buyer. For purposes of this Agreement, a Dispute will be deemed to arise on the date on which either party to this Agreement, or the Buyer, gives notice of a Dispute to any other party (or to Buyer). On a rescission by QI, Exchanger will be deemed to assume all obligations and liabilities of seller under the Sale Contract and will thereafter indemnify, release, and hold QI harmless from any claims of liability, litigation, settlement negotiations, cost, or expense that may arise between Exchanger and Buyer in connection with the Dispute, the Sale Contract, or this Agreement.

Comment: If the exchanger desires to receive some of the net cash proceeds on the disposition of the relinquished property, they must be distributed by the closing agent, or directly by the buyer (see section 3.1.3 of the form). If the net purchase price is distributed to the QI, then distributions from the QI before the permitted time periods will jeopardize the entire exchange transaction (see §4.55).

This form contemplates that the QI will satisfy its obligation to acquire and transfer the relinquished property by taking an assignment of the exchanger's contract right to sell (see §4.56).

The QI's fees (see section 3.1.4 of the form) vary widely—the authors are aware of fees as low as $250 per transaction, and as high as tens of thousands of dollars. The fee is a product of many factors, including complexity of the transaction, tax and legal sophistication and expertise of the QI, the reputation and prior experience of the exchanger in working with the QI, costs of the QI's arrangement assuring security of funds (*e.g.,* fidelity bonds and insurance on officers of QI), and competition from other companies offering the same service.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.80 F. Form: Relinquished Property Closing

§4.80 F. Form: Relinquished Property Closing

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.75-4.103.

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4.80-1 Relinquished property closing

4. Relinquished Property Closing.

4.1 Closing Agent. Closing Agent will handle the processing of the exchange and sale of Exchanger's interest in the Relinquished Property. Exchanger and QI each covenant and agree to execute instructions to Closing Agent consistent with this Agreement for the purpose of effecting the exchange provided for in this Agreement and the subsequent sale of Exchanger's interest in the Relinquished Property to Buyer.

4.2 Closing Costs. All closing costs and all transfer taxes incurred on the transfer of the Exchanger's interest in the Relinquished Property to QI, and all such costs incurred by QI on its subsequent sale of Exchanger's interest in the Relinquished Property to Buyer, will represent a reduction of the Exchange Credit.

4.3 Prorations; Insurance. All property taxes, insurance premiums, rents, and interest on Exchanger's interest in the Relinquished Property will be prorated as of the closing.

4.4 Direct Deeding. Without in any way affecting QI's obligation to acquire Exchanger's interest in the Relinquished Property, in order to save transfer taxes, title insurance premiums, and additional closing costs, QI will direct Exchanger at the closing to execute a deed conveying legal title of Exchanger's interest in the Relinquished Property directly to the Buyer.

4.5 Timely Closing. If QI does not transfer the Relinquished Property to Buyer on or before the date set forth in the Sale Contract, and the parties to this Agreement do not mutually agree to extend the closing date, this Agreement will be rescinded, with the exception of this _ _[*e.g., Section 4 and Sections 9, 12, and 13*]_ _ of this Agreement, and Exchanger's assignment to QI of the Sale Contract will be deemed null and void.

Comment: See §§2.62-2.64 for discussion of direct deeding (covered in section 4.4 of this form).

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.81 G. Form: Conditions of Title to Exchanger's Interest in Relinquished Property

§4.81 G. Form: Conditions of Title to Exchanger's Interest in Relinquished Property

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.75-4.103.

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4.81-1 Conditions of title to exchanger's interest in the relinquished property

5. <u>Conditions of Title to Exchanger's Interest in the Relinquished Property</u>. Exchanger will transfer title to Exchanger's interest in the Relinquished Property to Buyer, free and clear of (a) all liens other than the lien for general and special taxes and assessments that are not yet payable and (b) items permitted as exceptions to title under the Sale Contract on QI's delivery of title to Buyer, except to the extent liens and encumbrances are to be cleared with consent of Exchanger by application of the price paid by Buyer to QI on purchase of the Relinquished Property.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.82 H. Form: Federal and State Income Tax Withholding

§4.82 H. Form: Federal and State Income Tax Withholding

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4.82-1 Federal and state income tax withholding

6. Federal and State Income Tax Withholding.

6.1 Federal Withholding. Exchanger will either (a) execute and deliver to Closing Agent a certification that Exchanger is a "United States Person" as defined in IRC §7701(a)(30), or (b) if Exchanger is not a United States Person, then Exchanger must deliver to QI, before closing for transfer of the Relinquished Property either (i) a "Notice of Nonrecognition Treatment" under Regulation §1.1445-2(d)(2); (ii) a withholding certificate issued by the Internal Revenue Service under Regulation §1.1445-3; or (iii) other evidence satisfactory to QI demonstrating that QI is not required to withhold funds under IRC §1445. If QI has actual knowledge or reason to believe that any certificate or notice provided by Exchanger is false, QI may, in its sole discretion (x) withhold any amounts required under IRC §1445 and applicable state and local law or (y) terminate and rescind this Agreement.

6.2 State Withholding. If Exchanger is subject to state or local withholding, Exchanger will deliver to QI before transfer of Exchanger's interest in the Relinquished Property (a) a withholding waiver certificate or (b) instructions in a form satisfactory to QI and Closing Agent to withhold an appropriate amount pending receipt of a withholding waiver certificate.

Comment: If the exchanger is subject to federal or state withholding tax, and fails to obtain the required exemptions from withholding, the closing agent will either (1) retain the amount that it estimates is required to be withheld or (2) require the QI to agree to be the withholding agent, and execute an indemnity in favor of the closing agent. Neither of these alternatives is favored: The QI should ascertain, as soon as possible, whether federal or state withholding is required and make sure that the exchanger has applied for all exemptions so that they have been granted before the closing date for the relinquished property.

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I. Acquisition of Replacement Property

§4.83 1. Form: Identification of Specific Replacement Property

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4.83-1 Identification of specific replacement property

7. Acquisition of Replacement Property.

7.1 Identification of Specific Replacement Property.

7.1.1 Exchanger identifies the parcel or parcels of property shown on Exhibit B-1 or B-2 attached to this Agreement as Replacement Property to be acquired by QI in accordance with the terms of this Agreement. Identification by Exchanger of Replacement Property under this _ _[*e.g., Section 7.1*]_ _ will not preclude Exchanger from identifying other Replacement Property subsequent to receipt of the Replacement Property, under _ _[*e.g., Section 7.2*]_ _ of this Agreement.

7.1.2 Exchanger assigns to QI the agreement[s] under which Exchanger has acquired rights to purchase such Replacement Property from the Sellers of the Replacement Property.

Comment: See §§4.20-4.21 for a discussion of the identification issues, including timing, methods, specificity of descriptions of identified properties, and revocation.

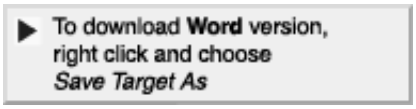
Sections 7.1.1 and 7.1.2 of the form are used if the exchanger is ready, at the time it signs the exchange agreement, to identify one or more potential replacement properties. Because of the subtle issues involved in revocation of identification (see §4.28), the more common practice is for the exchanger not to identify any property initially (unless it has a binding, contingency-free contract for the acquisition), and wait to identify until the earlier of such time as it has such a contract, or a few days before the 45th day (to make sure it meets the timing requirement).

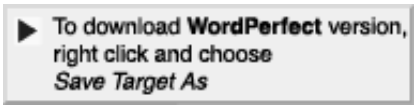
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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.84 2. Form: Identification of Other Replacement Property

§4.84 2. Form: Identification of Other Replacement Property

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4.84-1 Identification of other replacement property

7.2 <u>Identification of Other Replacement Property</u>.

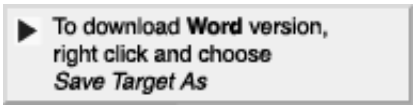
7.2.1 Before the end of the Identification Period, if Exchanger desires to identify Replacement Property in addition to, or in lieu of, any Replacement Property identified in _ _[*e.g., Section 7.1*]_ _ of this Agreement, Exchanger will give written notice to QI using one of the Replacement Property Identification Forms attached to this Agreement as Exhibit B-1 or B-2 of all property that may constitute Replacement Property. Any such identification (including any identification made under _ _[*e.g., Section 7.1*]_ _) may be revoked and a new Replacement Property identified on Exchanger's written notice to QI before the end of the Identification Period. After the Identification Period ends, Exchanger may revoke outstanding identifications but may not substitute new ones.

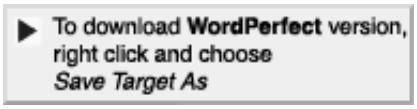
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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.85 3. Form: Contracts to Acquire Replacement Property

§4.85 3. Form: Contracts to Acquire Replacement Property

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4.85-1 Contracts to acquire replacement property

7.3 Contracts To Acquire Replacement Property.

7.3.1 Exchanger will establish the terms of acquisition with the Seller(s) of any identified Replacement Property and provide QI with the form of acquisition agreement(s) acceptable to Exchanger.

7.3.2 QI will thereafter accept an assignment of Exchanger's contract rights to purchase any of the identified Replacement Property or, at Exchanger's direction, enter into a binding written contract in the form approved by Exchanger with such Seller to acquire any identified Replacement Property.

Comment: The QI satisfies its obligation to acquire and transfer replacement property by taking an assignment of the exchanger's purchase rights. See §4.56.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.86 4. Form: Acquisition and Exchange

§4.86 4. Form: Acquisition and Exchange

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4.86-1 Acquisition and exchange

7.4 Acquisition and Exchange. QI will acquire all Replacement Property specified by Exchanger through escrow procedures specified in the relevant acquisition agreement. Concurrent with acquisition of each Replacement Property, QI will cause the transfer and conveyance of the same to Exchanger. To facilitate the transfer of Replacement Property to Exchanger and to save additional transfer taxes and escrow fees, QI will be deemed to have satisfied its obligations under this Agreement if it causes the Seller of any Replacement Property to transfer legal title of the same directly to Exchanger rather than QI first acquiring legal title and then conveying it to exchanger.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.87 5. Form: Effect of Identified Replacement Property Remaining Unacquired

§4.87 5. Form: Effect of Identified Replacement Property Remaining Unacquired

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4.87-1 Effect of identified replacement property remaining unacquired

7.5 Effect of Identified Replacement Property Remaining Unacquired. Exchanger expressly acknowledges that if, after the end of the Identification Period, and before the end of the Exchange Period, any identified Replacement Property has not been acquired by Exchanger within the Exchange Period, for any reason other than for reasons beyond Exchanger's control, which reasons are specifically stated in the Identification Form, then any Exchange Credit that is not used during the Exchange Period to acquire any identified Replacement Property, and the Yield on the entire Exchange Credit, will not be disbursed to Exchanger until the end of the Exchange Period, unless Exchanger has acquired all Replacement Property that Exchanger is entitled to receive pursuant to this Agreement.

Comment: See §4.63 for discussion of what constitutes reasons beyond exchanger's control. See §4.89 for provision of this form enabling exchanger to limit number of properties exchanger is entitled to receive.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.88 6. Form: QI's Financial Obligation to Acquire Replacement Property

§4.88 6. Form: QI's Financial Obligation to Acquire Replacement Property

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4.88-1 QI's financial obligation to acquire replacement properties

7.6 QI's Financial Obligation to Acquire Replacement Property.

7.6.1 In no event will QI be required to make a total cash payment for all Replacement Property, including all costs and expenses of acquisition, in excess of the amount of the Acquisition Credit as defined in _ _[*e.g., Section 7.6.2*]_ _ of this Agreement.

7.6.2 The Acquisition Credit will consist of (a) the Exchange Credit calculated on QI's acquisition and subsequent disposition of the Relinquished Property in the manner described in _ _[*e.g., Section 3.1*]_ _ of this Agreement; plus (b) an amount equal to the Yield, as defined in _ _[*e.g., Section 7.6.3*]_ _ of this Agreement; less (c) the principal balance, plus any accrued but unpaid interest due, of any promissory note taken in partial payment for the Relinquished Property (Purchase Note).

7.6.3 The parties agree that the Yield will be calculated by multiplying the unexpended portions of cash received by QI from the sale of the Relinquished Property to Buyer by the interest rate paid from time to time by _ _[*name*]_ _ Bank on money market account deposits during the period between (a) _ _[*e.g., two (2)*]_ _ days following receipt of funds by QI as the result of QI's transfer of the Relinquished Property and (b) the date of QI's deposit of funds into any escrow for acquisition of Replacement Property or QI's transfer of funds to Exchanger under this Agreement.

7.6.4 Except on a minimum of _ _[*e.g., three (3)*]_ _ business days prior written notice from Exchanger, QI will not be required to expend any funds in excess of _ _[*e.g., Ten Thousand Dollars ($10,000)*]_ _ in furtherance of its obligations under this Agreement. Exchanger expressly acknowledges that Exchanger must provide such notice in order to require QI's expenditure of any funds under this Agreement.

7.6.5 QI will not be required to assume any secured loan on any Replacement Property to be acquired by it or to execute any promissory note or other evidence of indebtedness in connection with any such acquisition that would impose any personal liability on QI to repay such obligation, nor will QI be required to execute any agreement nor participate in any transaction that, in the opinion of QI's counsel, would require QI to engage in any unlawful or fraudulent actions. However, QI acknowledges that Exchanger intends that the Replacement Property to be acquired will have both (a) outstanding balances on existing liabilities and (b) total exchange value, which are equal to or greater than the Exchange Value and those liabilities to which the Relinquished Property is subject as of the date of transfer of the Relinquished Property to QI.

Comment: It is possible (but unusual) for the exchanger to successfully negotiate with the seller (of the replacement property) so that the seller agrees to accept, as consideration for part of the price the seller will be paid, the assignment of the purchase note (defined in section 7.6.2 of the form). In that circumstance, this agreement should be amended to reflect that the QI will assign the purchase note (and any security) given by the buyer to the seller on acquisition of the replacement property. This structure allows the exchanger to use its full equity to acquire the replacement property, rather than report the purchase note as an installment sale (see §4.73). Care must be taken, however, if the exchanger wants to have this flexibility; once the purchase note is delivered to the exchanger, it will be subject to reporting on the installment method, and the exchanger will not be able to avoid that result by later using it as additional consideration (in addition to the monies deposited by the QI) to acquire the replacement property.

Section 7.6.2 of the form describes the net cash proceeds from the disposition of the relinquished property that the QI holds. If the QI receives a purchase note from the buyer, and the QI sells that note during the exchange period,

then the net cash proceeds from the sale of the note would be included in the definition of acquisition credit. The interest paid on the note, while it is held by the QI, would be treated in the same manner as the yield.

Section 7.6.2 permits the QI to apply the yield (interest or growth factor) to acquire the replacement property. However, this will not avoid having the amount of the yield taxed to the exchanger as ordinary income (see §§4.58-4.61), which then allows the exchanger to add that amount to the replacement property's adjusted tax basis, or, alternatively, if the yield funds are applied to deductible closing costs (if any), the income and expense items will offset each other. In this event, it is advisable to require a subescrow statement to specifically earmark the receipt, by the closing agent, of the yield from the QI and the application of those specific funds to the deductible closing costs.

Section 7.6.3 assumes that the exchanger will receive all interest paid by the depository institution into which the exchange funds are deposited. This will ordinarily avoid a need to determine whether the "deemed loan" regime of Reg §§1.468B-6, 1.7872-5, and 1.7872-16 applies to the exchange arrangement. See §§4.57-4.57D, 4.60. When any transaction exceeds the $2 million threshold for application of these rules, the attorney must consider how they will apply to the exchanger.

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§4.89 7. Form: Number of Properties to Be Acquired May Be Limited

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4.89-1 Number of properties to be acquired may be limited

7.7 Number of Properties to Be Acquired May Be Limited. If Exchanger specifically states in the Identification Form that Exchanger intends to acquire less than all of the identified Replacement Property (*e.g.,* "Exchanger intends to acquire only one [two] of the three properties identified here"), then after Exchanger has, before the end of the Exchange Period, acquired that number of identified Replacement Property, Exchanger will not be entitled to acquire any other property as Replacement Property, regardless of whether it is identified to QI.

Comment: This provision is intended to permit the QI to distribute to the exchanger, before the end of the exchange period and after the exchanger has received the requisite number of properties to which it is entitled, any remaining acquisition credit, without the exchanger's receipt of such funds adversely affecting the validity of the IRC §1031 exchange transaction. See §4.55.

This provision gives the exchanger flexibility in the process of identifying properties when it will not want (or be financially able) to acquire all identified properties; *e.g.,* if the exchanger locates a potential replacement property which has a purchase price that will require most—but not all—of its acquisition credit, and which requires a lot of deferred maintenance. If the exchanger has no other resources of its own and cannot convince the lender to hold back the loan proceeds, the exchanger can gain some flexibility by expressly stating, on the identification form, that after the exchanger has acquired one property, it will not be entitled to receive any other identified property as replacement property. After the exchanger has completed the acquisition (with the QI's participation) of one of the identified properties, it will then not be entitled to receive any other replacement property. This procedure will allow the QI to distribute the remaining acquisition credit to the exchanger (so that the exchanger can use the funds to pay for deferred maintenance) after the exchanger has acquired that one replacement property, regardless of whether the 180-day exchange period has expired. See Reg §1.1031(k)-1(g)(6)(ii). The receipt of those funds will be taxable as boot. See §3.12. However, by expressly limiting (on the identification form) the number of properties to which the exchanger is limited (which would be less than the total number identified), once the exchanger acquires that number of properties, even if the QI is holding additional funds and could acquire another identified property, the express limitation in the form will prevent the exchanger from acquiring more than the limit to which it has agreed to be entitled, and the exchanger will then receive taxable cash boot from the QI. See §4.63.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.90 J. Form: Termination of Exchange

§4.90 J. Form: Termination of Exchange

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4.90-1 Termination of exchange

8. Termination of Exchange.

8.1 Exchanger's Right to Cash. Except as expressly provided in this Agreement, Exchanger will have no right to request or receive anything other than like-kind real property before expiration of the Exchange Period.

8.2 Events Giving Right to Cash Before End of Exchange Period. On expiration of the Identification Period, Exchanger will have the right to require QI to distribute a sum equal to any unexpended portions of the Acquisition Credit to Exchanger if (a) there remains no identified Replacement Property that has not been acquired; (b) QI has acquired all Replacement Property that was identified under _ _[*e.g., Section 7*]_ _ of this Agreement; (c) Exchanger has acquired all Replacement Property that it is entitled to acquire under _ _[*e.g., Section 7.7*]_ _ of this Agreement; or (d) it is impossible for QI to acquire any of the remaining identified Replacement Property because of material and substantial circumstances beyond Exchanger's control and described as conditions in Exchanger's original Identification Notice. The parties to this Agreement intend that these conditions be interpreted and imposed in a manner consistent with the limitations in Regulation §1.1031(k)-1(g)(6).

8.3 At End of Exchange Period. Unless _ _[*e.g., Section 8.7*]_ _ of this Agreement applies, on expiration of the Exchange Period, QI will distribute to Exchanger a sum equal to any balance of the Acquisition Credit that QI has not already used to acquire Replacement Property for conveyance to Exchanger. The payment of such amounts will be made in cash, provided, however, that to the extent that QI holds any Purchase Note, payment will be made by QI's assignment, without recourse, of such Purchase Note to Exchanger (and the assignment of all security given with respect to such Purchase Note), plus the delivery to Exchanger of all payments of interest or principal on the Purchase Note that have been actually received by QI. QI will distribute any remaining Acquisition Credit, and any Purchase Note, to Exchanger within _ _[*e.g., 10*]_ _ days after the Exchange Period ends.

Comment: On section 8.2 of the form, see discussion in §4.63. See §§3.6-3.11 for discussion of tax treatment of distribution of cash held by QI at the end of the exchange period. See §§4.70-4.73 for tax treatment of distribution of purchase note held by QI at the end of the exchange period.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.91 K. Form: Indemnities by Exchanger

§4.91 K. Form: Indemnities by Exchanger

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4.91-1 Indemnities by exchanger

9. Indemnities by Exchanger.

9.1 General Indemnity. Exchanger will, and agrees to, hold QI harmless and indemnify QI, its directors, officers, employees, attorneys, and agents from any claim, liability, demand, expense, tax, or assessment of any nature or kind, expressed or implied, whether sounding in tort or in contract that may be asserted against QI, its directors, officers, employees, and agents, by any person (other than Exchanger), firm, corporation, governmental agency, or taxing authority, including but not limited to any and all supplemental tax bills issued by the tax collector in any county in which any transaction contemplated by this Agreement is consummated, that may arise from any acts or omissions, active or passive, related to carrying out the terms of this Agreement or from participation in this transaction, except any that arise from the gross negligence or willful misconduct of QI or any other person to be indemnified.

9.2 Indemnity on Hazardous Materials. Exchanger will also indemnify, defend (by counsel reasonably acceptable to QI), protect, and hold QI and its directors, officers, employees, attorneys, and agents, free and harmless from and against any and all claims, liabilities, penalties, forfeitures, losses, or expenses (including attorney fees) or death of, or injury to any person or damage to any property, arising from or caused in whole or in part, directly or indirectly, by the presence in, on, under, or about the Relinquished Property or the Replacement Property or any improvements on it of any Hazardous Materials (as defined in the following paragraph) or the use, analysis, discharge, or generation of Hazardous Materials to, in, on, under, or about or from any such property or improvements on such property. Exchanger's obligations include, without limitation, and whether foreseeable or unforeseeable, all costs of any required or necessary repair, cleanup, or detoxification or decontamination of any of the Relinquished Property or Replacement Property or any improvements on these Properties, and the preparation and implementation of any closure, remedial action, or other required plans in connection with these Properties. These obligations to indemnify QI survive the transfer of any such Property or improvements to QI's successor in interest. For purposes of these indemnity provisions, any acts or omissions of, or by, employees, agents, assignees, or representatives of Exchanger or others acting for or on behalf of Exchanger (whether or not they are negligent, intentional, willful, or unlawful) are strictly attributable to Exchanger.

For purposes of this section, "Hazardous Materials" include but are not limited to substances defined as "hazardous substance," "hazardous materials," or "toxic substances" in the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended (42 USC §§9601 et seq.); the Hazardous Materials Transportation Act (49 USC §§1801 et seq.); the Resource Conservation and Recovery Act (42 USC §§6901 et seq.); the U.S. Department of Transportation Table (49 CFR pt 172.101 and its amendments); the Clean Water Act (33 USC §§1251 et seq.); or by the U.S. Environmental Protection Agency (40 CFR pt 302); any material waste or substance that constitutes (a) petroleum or petroleum-related products, (b) asbestos or asbestos-containing materials, (c) polychlorinated biphenyls, (d) flammable explosives, (e) radioactive materials, and (f) any such other substances, materials, and wastes that are or become regulated under applicable local, state, or federal law, or that are classified as hazardous or toxic under federal, state, or local laws or regulations, as any of the above-mentioned laws may be amended from time to time, or in the Regulations adopted and publications promulgated under these laws.

Comment: Although the QI is not in the chain of title by virtue of the direct deeding procedure, as any claim arising from environmental, hazardous, or toxic conditions on the property could result in lengthy and costly litigation, it is advisable to include an indemnity such as this to give the QI some protection if, having had a part in the transaction, it is named in the litigation.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.92 L. Form: Execution of Documents; Further Documentation

§4.92 L. Form: Execution of Documents; Further Documentation

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.75-4.103.

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4.92-1 Execution of documents; further documentation

10. Execution of Documents; Further Documentation. The parties agree to execute any and all additional documents or instruments necessary to carry out this Agreement. The costs incurred in preparing any documents needed to conclude the transfer of any Relinquished or Replacement Property will be borne by the party on whose behalf the documents are prepared.

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§4.93 M. Form: Conflict With Prior Agreements

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4.93-1 Conflict with prior agreements

11. Conflict With Prior Agreements. If and to the extent that this Agreement conflicts with any prior written or oral agreement or understanding between the parties to this Agreement, the terms of this Agreement will prevail. No modification or waiver of the terms of this Agreement is valid unless made in a writing signed by both parties.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.94 N. Form: Attorney Fees

§4.94 N. Form: Attorney Fees

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.75-4.103.

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4.94-1 Attorney fees

12. Attorney Fees. If any party to this Agreement institutes legal action or arbitration proceedings against any other party to interpret or enforce this Agreement or to obtain damages for any alleged breach of this Agreement, the prevailing party in such action or proceeding is entitled to recover reasonable attorney and experts' fees and costs incurred in prosecuting or defending such action, including fees and costs incurred in discussing settlement of the action whether before or after the action or proceeding is filed, in addition to all other recoverable costs and damages.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.95 O. Form: Survival

§4.95 O. Form: Survival

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4.95-1 Survival

13. Survival. The terms of this Agreement survive the closing and the delivery of Exchanger's interest in the Relinquished Property to QI and of the Replacement Property to Exchanger.

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§4.96 P. Form: Time

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4.96-1 Time

14. Time. Time is of the essence in this Agreement.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.97 Q. Form: Assignment

§4.97 Q. Form: Assignment

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.75-4.103.

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4.97-1 Assignment

15. Assignment. This Agreement inures to the benefit of, and is binding on, the parties to this Agreement, their estates, heirs, representatives, successors in interest, and assigns, provided, however, that neither party has any right to assign this Agreement or any of that party's rights under it without the prior written consent of the other party, which such party may withhold in its sole discretion.

Comment: A QI should not be able to unilaterally withdraw or assign its rights, because to do so could result in loss of the safe harbor from constructive receipt. See §4.53. The taxpayer should not be able to assign its rights, because doing so could constitute a right to obtain the benefits of future QI performance in violation of Reg §1.1031(k)-1(g)(6).

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§4.98 R. Form: Notices

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.75-4.103.

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4.98-1 Notices

16. Notices. All notices required or permitted to be given under this Agreement must be in writing and will be effective on (a) personal delivery to the party to whom they are addressed; (b) if telecopied, on receipt of confirmation that successful facsimile transmission has occurred; or, (c) if mailed, _ _[*e.g., 3*]_ _ days after deposit in the United States Mail first class postage prepaid, registered, or certified, and addressed to each party at the following notice address:

To Exchanger: As shown in _ _[*e.g., Section 1.6*]_ _

To QI: _ _[*address*]_ _

Facsimile: _ _[*number*]_ _

Either party may change its address for notice by giving notice to the other party in accordance with this section.

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§4.99 S. Form: No Agency

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.75-4.103.

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4.99-1 No agency

17. No Agency. Exchanger acknowledges that for federal and state income tax purposes only QI is acting as a principal in all the transactions contemplated by this Agreement and in no way may be deemed an agent of Exchanger, and to such extent, QI will not have any obligations to Exchanger as an agent of Exchanger nor will Exchanger have any obligations to QI as a principal of QI.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.100 T. Form: No Warranty on Tax Consequences

§4.100 T. Form: No Warranty on Tax Consequences

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.75-4.103.

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4.100-1 No warranty on tax consequences

18. No Warranty on Tax Consequences. QI makes no representation or warranty, nor does QI bear any responsibility or liability concerning the federal or state tax consequences to Exchanger of the transaction contemplated in this Agreement, including, without limitation, the status of any Replacement Property as like-kind property or the qualification of this transaction as a like-kind exchange under Internal Revenue Code §1031 or applicable state tax laws.

Comment: QIs normally wish to avoid being held responsible for the qualifications of an exchange under §1031 except when their performance is involved.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.101 U. Form: Governing Law

§4.101 U. Form: Governing Law

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.75-4.103.

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4.101-1 Governing law

19. Governing Law. This Agreement shall be interpreted under and governed by the laws of the Forum State specified in _ _[*e.g., Section 1.10*]_ _.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.102 V. Form: Arbitration of Disputes

§4.102 V. Form: Arbitration of Disputes

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§4.75-4.103.

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4.102-1 Arbitration of disputes

20. Arbitration of Disputes. Any dispute arising from this Agreement, whether for interpretation or enforcement of its terms, will be determined and settled by arbitration before a single arbitrator under the then prevailing commercial rules of the American Arbitration Association, provided, however, that each party is entitled to engage in discovery to the extent permitted under California Code of Civil Procedure §§2016.010-2036.050. Arbitration must be held in _ _[*city*]_ _, California. Any award rendered in such arbitration is final and binding on each of the parties and judgment may be entered on the judgment in the Superior Court of the State of California for the County of _ _[*name*]_ _.

NOTICE: BY INITIALING IN THE SPACE BELOW YOU ARE AGREEING TO HAVE ANY DISPUTE ARISING FROM THE MATTERS INCLUDED IN THIS "ARBITRATION OF DISPUTES" PROVISION DECIDED BY NEUTRAL ARBITRATION AS PROVIDED BY CALIFORNIA LAW, AND YOU ARE GIVING UP ANY RIGHTS YOU MIGHT POSSESS TO HAVE THE DISPUTE LITIGATED IN A COURT OR JURY TRIAL. BY INITIALING IN THE SPACE BELOW YOU ARE GIVING UP YOUR JUDICIAL RIGHTS TO DISCOVERY AND APPEAL, UNLESS SUCH RIGHTS ARE SPECIFICALLY INCLUDED IN THE "ARBITRATION OF DISPUTES" PROVISION. IF YOU REFUSE TO SUBMIT TO ARBITRATION AFTER AGREEING TO THIS PROVISION, YOU MAY BE COMPELLED TO ARBITRATE UNDER THE AUTHORITY OF THE CALIFORNIA CODE OF CIVIL PROCEDURE. YOUR AGREEMENT TO THIS ARBITRATION PROVISION IS VOLUNTARY.

WE HAVE READ AND UNDERSTAND THIS PROVISION AND AGREE TO SUBMIT DISPUTES ARISING FROM THE MATTERS INCLUDED IN THE "ARBITRATION OF DISPUTES" PROVISION TO NEUTRAL ARBITRATION.

_____ QI _____ EXCHANGER

Comment: In California, parties who agree in their contract to submit their disputes to arbitration impliedly waive their right to a trial by jury. See *Madden v Kaiser Found. Hosps.* (1976) 17 C3d 699, 714, 131 CR 882. Counsel for the QI should draft and insert an appropriate provision emphasizing that waiver as determined by the law of the state in which the QI is formed or has its principal office. This provision assumes that the QI is formed in or has its principal office in California. This waiver is not affected by the prohibition against predispute waivers of jury trials in a *judicial forum*. *Grafton Partners LP v Superior Court* (2005) 36 C4th 944, 955, 32 CR3d 5.

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§4.103 W. Form: Signatures

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4.103-1 Signatures

IN WITNESS WHEREOF, the parties have executed this Agreement as of the date first above written.

Exchanger:

Date: _ _ _ _ _ _

_ _[*NAME OF LIMITED LIABILITY COMPANY*]_ _,
a _ _[*state of organization*]_ _ **limited liability company**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

QI:

Date: _ _ _ _ _ _

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **Corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: This signature block assumes that the exchanger is a limited liability company and the QI is a corporation. Suitable modifications to the signature block will be necessary if the exchanger or the QI is an individual or other type of legal entity. The signature block for any entity should include the name of the entity, type of entity, and state of organization.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/ VII. EXHIBITS TO REAL PROPERTY EXCHANGE AGREEMENT/§4.104 A. Form: Exhibit A; Relinquished Property Description

VII. EXHIBITS TO REAL PROPERTY EXCHANGE AGREEMENT

§4.104 A. Form: Exhibit A; Relinquished Property Description

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4.104-1 Exhibit A; relinquished property description

EXHIBIT A

RELINQUISHED PROPERTY DESCRIPTION

Comment: Exhibit A is a legal description of the relinquished property.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.105 B. Form: Exhibit B-1; Replacement Property Identification Form

§4.105 B. Form: Exhibit B-1; Replacement Property Identification Form

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4.105-1 Exhibit B-1; replacement property identification form

EXHIBIT B-1

REPLACEMENT PROPERTY IDENTIFICATION FORM
(THREE PROPERTIES)

_ _[*I/We*]_ _ acknowledge that under a Real Property Exchange Agreement dated _ _[*date*]_ _ (Exchange Agreement), _ _[*my/our*]_ _ interest in the Relinquished Property (as defined in the Exchange Agreement) was transferred to _ _[*name*]_ _ (QI), on _ _[*date*]_ _. _ _[*I/We*]_ _ understand that, for purposes of Internal Revenue Code §1031, to complete a like-kind exchange, _ _[*I/we*]_ _ must identify the property _ _[*I/we*]_ _ wish to acquire no later than 45 days after the date _ _[*my/our*]_ _ interest in the Relinquished Property was transferred to QI. In accordance with the Exchange Agreement, _ _[*I/we*]_ _ identify the following real property as Replacement Property (as defined in the Exchange Agreement):

Replacement Property #1 _____
Approx _ _[_ _ _]_ _ % interest (if less than 100%)
Address/Description: _____

Replacement Property #2 _____

Approx _ _[_ _ _]_ _ % interest (if less than 100%)
Address/Description: _____

Replacement Property #3 _____

Approx _ _[_ _ _]_ _ % interest (if less than 100%)
Address/Description: _____

Of the foregoing identified potential Replacement Property _ _[*I/we*]_ _ intend to acquire ONE / TWO / ALL such properties (circle one).

Executed on this _ _[*date*]_ _.

QI: _ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Exchanger:

_ _[*NAME OF LIMITED LIABILITY COMPANY*]_ _,
a _ _[*state of organization*]_ _ **limited liability company**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Note to Exchanger: IF ANY OF THE ABOVE PROPERTIES ARE TO BE REVOKED AS IDENTIFIED PROPERTIES, YOU MUST SEND A WRITTEN NOTICE OF REVOCATION WITHIN 45 DAYS AFTER THE TRANSFER OF YOUR INTEREST IN THE RELINQUISHED PROPERTY. UNLESS YOU ARE ABSOLUTELY CERTAIN THAT YOU CAN AND WILL ACQUIRE ALL IDENTIFIED PROPERTIES, DO NOT IDENTIFY MORE THAN THREE PROPERTIES. IF YOU WANT TO IDENTIFY MORE THAN THREE PROPERTIES, BUT ARE NOT ABSOLUTELY CERTAIN THAT YOU CAN AND WILL ACQUIRE ALL OF THEM, USE EXHIBIT B-2 TO IDENTIFY PROPERTIES WHOSE TOTAL COMBINED VALUE IS NO MORE THAN 200 PERCENT OF THE VALUE OF YOUR INTEREST IN THE RELINQUISHED PROPERTY.

Comment: On identification of replacement property generally, see §§4.19-4.28. On designation of replacement property and three-party rule, see §4.23.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.106 C. Form: Exhibit B-2; Replacement Property Identification Form (200 Percent of Value)

§4.106 C. Form: Exhibit B-2; Replacement Property Identification Form (200 Percent of Value)

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4.106-1 Exhibit B-2; replacement property identification form (200 percent of value)

EXHIBIT B-2

REPLACEMENT PROPERTY IDENTIFICATION FORM
(200 PERCENT OF VALUE)

_ _[*I/We*]_ _ acknowledge that under a Real Property Exchange Agreement dated _ _[*date*]_ _ (Exchange Agreement), _ _[*my/our*]_ _ interest in the Relinquished Property (as defined in the Exchange Agreement) was transferred to _ _[*name*]_ _ (QI), on_ _[*date*]_ _. _ _[*I/We*]_ _ understand that for purposes of Internal Revenue Code §1031, to complete a like-kind exchange, _ _[*I/we*]_ _ must identify the property _ _[*I/we*]_ _ wish to acquire no later than 45 days after the date _ _[*my/our*]_ _ interest in the Relinquished Property was transferred to QI. In accordance with the Exchange Agreement _ _[*I/we*]_ _ identify the following real property as Replacement Property (as defined in the Exchange Agreement):

Replacement Property #1 _____

Value $_ _[_ _ _]_ _ _ _% interest
Address/Description: _ _[*address/description*]_ _
Approx _ _[_ _ _]_ _ _ _% interest (if less than 100%)_____

Replacement Property #2 _____

Value $_ _[_ _ _]_ _ _ _% interest
Address/Description: _ _[*address/description*]_ _
Approx _ _[_ _ _]_ _ _ _% interest (if less than 100%)

Replacement Property #3 _____

Value $_ _[_ _ _]_ _ _ _% interest
Address/Description: _ _[*address/description*]_ _
Approx _ _[_ _ _]_ _ _ _% interest (if less than 100%)

Total Value: $_ _[*dollar amount*]_ _

<u>Additional Sheets ARE / ARE NOT</u> <u>attached (circle one).</u>

Of the foregoing identified potential Replacement Property _ _[*I/we*]_ _ intend to acquire ONE / TWO / THREE / FOUR / FIVE / ALL such properties (circle one).

Executed on this _ _[*date*]_ _.

Exchanger: __[*Signature*]__
_ _[*Typed name*]_ _

Note to Exchanger: THE TOTAL VALUE OF IDENTIFIED PROPERTIES USING THIS FORM CANNOT BE MORE THAN 200 PERCENT OF VALUE OF YOUR RELINQUISHED PROPERTY. IF ANY OF THE ABOVE PROPERTIES ARE TO BE REVOKED AS IDENTIFIED PROPERTIES, YOU MUST SEND A WRITTEN NOTICE OF REVOCATION WITHIN 45 DAYS AFTER THE TRANSFER OF YOUR INTEREST IN THE RELINQUISHED PROPERTY.

Comment: On identification of replacement property generally, see §§4.19-4.28. On designation of replacement property and 200 percent rule, see §4.24.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/ VIII. ANCILLARY DOCUMENTS/§4.107 A. Form: Letter to Client

VIII. ANCILLARY DOCUMENTS

§4.107 A. Form: Letter to Client

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4.107-1 Letter to client

_ _[*Client name*]_ _
_ _[*Address*]_ _
Re: _ _[*Identify property*]_ _
Reference No: _ _[_ _ _ _ _ _]_ _

Dear _ _[*name*]_ _:

Enclosed with this letter are the following documents prepared in connection with the exchange by _ _[*name of exchanger*]_ _, a _ _[*legal entity*]_ _ (Exchanger) of _ _[d*escription of property*]_ _; _ _[s*treet address or other description*]_ _ (Relinquished Property), with _ _[*name of qualified intermediary*]_ _ (QI), followed by the sale of the Relinquished Property to _ _[*name of purchaser of Relinquished Property*]_ _ (Buyer) under the sale agreement between Exchanger and Buyer (Sale Agreement):

1. Two copies of a _ _[*Real/Personal Property Exchange Agreement*]_ _, which constitutes the basic exchange agreement between Exchanger and QI;

2. One copy of IRS Form W-9; and

3. One copy of this letter.

In this transaction, Exchanger will transfer its interest in the Relinquished Property to QI in exchange for QI's promise to acquire and convey to Exchanger, at its direction, other like-kind property (Replacement Property). The Exchange Agreement contains an assignment of Exchanger's rights under the Sale Agreement. QI will purchase one or more Replacement Properties using funds equal to the net cash received on the sale to Buyer of the Relinquished Property, after adjustment for QI's fees (Acquisition Credit). QI will also credit Exchanger with a Yield equal to current _ _[*e.g., money market*]_ _ interest rates on the unexpended portion of the Acquisition Credit, which will be disbursed on expiration of the 180-day exchange period applicable in the transaction.

The arrangement with QI is intended to comply with requirements for a deferred exchange under Internal Revenue Code §1031. The reason for QI's involvement is to provide a qualified intermediary in the exchange that will not be deemed Exchanger's agent for tax purposes; this role is important because receipt of proceeds from disposition of the Relinquished Property by Exchanger or its agent would result in the transaction's being treated as a sale, rather than an exchange under §1031.

Internal Revenue Code §1031 provides two specific time restrictions that must be met to qualify a deferred (sometimes referred to as a delayed or non-simultaneous) exchange for nonrecognition-of-gain treatment. The first is that Exchanger must identify the Replacement Property within 45 days after Exchanger transfers the Relinquished Property. The second is that Exchanger must acquire all Replacement Property no later than the earlier of (i) 180 days after the date Exchanger disposes of the Relinquished Property (including in this computation both the day of disposition of the Relinquished Property and the day of acquisition of the Replacement Property), or (ii) the due date (with any extensions) of Exchanger's federal income tax return for the tax year in which the disposition of Relinquished Property occurs. If Exchanger's tax return for the year in which it transfers the Relinquished Property is due before expiration of the full 180-day period, Exchanger must file for the applicable extension of time to submit its tax return in order for the full 180-day period to be available for acquisition. Early filing of the return, or failure to file for any extension if necessary, will cut off

any remaining time left in the 180-day period. Please remember that both of these deadlines are absolute, and are not extendible under any circumstances.

Regulation §1.1031(k)-1 (Deferred Exchange Regulations) sets forth additional rules governing this transaction. These Regulations make it clear that identification should be made in writing to the taxpayer's exchange partner, which in this case is QI. Consequently, Exchanger should provide written advice to QI of the Replacement Property to be acquired by QI. No official Internal Revenue Service form for making the identification has been issued, but Exhibits B-1 and B-2 to the Exchange Agreement provide two identification forms—one for each of the two options described below. Exchanger should complete one of these forms and return it to QI designating Exchanger's Replacement Property or Properties. Be sure that the form is completed and delivered to QI no later than 45 days after the transfer of the Relinquished Property, because failure to timely identify the Replacement Property will disqualify the exchange for tax-deferred treatment.

The Deferred Exchange Regulations provide two basic options relating to the number of alternative properties that may be identified as potential Replacement Property. Under one option, Exchanger may identify three alternatives, without regard to which of the three Exchanger intends to acquire (to use this option, use Exhibit B-1). If Exchanger identifies more than three properties, then, under the second option, Exchanger may identify as many properties as it wants, as long as the total fair market values of all identified properties (as of the end of the identification period) is not more than 200 percent of the gross selling price of the Relinquished Property (to use this option, use Exhibit B-2). Failure to comply with one of these two options may mean that Exchanger's entire exchange is invalid because, if Exchanger does not stay within the limits of either option, the Exchanger would have to acquire virtually all identified properties for its exchange to qualify under §1031. However, Exchanger is permitted to make changes in the identified properties by revoking some identifications and substituting others during the 45-day identification period as long as it satisfies the applicable limits at the end of the period.

Because of the crucial importance of proper, timely identification of Replacement Property, be sure that Exchanger understands these requirements and pays particular attention to keeping records of properties identified, identifications revoked, etc. QI does not assume responsibility to remind Exchanger of the upcoming expiration of the identification or exchange periods; this is Exchanger's responsibility to monitor. Further, for QI to maintain its integrity vis-à-vis all exchange transactions that it handles, QI is unable to accept any forms of identification after expiration of the 45-day identification period.

Because Exchanger must complete acquisition of all Replacement Property within 180 days after the transfer of the Relinquished Property, please allow enough time to complete the acquisition transactions so that this deadline will not present a problem.

The Yield credited to Exchanger in the transaction will be taxable as ordinary income, regardless of the successful deferral of tax on gain from the disposition of the Relinquished Property. QI will issue a Form 1099 statement of interest earnings.

Under the tax laws, the constructive receipt doctrine treats the right to elect to receive cash instead of property as the equivalent of actually receiving cash. In the Exchange Agreement and the ancillary documents, language and concepts required by the Deferred Exchange Regulations have been used to avoid constructive receipt of cash. For example, Exchanger, after transferring the Relinquished Property, has no right to change its mind and receive cash before completion of the full 180-day period, unless Exchanger fails to identify any properties within the 45-day identification period, or unless those that are identified have either all been acquired or prove impossible to acquire owing to circumstances beyond Exchanger's control. In other words, except in limited circumstances, until the entire 180-day period passes without Exchanger using up the net equity from the Relinquished Property to acquire Replacement Property, it cannot elect to receive cash instead of property. Thus, Exchanger must proactively seek Replacement Properties to use up Exchanger's exchange equity.

Moreover, to preclude any argument by the IRS that Exchanger is entitled to assign to a third party its right to designate and acquire Replacement Property (and therefore have, in effect, a right to elect to receive cash), the Exchange Agreement provides that Exchanger has no right to assign or pledge its rights under that Agreement.

After Exchanger identifies a specific Replacement Property (subject to the rules described above), please advise QI when it has signed an acquisition agreement for that Replacement Property, so that QI can prepare a

form of Assignment Agreement. Execution of each Assignment Agreement will assign to QI Exchanger's purchase rights. QI will then complete the Replacement Property purchase, using funds up to the total available Acquisition Credit. If the Acquisition Credit held by QI (less prior disbursements made to acquire other Replacement Properties for Exchanger) is insufficient to acquire the designated Replacement Property, then Exchanger must add the necessary amount of cash or loans to close that transaction. QI will transfer the Replacement Property to Exchanger through an exchange escrow/settlement that closes concurrently with the purchase escrow/settlement. For convenience purposes and to avoid double transfer taxes, QI will arrange for the Replacement Property to be transferred directly to Exchanger from the Seller.

The Exchanger should take the following steps in connection with the documents enclosed.

1. Review the Exchange Agreement and be sure TO understand its terms and the structure of the exchange.

2. Sign all copies of the Exchange Agreement, and complete and sign IRS Form W-9;

3. Retain one copy of the Exchange Agreement for Exchanger's files. Return all other enclosed documents to QI;

4. Arrange with the escrow/settlement agent to sign additional instructions and documents necessary to complete the transfer of the Relinquished Property;

5. Execute the enclosed copy of this letter where indicated and return it to QI to indicate Exchanger's understanding and acceptance of the risks involved in the exchange. The original is for Exchanger's files.

If you or the Exchanger have any questions about the transaction, do not hesitate to call us. We appreciate the opportunity to assist you and the Exchanger in this transaction.

Very truly yours,

__[*Attorney's signature*]__

ON BEHALF OF EXCHANGER I HAVE FULLY READ, UNDERSTAND, AND AGREE WITH THE CONTENTS OF THE FOREGOING LETTER AND APPRECIATE AND CONFIRM THAT EXCHANGER IS WILLING TO TAKE THE RISKS OUTLINED ABOVE AND TO INCUR THE FEES DESCRIBED.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

Comment: See §§4.105-4.106 for forms of Exhibits B-1 and B-2 referred to in this form letter to the client. This letter is addressed to an authorized agent of the Exchanger.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.108 B. Form: Phase 1 Escrow Letter

§4.108 B. Form: Phase 1 Escrow Letter

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4.108-1 Phase 1 escrow letter

_ _[*Name of escrow/settlement agent*]_ _
_ _[*Address*]_ _
Re: Subject Property: _ _[p*roperty address abbreviated*]_ _
Your Escrow #: _ _[_ _ _ _ _ _]_ _
Our Reference No.: _ _[e*scrow company's number*]_ _

Dear _ _[*escrow agent*]_ _**:**

_ _[*Name of qualified intermediary*]_ _ **(QI) has agreed to participate in an exchange of certain** _ _[*real/real and personal*]_ _ **property, which is the subject of your above-referenced escrow (Relinquished Property), with** _ _[*name of exchanger*]_ _ **(Exchanger). This letter is intended to provide you with supplemental instructions on this transaction.**

Within your escrow, there will be two concurrent and integrated transactions: There will be the exchange transaction between Exchanger and QI, and, immediately after, the sale transaction between QI and _ _[*name of buyer*]_ _ **(Buyer).**

A. <u>Exchange Transaction</u>. In the exchange transaction, QI will acquire the Relinquished Property from Exchanger. The transfer of legal title to the Relinquished Property will be by way of direct conveyance from Exchanger to the Buyer; QI will not acquire legal title to property in the Exchange Escrow.

The Exchange Value for the Relinquished Property is $_ _[*dollar amount*]_ _**.**

[*If applicable, add the following option*]

[*Option: Allocate exchange value between real and personal property*]

This amount is allocated $_ _[*dollar amount*]_ _ **to the real property and $**_ _[*dollar amount*]_ _ **to the personal property.**

[*Continue*]

The amounts of charges and credits set forth on the Settlement Statements, approved as part of this escrow, will be used to calculate the equity transfer (Net Exchange Value) of other property to be delivered to Exchanger at a later date. Exchanger _ _[, e*xcept as provided in paragraph B below,*]_ _ **will not have the right at any time to demand payment of cash (including, but not limited to, any disbursement made after the close of escrow) in lieu of the equity transfer described above unless such payment is made outside this escrow and in accordance with the Exchange Agreement between Exchanger and QI. No disbursements of costs or third party demands (*e.g.,* commissions, transfer taxes) will be made in connection with the sale transaction.**

The closing of the Exchange transaction is conditioned on, and will be concurrent with, the closing of the sale transaction.

B. <u>Sale Transaction</u>

You must deliver to the Buyer the enclosed Notice of Contract Assignment before the transfer of the Relinquished Property to the Buyer.

QI will cause Exchanger to deposit in escrow: (i) An executed and acknowledged Deed conveying fee title in the Relinquished Property to the Buyer; (ii) any sums needed from Exchanger to close escrow _ _[*; (iii) an*

executed Bill or Bills of Sale necessary to convey the personal property being transferred]_ _.

The Buyer will deposit in good funds the Purchase Price for the Relinquished Property, which equals the Exchange Value, plus the Buyer's share of closing costs. Under assignment of the Sale Contract, subject to the completion of the Exchange transaction, QI will sell the Relinquished Property to the Buyer.

You are authorized to deliver to the Buyer the Deed _ _[*and Bill(s) of Sale*]_ _ **when, but only when, you are prepared to disburse _ _**[*(i) to Exchanger the sum of $_ _ _ _ _ _ by your check drawn on good funds and (ii)*]_ _ **to QI the Net Exchange Value _ _**[*reduced by the sum described in (i)*]_ _**. All charges, fees, and prorations between the Buyer and QI must be reviewed and approved by QI and by Exchanger before closing; any and all costs that might customarily be charged to Exchanger should, in this transaction, be charged to QI and represent reductions of the Net Exchange Value.**

You are hereby designated as the Real Estate Reporting Person for the Exchange Escrow and the Sale Escrow, as that term is used and defined in Internal Revenue Code §6045(e)(2), and you are responsible for making the filings required by Internal Revenue Code §6045.

After the closing, please forward to QI the Net Exchange Value _ _[*designate whether by check or wire transfer to a QI-controlled account*]_ _ **and final settlement statements for the Escrow.**

Please acknowledge receipt of this letter of instructions by signing your name on the last page of the enclosed copy of this letter and returning the copy to us. Please direct all preclosing questions and documents relating to this escrow to _ _[*name*]_ _**, our exchange administrator, at the above telephone and address.**

Thank you in advance for your assistance and cooperation.

Very truly yours,
__[*Signature*]__

cc: _ _[*Name of exchanger*]_ _

_ _[*NAME*]_ _ **TITLE INSURANCE COMPANY ACCEPTS THE FOREGOING ESCROW INSTRUCTIONS.**

Date: _ _ _ _ _ _

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **Corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: This is drafted for a real estate transaction; changes should be made in this form if the subject property is personal property. If the exchanger is to receive cash, then the relevant option language in paragraphs A and B relating to the distribution of cash to the exchanger must be included in the escrow instructions. The QI, or someone representing the QI, should sign this letter.

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§4.109 C. Form: Notice of Contract Assignment

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4.109-1 Notice of contract assignment

NOTICE OF CONTRACT ASSIGNMENT

To: _ _[*Name of buyer*]_ _
From: _ _[*Name of QI*]_ _
Re: ASSIGNMENT OF CONTRACT RIGHTS
Exchanger: _ _[*Name of exchanger*]_ _
Property: _ _[*Property description*]_ _
Title Company: _ _[*Name of title company*]_ _
Escrow Number: _ _[*Number*]_ _

PLEASE BE ADVISED THAT UNDER AN EXCHANGE AGREEMENT, ALL RIGHTS UNDER YOUR CONTRACT TO ACQUIRE THE ABOVE-REFERENCED REAL PROPERTY HAVE BEEN ASSIGNED BY THE PARTY LISTED ABOVE AS EXCHANGER, TO _ _[*NAME*]_ _ (QI). QI WILL FUNCTION IN THIS TRANSACTION AS A QUALIFIED INTERMEDIARY TO PERMIT EXCHANGER TO COMPLETE A LIKE-KIND EXCHANGE OF EXCHANGER'S INTEREST IN THE SUBJECT PROPERTY.

Comment: This form accompanies the Phase I escrow letter (see §4.108). For further discussion, see §4.56.

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Source: Real Property/Real Property Exchanges/4 Deferred Exchanges/§4.110 D. Form: Replacement Property Contract Assignment Agreement

§4.110 D. Form: Replacement Property Contract Assignment Agreement

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4.110-1 Replacement property contract assignment agreement

THIS ASSIGNMENT AGREEMENT (Agreement) is entered as of _ _[*date*]_ _, into by and between _ _[*name of Exchanger*]_ _, (Exchanger) and _ _[*name of qualified intermediary*]_ _, a _ _[*legal entity type and state of organization*]_ _ (QI).

Exchanger and _ _[*name of seller of replacement property*]_ _ (Seller) have entered into that certain _ _[*title of purchase agreement for Replacement Property*]_ _ dated _ _[*date of purchase agreement*]_ _, as amended to date (Purchase Contract) in which Exchanger agreed to purchase fee title to that certain real property, described in Exhibit A attached to and incorporated in this Agreement by this reference, located at _ _[*description of property: street address, city, county and state/tax parcel number, city, county, state*]_ _ (Replacement Property).

Exchanger desires to assign to QI all of Exchanger's rights set forth in the Purchase Contract to acquire the property for transfer to Exchanger in connection with a tax-deferred exchange of property between Exchanger and QI, as qualified intermediary.

Therefore, Exchanger transfers and assigns to QI all of Exchanger's rights, title, and interest in the Purchase Contract, and any consideration paid by Exchanger to Seller or to the escrow agent handling this transaction, and QI accepts such assignment.

IN WITNESS WHEREOF, the parties to this Agreement have executed it as of the dates shown above. Despite the foregoing, this Agreement will be null and void if Seller does not transfer the Replacement Property to QI under the terms of the Purchase Contract.

Exchanger:

Date: _ _ _ _ _ _

_ _[*NAME OF LIMITED LIABILITY COMPANY*]_ _,
a _ _[*state of organization*]_ _ **Limited Liability Company**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

QI:

Date: _ _ _ _ _ _

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **Corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

CONSENT OF SELLER

The undersigned party consents to this Assignment Agreement, *provided* that this consent will in no way be deemed to release either Exchanger or the undersigned from any of Exchanger's or the undersigned's agreements, representations, warranties, or indemnifications set forth in the Purchase Contract that are to survive the close of the escrow and the transfer of the Replacement Property to Exchanger, nor will this Agreement be deemed to enlarge the rights, duties, or obligations of any party under the Purchase Contract.

SELLER:

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

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§4.111 E. Form: Phase 2 Escrow Letter

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4.111-1 Phase 2 escrow letter

_ _[*Name of escrow agent*]_ _
_ _[*Address*]_ _
Re: Acquisition of _ _[*Property description*]_ _
Your Reference No. _ _[*Escrow number*]_ _

Dear _ _[*name of escrow agent*]_ _**:**

_ _[*Name of QI*]_ _ **(QI) has previously entered into an Exchange Agreement (Exchange Agreement) with** _ _[n*ame*]_ _ **(Exchanger) in which Exchanger transferred to QI certain real property in exchange for QI's agreement to transfer to Exchanger other like-kind real property. Exchanger has, under the Exchange Agreement, identified property that is the subject of your above-referenced escrow (Replacement Property) as replacement property in its exchange and entered into that certain** _ _[*title of purchase agreement*]_ _ **dated** _ _[*date of purchase agreement*]_ _ **(Purchase Contract) with** _ _[*name of seller of replacement property*]_ _ **(Seller) to acquire the Replacement Property.**

Under a Replacement Property Contract Assignment Agreement (Assignment Agreement), Exchanger has assigned and delegated to QI all of Exchanger's rights, title, and interest in the Purchase Contract. We deposit with these instructions one fully executed copy of the Assignment Agreement and three copies of a Consent to Assignment to be executed by the Seller. As a condition to the settlement of the transactions described in these instructions, please obtain Seller's signatures to the Consent.

Completion of the exchange between QI and Exchanger through acquisition of the Replacement Property will be accomplished in your escrow through a Purchase Transaction and an Exchange Transaction. Parties to the Purchase Transaction are QI and Seller. Parties to the Exchange Transaction are QI and Exchanger.

A. Purchase Transaction.

QI, as the valid assignee of Exchanger with respect to the Purchase Contract, desires to acquire the Replacement Property so that it may then be transferred to Exchanger to complete QI's obligations under the Exchange Agreement.

QI shall deposit $_ _[*dollar amount*]_ _ **to this escrow to be applied to the purchase price of the Replacement Property. If these funds are insufficient to acquire the Replacement Property, including the payment of all costs and expenses to be paid by the Buyer under the Purchase Contract, Exchanger shall supply all additional funds needed.**

Any deposit made into the escrow account by Exchanger before this date should be refunded to Exchanger if QI's deposit is otherwise sufficient to close escrow. Exchanger's funds are not to be used in connection with the close of escrow unless under these instructions Exchanger would otherwise be required to pay additional funds to you to close. If funds deposited by QI are an overpayment resulting in QI's being entitled to a refund on closing, please remit the refund to QI at the above address.

QI will not acquire legal title to the Replacement Property in this transaction. QI instructs you to cause the Seller to convey legal title directly to Exchanger, to complete QI's obligations in connection with the Exchange Transaction, which will occur concurrently with, and immediately after, the Purchase Transaction. In connection with the transfer of the Replacement Property by the Seller, you are required to (i) ensure that the Seller complies with applicable federal and state withholding requirements; (ii) obtain Exchanger's approval to all proposed settlement schedules; and (iii) issue an Owner's Policy of Title Insurance in the amount of the purchase price, showing Exchanger as the insured, in form and content and subject only to any exceptions

approved by Exchanger and containing the endorsements requested by Exchanger.

B. Exchange Transaction.

In the Exchange Transaction, QI should be credited with the gross purchase price of the Replacement Property plus all closing costs paid by QI and should be debited an Exchange Credit equal to the amount of funds supplied by QI plus all additional funds that are supplied by Exchanger. Closing of the Exchange Transaction is conditioned on the concurrent (and immediately preceding) closing of the sale of the Replacement Property to QI.

You are designated as the Real Estate Reporting Person for these transactions, as that term is used and defined in Internal Revenue Code §6045(e)(2), and are responsible for making the filings required by Internal Revenue Code §6045.

Following the closing, please provide the undersigned and Exchanger each with a copy of QI's closing settlement statements, two duplicate copies of the fully signed Consent to Assignment; and copies of all certificates executed by the Seller in connection with satisfaction of federal and state income tax withholding requirements. Please refund to QI any excess funds paid into the escrow by QI.

Please confirm your receipt of this letter and agreement to act in accordance with the instructions in it by executing a copy and returning it to the undersigned by both facsimile and mail. Please direct all preclosing questions and documents relating to this escrow to _ _[*name*]_ _, our exchange administrator at the above telephone and address.

Very truly yours,
__[*Signature*]__

cc: _ _[*Name of exchanger*]_ _

_ _[*NAME*]_ _ **TITLE INSURANCE COMPANY ACCEPTS THE FOREGOING ESCROW INSTRUCTIONS.**

Date: _ _ _ _ _ _

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **Corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: These instructions are drafted for a real estate transaction; changes should be made in this form if the subject property is personal property.

The requirement that the exchanger supply any needed additional funds in the second paragraph of Section A of this form assumes that the QI has no remaining exchange funds after making the deposit. Any remaining funds should be used to fund any shortfall before the exchanger is expected to make any deposits. To avoid the exchanger's receipt of any exchange funds before the end of the 180th day, the QI and the escrow agent must ensure that no funds are inadvertently disbursed to the exchanger (see last sentence of second paragraph of Section A of the form).

Often, the exchanger makes the initial deposit—and sometimes additional deposits—on account of the purchase price (usually during the contingency period). If the QI has sufficient funds to pay the full cash portion of the purchase price, including credits for deposits previously paid, then the QI's funds should replace these deposits, which should be refunded to the exchanger, to ensure that all of the exchanger's exchange proceeds are fully used before the exchanger's funds are used. See the third paragraph of Section A of this form.

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5

"Reverse" and Construction Exchanges

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I. INTRODUCTION AND BACKGROUND

§5.1 A. Rationale of Reverse Exchanges

In a deferred exchange under IRC §1031(a)(3), the taxpayer first transfers relinquished property and then acquires replacement property. For various reasons (planned or unplanned), a taxpayer may need to reverse the order and acquire replacement property before disposing of relinquished property. Acquisition of replacement property before disposition of relinquished property is often called a "reverse exchange."

The reasons taxpayers may need or wish to explore the availability of reverse exchanges include the following:

- There may be unexpected delays in the taxpayer's ability to complete a transfer of relinquished property in what was intended to be a simultaneous or deferred exchange.
- The taxpayer may need to complete a desirable purchase before being able to market or arrange a transfer of a property that will become relinquished property in a like-kind exchange.
- By having replacement property unconditionally available for acquisition from a cooperative party immediately following disposition of a relinquished property, taxpayers avoid any risk of failing to meet the identification or exchange period requirements of IRC §1031(a)(3).
- Given the rule derived from *Bloomington Coca-Cola Bottling Co. v Commissioner* (7th Cir 1951) 189 F2d 14—that improvements on land already owned are not like in kind to real estate—a taxpayer may wish to have a third party accommodator acquire and own property on which improvements are being created before acquiring the property as part of an exchange.

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§5.2 B. Inapplicability of IRC §1031(a)(3)

A reverse exchange is not actually covered by IRC §1031(a)(3), which merely provides time constraints for deferred exchanges. In a deferred exchange, the taxpayer has a 45-day "identification period" to designate a limited number of potential replacement properties and a 180-day "exchange period" (commencing at the same time as the identification period) to complete the acquisition of one or more identified replacement properties. See §§4.9-4.31. Neither period can be extended, and failure to satisfy the rules results in the treatment of an exchange as a fully taxable sale.

In the preamble to the final regulations on deferred exchanges, the Internal Revenue Service stated that those regulations do not apply to reverse exchanges. The IRS also stated that it would continue to study the applicability of the general rule of §1031(a)(1) to reverse exchanges. TD 8346, 1991-1 Cum Bull 150.

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§5.3 C. Limited Authority Supports "True" Reverse Exchanges

There is little judicial authority expressly addressing reverse exchanges, and none explicitly approves a reverse exchange in a real property setting. The landmark case of *Starker v U.S.* (9th Cir 1979) 602 F2d 1341, however, may be helpful in analyzing the applicability of IRC §1031 to reverse exchanges. In *Starker,* the court held that §1031 does not require a simultaneous exchange of properties. The reasons the court gave for allowing the nonsimultaneous exchanges were not limited to deferred exchanges and can arguably apply to reverse exchanges. For a detailed discussion of *Starker*, see §§4.7-4.8. In both deferred and reverse exchanges, the requirements of §1031 must be met (*i.e.,* there must be an exchange, and the taxpayer must not have actual or constructive receipt of the exchange proceeds).

On IRC §1031's applying to all types of exchanges, see chap 2.

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§5.4 1. Tax Court and Other Cases

In *Bennie D. Rutherford*, TC Memo 1978-505, the taxpayer (Rutherford) received 12 half-blood heifers (the replacement property) from Wardlaw and, in exchange, agreed to inseminate them artificially with the semen of a pure blood bull and to deliver to Wardlaw the first 12 three-quarter-blood heifers (relinquished property) born at various times in the future. Rutherford's obligation to Wardlaw was secured by a collateral agreement giving Wardlaw a security interest in the half-blood heifers received from Rutherford. The taxpayer did not transfer the last of the offspring to Wardlaw until 3 years after the taxpayer acquired the original heifers.

Despite the time lapse, the Tax Court held that IRC §1031 applied to the transaction and thus disallowed the taxpayer's claims for investment tax credit and depreciation deductions. See §1.23. The court concluded that the transaction qualified as a like-kind exchange under §1031 even though the taxpayer received replacement property before transferring the relinquished property. The court apparently did not consider the holding requirement of IRC §1031(a) regarding the relinquished property (the 12 three-quarter-blood heifers) to apply, "at least under the circumstances of this case." See §§2.23-2.33. The taxpayer could not have held the property for productive use in a trade or business or for investment because the three-quarter-blood heifers did not exist when the exchange agreement was executed or when the replacement property was transferred to the taxpayer. Instead, they were bred solely for transfer to Wardlaw to fulfill the contractual obligation.

In several cases, the IRS successfully challenged taxpayers' assertions that the purchase of one property followed by the sale of another was an exchange within the meaning of IRC §1031(a) when there was no evidence that the purchase and sale were undertaken as integrated transactions intended to effect the exchange of the property sold by the taxpayer for the property purchased by the taxpayer. For example, in *Bezdjian v Commissioner* (9th Cir 1988) 845 F2d 217, taxpayers who had purchased one property for cash and three weeks later sold another property to a third party buyer for cash, plus the assumption of a mortgage, maintained that the property they purchased replaced the property they sold in an exchange covered by IRC §1031. The Ninth Circuit Court of Appeals, affirming the Tax Court's rejection of this position, concluded that, although the taxpayer might have intended to effect an exchange, there was no transactional evidence that an integrated transaction had occurred. Rather, the court found that the purchase and the sale were independent transactions, and it distinguished the *Bezdjian* facts from those of *Biggs v Commissioner* (5th Cir 1980) 632 F2d 1171, in which the taxpayer explicitly arranged a three-way exchange with the cooperation of the seller of the replacement property. For discussion of *Biggs*, see §5.12.

In *Edward C. Lee*, TC Memo 1986-294, the taxpayers sold five parcels of agricultural land in Hawaii by simultaneously conveying title to five unrelated buyers and applying the proceeds of those sales to purchase a farm in Washington. The proceeds were transferred directly from the buyers of the Hawaii parcels to a real estate broker, then to the seller of the Washington farm, and did not pass through the taxpayers' hands. The Tax Court's denial of like-kind exchange treatment was based on its finding that there was no evidence that an exchange transaction had occurred. Despite the immediate application of sale proceeds from one transaction to another, the court found that "the record in this case is nearly devoid of information about the interrelationship between the sales of the Hawaii property and the purchase of the Washington farm" and determined that, as a matter of law, the taxpayers "must demonstrate that the transfers of property [are] interdependent parts of an overall plan in order for such transfers to constitute an 'exchange' within the meaning of section 1031." The Tax Court reached the same conclusions on similar facts in *Julius Dibsy*, TC Memo 1995-477, and *Chad A. Lincoln*, TC Memo 1998-421.

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§5.5 2. 1992 ABA Proposal [Deleted]

This section has been deleted because the proposal described was never pursued by the IRS.

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§5.6 3. IRS Letter Rulings

In 1998, the IRS for the first time signaled a willingness to approve exchanges in which replacement property was acquired before relinquished property was transferred. In IRS Letter Rulings 9814019 and 9823045, an electric power transmission company operated overhead power lines located in an easement on a landowner's property. Wishing to relocate the power lines to serve a different customer, the power company proposed to abandon the old easement and in exchange to acquire from the same landowner a new easement over which to run the new lines. Before it could relinquish its old easement and dismantle its old lines, the power company needed to acquire the new easement, erect its lines, and test them. The power company sought like-kind exchange treatment for the acquisition of the new easement and release of the old easement, apparently because the fair market value of the new easement exceeded the power company's basis in the old easement, resulting in realized gain. The IRS concluded that the transaction constituted a valid reverse like-kind exchange. This ruling indicated the IRS's new and friendlier attitude toward the concept of a reverse like-kind exchange, but its utility as an indication of permissible limits to such transactions is limited because two-party exchanges of nondepreciable property are relatively rare.

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§5.7 D. Parking Structures as Alternatives to True Reverse Exchanges

Because of the lack of clear authorization for a pure reverse exchange in which a taxpayer acquires replacement property before transferring relinquished property, most exchange transactions involving an acquisition followed by a disposition have used a "parking" structure, in which an accommodator or a cooperative buyer purchases the property intended to serve as the taxpayer's replacement property. Using one of several formats described in §§5.8-5.10, the accommodator substitutes for the taxpayer as owner of one of the properties involved in the exchange in order for the taxpayer to avoid concurrent ownership of both properties. These transactions also involve an initial seller of the property that is intended to serve as replacement property and, unless the accommodator itself is a cooperative buyer, an ultimate third-party buyer of the property that is intended to serve as the relinquished property.

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1. Forms of Parking Transactions

§5.8 a. Exchange Last Parking Arrangements

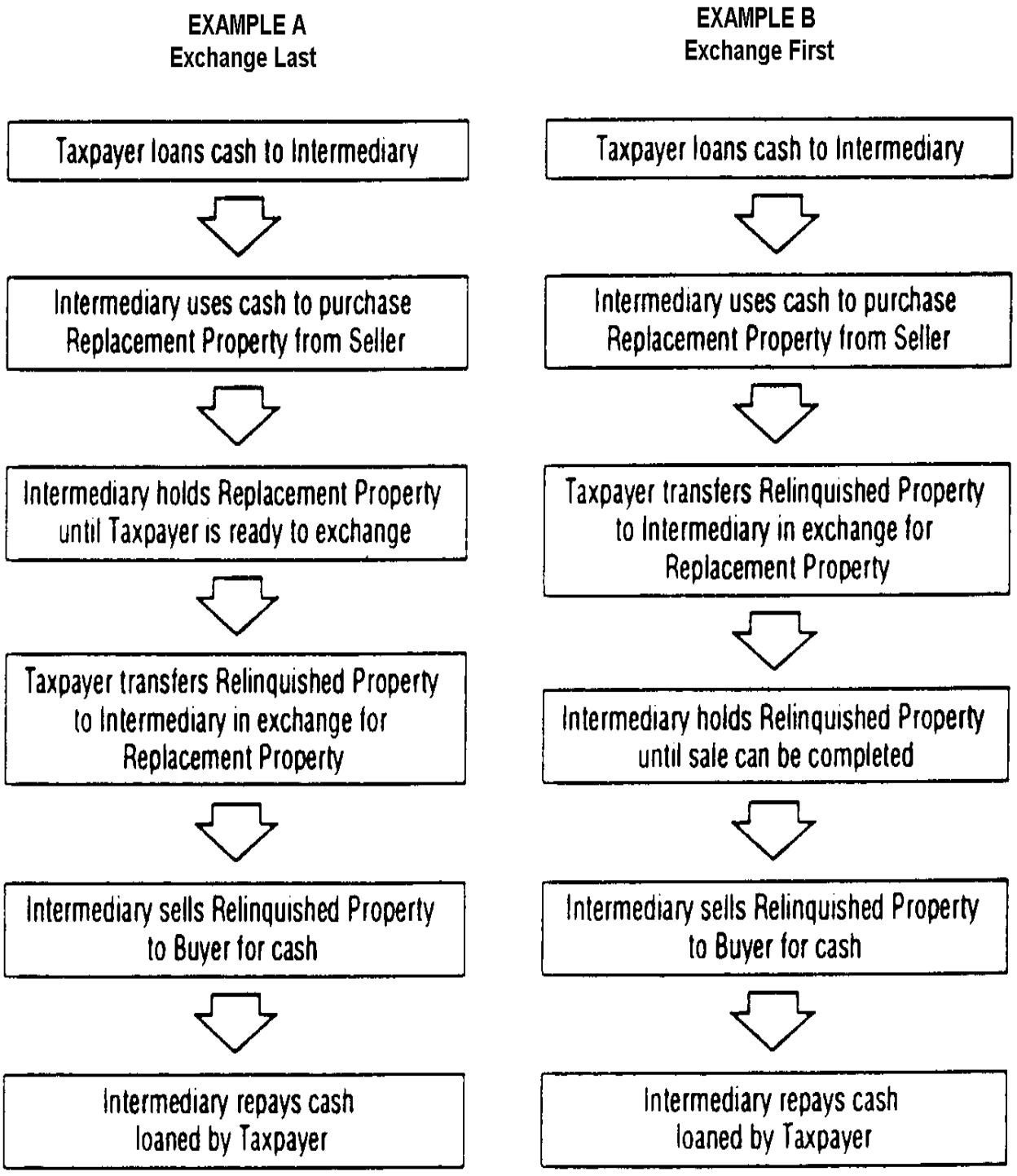
In the most common form of "parking" transaction, sometimes called an "Exchange Last" structure, the accommodator holds title to the replacement property from the time of its purchase from a seller until the taxpayer sells the relinquished property to a buyer. The Exchange Last structure typically works as follows:

- The accommodator first acquires what will ultimately become the taxpayer's replacement property and holds title to this property;
- The taxpayer provides or arranges financing to fund the accommodator's purchase of the replacement property;
- The taxpayer holds an option either to acquire the replacement property from the accommodator in a like-kind exchange or to purchase it for cash by assuming the purchase money financing;
- The accommodator may have a right to "put" (require the buyer to purchase) the replacement property to the taxpayer after a specified time period; and
- When the taxpayer's relinquished property is to be transferred to a buyer, the taxpayer completes a simultaneous or deferred exchange (typically using a qualified intermediary) for the replacement property.

This structure is called Exchange Last because the exchange of the replacement property for the relinquished property occurs as the last step of the sequence: (1) replacement property purchase, (2) relinquished property sale, and (3) exchange. See Example A in Figure 6.

Print

FIGURE 6:
Parking Arrangement With Independent Intermediary



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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.9 b. Exchange First Parking Arrangements

§5.9 b. Exchange First Parking Arrangements

An alternative structure, sometimes called "Exchange First," involves completing an exchange (typically through a qualified intermediary) concurrently with the accommodator's purchase of replacement property, resulting in the taxpayer's receipt of the replacement property in return for transfer of the relinquished property to the accommodator. The Exchange First structure typically operates as follows:

- The accommodator funds but does not take ownership of the replacement property;
- A qualified intermediary acquires the replacement property from a seller and transfers it to the taxpayer in an exchange transaction in which the taxpayer transfers the relinquished property to the accommodator—the result is that the taxpayer has completed an exchange, and the accommodator owns the relinquished property;
- The taxpayer arranges financing for the qualified intermediary's purchase of the replacement property, which financing will be assumed in whole or in part by the accommodator when it acquires the relinquished property as part of the exchange;
- The accommodator holds the relinquished property until it is sold to the buyer;
- Proceeds from the sale to the buyer are used to retire the debt assumed by the accommodator in connection with receipt of the relinquished property, with any excess paid over to the taxpayer;
- The taxpayer may have a right to repurchase the relinquished property after a defined period of time if it has not been sold to a third party buyer, and the accommodator may have a right to put (require the buyer to purchase) the parked property to the taxpayer after a specified period.

This structure is called Exchange First because the exchange of the replacement property for the relinquished property occurs at the initial phase of the sequence: (1) replacement property purchase, (2) exchange, (3) relinquished property sale. See Example B in Figure 6 in §5.8.

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.10 c. Advantages and Disadvantages of Exchange Last Versus Exchange First Transactions

§5.10 c. Advantages and Disadvantages of Exchange Last Versus Exchange First Transactions

Advantages of the Exchange Last format include the following:

- When acquisition of a specific parked replacement property will not fully defer gain realized on disposition of the relinquished property, IRC §1031(a)(3) identification and exchange periods will start later, *i.e.,* on the sale of the relinquished property rather than purchase of the replacement property, if the relinquished property is exchanged last.
- If the taxpayer is not sure which of several relinquished properties will be used in the exchange, the decision can be made when a contract to sell one of them is made, rather than when the replacement property is acquired, if the Exchange Last format is used. If the exchange occurs first, the taxpayer must select the relinquished property at the outset. (Note, however, that for transactions intended to qualify for the safe harbor under Rev Proc 2000-37, 2000-2 Cum Bull 308, discussed in §§5.16-5.26, the taxpayer's flexibility will be limited by the 45-day identification requirement.)
- For certain transactions, there is less risk in an Exchange Last format in that the accommodator will be disregarded and the taxpayer treated as having never transferred the parked property because the taxpayer will not have previously owned or controlled it. The IRS is unlikely to assert that the transaction is a sale-leaseback disguised as a like-kind exchange, under the authority of such cases as *Century Elec. Co. v Commissioner* (8th Cir 1951) 192 F2d 155.
- Because the exchange is concurrent with the sale of the relinquished property, reconciliation of equity values can occur with knowledge of the actual market value of the relinquished property, rather than a value assumed at the time of the replacement property purchase.
- For build-to-suit arrangements, Exchange Last is the only option because construction completed on replacement property after the taxpayer takes title does not qualify as like-kind property. See §§5.35-5.39.

Advantages of the Exchange First format include the following:

- When a lender providing outside financing to acquire the replacement property requires the taxpayer to secure the loan with a deed of trust or mortgage on that property, the Exchange First format allows the taxpayer to execute that deed of trust or mortgage because the taxpayer is obtaining title to the replacement property immediately.
- If the replacement property has management problems, the taxpayer's immediate acquisition of title may be necessary.
- When it is too late to change deeds that are already drawn and executed conveying title of replacement property to the taxpayer.

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§5.11 2. Authority Relating to Exchange Parking Arrangements

Several reported decisions have addressed like-kind exchanges in which a cooperating party acquired or held property before a taxpayer acquired it in an exchange. Cases decided favorably for the taxpayer are discussed in §5.12; the Tax Court decision in *Donald DeCleene* (2000) 115 TC 457 (against the taxpayer) is discussed in §5.13; bankruptcy cases are discussed in §5.14; IRS Letter Ruling 200039005 is discussed in §5.15.

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§5.12 a. Cases Upholding Exchange Treatment

In *J. H. Baird Publishing Co.* (1962) 39 TC 608, acq 1963-2 Cum Bull 4, the taxpayer combined a form of reverse exchange with improvements to be built on the replacement property. On behalf of the taxpayer, an accommodator acquired an unimproved lot using proceeds advanced to the accommodator by the buyer of the taxpayer's relinquished property. Two weeks later, the taxpayer transferred the relinquished property to the accommodator, who concurrently transferred the relinquished property to the buyer. The buyer transferred the balance of the net sales proceeds to the accommodator to use in building the improvements. Nine months later, the accommodator transferred the improved replacement property to the taxpayer.

Although the Tax Court found that the accommodator was not acting as the taxpayer's agent, the court held that the taxpayer did not dispose of the relinquished property until the buyer transferred the replacement property to the taxpayer. In concluding that the exchange qualified under IRC §1031, the court essentially found a concurrent exchange of properties.

In *Coastal Terminals, Inc. v U.S.* (4th Cir 1963) 320 F2d 333, a cooperative buyer who wanted to purchase the taxpayer's deep water oil terminal facility first directly acquired an inland site from a corporation owned 60 percent by the taxpayer, and built a new facility to the taxpayer's specifications on the inland site. The exchange occurred after completion of the new facility. The Court of Appeals upheld exchange treatment, emphasizing the cooperative buyer's use of its own funds and direct undertaking of obligations to buy and build the facility for trade with the taxpayer.

In *Boise Cascade Corp.,* TC Memo 1974-315, a prospective buyer of a San Francisco property owned by a subsidiary of Boise Cascade Corporation (BCC) agreed to acquire land in Yakima, Washington, from BCC for a nominal sum and then to build a plywood sheeting plant to BCC's specification on the Yakima parcel. The buyer agreed to advance $120, 000 toward the construction, and borrowed an additional $250,000 from another BCC subsidiary. BCC agreed to lease the Yakima property from the buyer and to bear any cost overruns for the plant. BCC also obtained an option to acquire the plant from the buyer at any time for $370,000. Under a separate agreement, the buyer agreed to acquire the San Francisco property from BCC's subsidiary in exchange for the Yakima property as improved by the plant. This exchange was completed and the Tax Court held that §1031 applied.

In *Biggs v Commissioner* (5th Cir 1980) 632 F2d 1171, a corporation owned by the taxpayer's attorney acted as an accommodator. The accommodator purchased replacement property and agreed to deed the property to the taxpayer either as part of an exchange or for cash equal to the accommodator's acquisition costs. The Tax Court held that the multiparty exchange qualified under §1031, even though the accommodator borrowed all the funds needed to purchase the replacement property from the taxpayer and had the right to put (require buyer to purchase) the replacement property to the taxpayer for a fixed price at all times. The Fifth Circuit affirmed, although the IRS did not raise on appeal the issue of whether the accommodator was acting as the taxpayer's agent.

In *Fred L. Fredericks*, TC Memo 1994-27, the Tax Court rejected the IRS's characterization of an accommodator as the taxpayer's agent, even though the accommodator was a corporation wholly owned by the taxpayer and participated in the transaction for the principal purpose of completing the exchange. The accommodator in *Fredericks* acquired property (previously under option to the taxpayer) and built improvements on it before making various transfers to the taxpayer over a two-year period to complete an exchange for the taxpayer's relinquished property.

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§5.13 b. The *DeCleene* Decision

The Tax Court ruled against the taxpayer in *Donald DeCleene* (2000) 115 TC 457. In *DeCleene,* the taxpayer purchased property in 1977 and used the property in his truck repair business for 15 years. In 1992, the taxpayer located and purchased an unimproved parcel of land in anticipation of building a new facility and relocating his business. After the taxpayer acquired the land, a local firm (buyer) expressed interest in acquiring the old facility from the taxpayer. The taxpayer organized the following transaction: (1) the buyer would purchase the new land from the taxpayer for a nonrecourse promissory note and would build a facility on it to the taxpayer's specifications; and (2) the buyer would transfer the land, as improved, to the taxpayer in exchange for the old facility within three months. The parties agreed that the old facility and the unimproved land had the same value. The taxpayer arranged for a bank loan to finance construction of the improvements and was directly liable on this debt. The taxpayer reported its transactions with the buyer as (1) a taxable sale of the land giving rise to a small ($5,373) short-term capital gain, and (2) an IRC §1031 exchange of the old facility for the land, as improved by the building.

The Tax Court concluded that the taxpayer's transaction (which the court expressly characterized as an attempted reverse exchange) failed to qualify as a like-kind exchange under §1031 because the taxpayer, in substance, never relinquished beneficial ownership of the land to the buyer. The court noted that a taxpayer "cannot engage in an exchange with itself." The court did not impose accuracy-related penalties against the taxpayer, however, finding that he had reasonably relied on the advice of professional tax advisers who structured the transactions with the buyer.

Several interesting elements of this Tax Court opinion are worth noting:

- The court begins its analysis by noting that the taxpayer created an "inherently ambiguous situation" by structuring its transaction with a cooperative buyer and not with a third party accommodator. This situation is easily remedied by using an accommodation title holder who is not the buyer of the taxpayer's property.
- Because the parties agreed that the new land and the taxpayer's old facility had the same value, and because the buyer paid for the land with a nonrecourse, interest-free note, the court properly points out that it is unclear whether the cash payment made by the buyer and received by the taxpayer at the exchange closing was a payment on the note or payment of the cash purchase price for the old facility. The parties could have solved this problem (and perhaps the burdens and benefits issue, discussed below, as well) if the buyer had paid cash for the land initially.

Finding that the buyer (1) made no economic outlay to acquire the land, (2) had no exposure for real estate taxes or, indeed, any other liabilities during the three-month period it owned the land, and (3) had no potential for economic gain or loss on the land under the terms of the exchange, the Tax Court concluded that the buyer was at no time the tax owner of the land and that, instead, the taxpayer continued to be the land's beneficial owner at all times. Under the doctrine of *Bloomington Coca-Cola Bottling Co. v Commissioner* (7th Cir 1951) 189 F2d 14 (see §5.27), IRC §1031 (former IRC §112) does not apply to an exchange of real property for improvements built on other real property owned by the taxpayer.

The Tax Court distinguished *J. H. Baird Publishing Co.* (1962) 39 TC 608, acq 1963-2 Cum Bull 4, *Biggs v Commissioner* (5th Cir 1980) 632 F2d 1171, *Fred L. Fredericks,* TC Memo 1994-27 (all discussed in §5.12), and other pro-taxpayer decisions on their facts, noting that none of those cases involved "a reverse exchange." Curiously, the taxpayer appeared not to rely on (and thus the Tax Court did not specifically address) *Boise Cascade Corp.,* TC Memo 1974-315 or *Coastal Terminals, Inc. v U.S.* (4th Cir 1963) 320 F2d 333, two cases involving cooperative buyers who obligated themselves to acquire replacement property, build improvements to the taxpayer's specifications, and then transfer the improved replacement property to the taxpayer in exchange for its relinquished property. The most significant differences between the facts in *DeCleene* and the facts in *Boise Cascade* and *Coastal Terminals* are the following:

- The taxpayers in *Boise Cascade* and *Coastal Terminals* did not own the property intended to serve as replacement property before the cooperative buyer obtained title (although in each case a party related to the

taxpayer did); and

- The cooperative buyers in *Boise Cascade* and *Coastal Terminals* used their own funds (entirely in one case and in part in the other) to finance the construction costs.

For discussion of the *Boise Cascade* and *Coastal Terminals* cases, see §5.12. For a discussion of the ongoing significance of the *DeCleene* decision, see §5.34.

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§5.14 c. Bankruptcy Cases

The Exchange First structure (see §5.9) has been the subject of two Bankruptcy Court decisions: *In re Exchanged Titles* (Bankr CD Cal 1993) 159 BR 303 and *In re Sale Guar. Corp.* (9th Cir BAP 1998) 220 BR 660, aff'd sub nom *Siegal v Newman (In re Sale Guar. Corp.)* (9th Cir 2000) 199 F3d 1375, but no tax authority has addressed the structure.

The issue in each of these bankruptcy cases was whether, after the accommodator's bankruptcy, the parked relinquished property could be recovered by the taxpayer or was subject to claims of the accommodator's creditors. In each case, the courts held that the taxpayer could recover the parked property, on the theory that it was being held in trust for the taxpayer under the exchange accommodation arrangement. This holding is, of course, inconsistent with the concept of the accommodator's independent ownership of the parked property.

In both the Exchange First and Exchange Last structures there are typically mechanisms such as a lease or management agreement transferring operating control of the parked property to the taxpayer or an affiliate while the accommodator holds legal title.

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§5.15 d. IRS Letter Ruling 200039005

In IRS Letter Ruling 200039005 the IRS denied like-kind exchange treatment to a taxpayer who had intended to enter into a deferred exchange but, when the sale of the relinquished property failed to close, attempted to structure an Exchange Last parking arrangement. To avoid the loss of his deposit held by the replacement property seller, the taxpayer closed on the intended replacement property as required by his contract but directed the seller to transfer legal title to an accommodator. The taxpayer (1) provided all of the funds for the purchase, (2) was personally liable on the mortgage while the accommodator was not, and (3) apparently also occupied the parked property without a formal lease in place. The taxpayer and accommodator did not enter into a written agreement regarding the terms and conditions under which the accommodator was holding the parked property or otherwise memorialize the taxpayer's intention to engage in an exchange.

Later, the taxpayer contracted to sell the property intended to serve as the relinquished property to a new cash buyer and assigned the sale agreement to the accommodator. To complete the purported exchange, the parties closed on the sale of the relinquished property to the new buyer, and the accommodator conveyed the replacement property to the taxpayer.

The taxpayer argued that his transaction with the accommodator qualified under the safe harbor regulations for deferred exchanges using a qualified intermediary. Because the accommodator (in the taxpayer's view) was acting as a qualified intermediary, it was permissible (in the taxpayer's view) for the accommodator to act as the taxpayer's agent. See Reg §1.1031(k)-1(g)(4)(i).

The IRS rejected that argument for several reasons, concluding that the accommodator was acting as the taxpayer's agent or nominee in acquiring the property intended to serve as replacement property. First, the qualified intermediary safe harbor under the deferred exchange regulations was inapplicable because (1) the original preamble to those regulations says so, and (2) in any event, the taxpayer had no written exchange agreement in place with the accommodator at the time the replacement property was acquired from the seller, as the safe harbor regulations require. Moreover, the transactions among the taxpayer, the accommodator, the seller, and the buyer lacked a mutuality of intent to effect an exchange. In particular, the IRS noted that the buyer was not yet a part of the transaction at the time the accommodator acquired title to the property intended to serve as replacement property from the seller.

NOTE: This aspect of the IRS's holding in IRS Letter Ruling 200039005 is strained. There is typically no mutuality of intent to exchange in deferred exchanges beyond the agreement between the qualified intermediary and the taxpayer. Although a seller and a buyer are involved in one part or another of the transaction, neither is technically a party to the exchange or intends to effect an exchange. Presumably, the taxpayer in IRS Letter Ruling 200039005 could have overcome any purported lack of mutuality by entering into an exchange agreement with the accommodator before the initial closing with the seller.

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II. SAFE HARBOR FOR REVERSE EXCHANGES (REV PROC 2000-37)

§5.16 A. Introduction

Owing to continuing confusion over the status of reverse exchanges, the Department of the Treasury and the Internal Revenue Service decided to explore whether administrative guidance on this topic should be issued, and added this project to the Treasury Business Plan for the 1999-2000 fiscal year.

In late 2000, the IRS issued Rev Proc 2000-37, 2000-2 Cum Bull 308. It stated that the IRS and the Treasury had determined that it is "in the best interest of sound tax administration to provide taxpayers with a workable means of qualifying their transactions under IRC §1031 in situations in which the taxpayer has a genuine intent to accomplish a like-kind exchange at the time that it arranges for the acquisition of the replacement property and actually accomplishes the exchange within a short time thereafter." Rev Proc 2000-37, §2.06. The mechanism for doing so is found in this revenue procedure, which provides a safe harbor for taxpayers to complete parking arrangements that follow its guidelines.

Revenue Procedure 2000-37 allows taxpayers to engage in either Exchange Last (see §5.8) or Exchange First (see §5.9) structures. The requirements of Rev Proc 2000-37 and some unresolved issues and planning opportunities are discussed in §§5.17-5.26.

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B. Requirements

§5.17 1. Qualified Exchange Accommodation Arrangement

Under Rev Proc 2000-37, §4, 2000-2 Cum Bull 308, the IRS will treat an exchange accommodation titleholder (EAT) as the beneficial owner of property for federal income tax purposes if the property is held in a qualified exchange accommodation arrangement (QEAA). The arrangement must be in writing and must specify that the EAT is holding the parked property for the benefit of the taxpayer to facilitate a §1031 exchange; that the EAT and the taxpayer agree to report the acquisition, holding, and disposition of the property as provided in Rev Proc 2000-37; and that the EAT will be treated as the beneficial owner of the parked property for federal income tax purposes. The accommodation agreement must be entered into within 5 business days after the EAT acquires "qualified indicia of ownership" of the parked property. See §5.19.

PRACTICE TIP: Because Rev Proc 2000-37 allows the qualified exchange accommodation arrangement to be created after the closing of the parking arrangement, it is possible to convert purchases into reverse exchanges at the last minute. If clients wish to do so, however, advisers must be wary of placing title to property into third party entities without appropriate contractual protections for the client. Property owners should be cautious about providing funding for an EAT to acquire property without clearly establishing the EAT's ownership role in a written contract.

In July 2004, Rev Proc 2000-37 was modified by Rev Proc 2004-51, 2004-2 Cum Bull 294, which provides that the safe harbors available in Rev Proc 2000-37 do not apply if the taxpayer owned the property intended to qualify as replacement property within the 180-day period preceding initiation of a QEAA. The IRS was concerned that taxpayers were using reverse exchanges to circumvent the prohibition against completing an exchange with oneself, or against reinvesting the proceeds from the sale of relinquished property in improvements to property that the taxpayer already owned, by transferring property to an EAT and then receiving it back from the EAT as replacement property, sometimes with newly constructed improvements. See discussion at §5.39A.

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§5.18 2. Role of Exchange Accommodation Titleholder

Revenue Procedure 2000-37, 2000-2 Cum Bull 308, permits an exchange accommodation titleholder (EAT) to hold either the replacement property (Exchange Last; see §5.8) or the relinquished property (Exchange First; see §5.9) during the accommodation arrangement.

The revenue procedure applies the same disqualified person limitations to EATs that apply to qualified intermediaries (QIs), qualified escrow holders, and qualified trust trustees under Reg §1.1031(k)-1(k). See Rev Proc 2000-37, §4.02(1). The disqualified person standard eliminates using the taxpayer's attorney, accountant, investment banker, broker, etc., as potential EATs. It also eliminates related parties under IRC §267(b) or §707(b)(1) (applying a 10 percent rather than a 50 percent common ownership test).

PRACTICE TIP: In some situations, however, it may be useful for a taxpayer to maintain a 10-percent or less ownership interest in an EAT (perhaps as a 1 percent owner/manager of a limited liability company) to facilitate financing and management of the parked property.

An EAT may also act as the taxpayer's QI if it meets the QI safe harbor requirements. See Rev Proc 2000-37, §4.03(1). The services that the EAT provides will not be considered in determining whether, when acting as the intermediary, it is a disqualified person. An agreement creating a qualified exchange accommodation arrangement (QEAA) is not synonymous with a deferred exchange agreement between a taxpayer and an intermediary, but these two agreements may be combined.

Despite the potential for combining the roles of the QI and the EAT, to preserve maximum flexibility it is generally preferable to have two separate entities perform these functions and have two separate agreements, one for the exchange transaction (which starts with disposition of relinquished property) and one for the parking transaction (which starts with purchase of replacement property). Usually, both the typical QI entity and the taxpayer will want to separate the QI and the EAT functions in a safe harbor reverse exchange so that the EAT can be established as a bankruptcy remote special purpose entity. Presumably (although not specifically addressed in Rev Proc 2000-37), the EAT (whether also a QI or not) may be designated as the taxpayer's agent without violating the safe harbor requirements, as long as the EAT otherwise satisfies the qualified indicia of ownership and tax reporting tests discussed in §§5.22-5.24. Such an agency relationship may facilitate financing and may avoid a second real estate transfer tax in some jurisdictions. At the same time, if the EAT is appointed as an agent, the taxpayer will likely forfeit any possibility of having a parking exchange that fails to qualify as a QEAA (for example, by not being completed within 180 days) and otherwise pass muster under IRC §1031 outside the safe harbor.

Many professional QIs are either banks or bank affiliates. The use of banks as QIs is further promoted by recently promulgated Reg §1.1031(k)-1(k)(4)(ii) (TD 8982, 2002-1 Cum Bull 544), which provides that a bank will not be a disqualified person even if a bank affiliate acts as the taxpayer's investment banker or broker. It is unclear, however, whether an entity subject to the Bank Holding Company Act of 1956 (12 USC §1843) may serve as an EAT because, in general, these entities are permitted to hold real estate only for their own use or in a fiduciary capacity (subject to a temporary exception for real estate acquired through foreclosure). See Directory for name and address of trade association for EATs.

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§5.19 3. Qualified Indicia of Ownership (QIO) Test

A property is considered to be held in a qualified exchange accommodation arrangement (QEAA) only if the exchange accommodation titleholder (EAT) possesses qualified indicia of ownership (QIO) at all times from the date of the acquisition of the replacement property or the relinquished property until it is transferred to the taxpayer or a third party buyer to complete the exchange. To satisfy the QIO test, the EAT must acquire legal title to the parked property or "other indicia of ownership of the property that are treated as beneficial ownership of the property under applicable principles of commercial law." Rev Proc 2000-37, §4.02(1), 2000-2 Cum Bull 308. This revenue procedure cites a contract for deed (*i.e.,* an installment sale contract under which the seller retains title as a security device) as an example of an arrangement short of legal title that satisfies the QIO test.

The revenue procedure also permits the EAT to hold the parked property through a single-member LLC or other entity disregarded as an entity separate from its owner for federal income tax purposes if the disregarded entity satisfies the QIO test. Use of a disregarded entity may facilitate financing arrangements and should permit the parties to avoid a second real estate transfer tax in some jurisdictions by transferring ownership of the entity, rather than title to the parked property, to complete the QEAA.

In IRS Letter Ruling 200111025, the IRS concluded that an EAT could be referred to in QEAA documentation as the taxpayer's agent without jeopardizing qualification under Rev Proc 2000-37. This ruling is similar to the rule for qualified intermediaries under the deferred exchange regulations. See Reg §1.1031(k)-1(g)(4)(iv)(C); §§4.53-4.57. In some states, including California, no transfer tax is imposed on a transfer from an agent to a principal or vice versa.

IRS Letter Ruling 200148042 permits the QEAA to specifically provide that the EAT is "acting as the taxpayer's agent for all purposes, except for federal tax purposes" to avoid the double transfer tax imposed on transfers of real property, as long as all of the other requirements under Rev Proc 2000-37 are met. This letter ruling does not address issues involving state income tax requirements. Further, if this language is used, and the EAT holds the parked property for more than 180 days, this language could make it very difficult for the parties to convert the transaction into a "non-safe-harbor" reverse exchange.

PRACTICE TIP: The risk of identifying an EAT expressly as an agent is that if safe harbor protection is lost, it will be difficult to sustain a backup position that the EAT was an independent owner of the parked property. When safe harbor protection is assured, planners may be able to use the express agency approach to avoid double transfer taxes.

The EAT must satisfy the QIO test at all times before the transfer of parked property to the taxpayer (in an Exchange Last structure; see §5.8) or the cash buyer (in an Exchange First structure; see §5.9). As long as the EAT satisfies the QIO test, it does not taint the exchange if the parties take inconsistent positions on their ownership of the parked property for nonfederal tax purposes, such as for accounting or state law purposes. For example, an exchanger has equitable ownership in property held by an EAT and therefore has standing to sue for damage caused to the property held by the EAT. See *Hall v Glenn's Ferry Grazing Ass'n* (D Idaho, Sept. 21, 2006, No. CV-03-386-S-BLW) 2006 US Dist Lexis 68051, modified (D Idaho, Jan. 25, 2007) 2007 US Dist Lexis 5609.

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§5.20 4. Identification and Replacement Periods

Revenue Procedure 2000-37, 2000-2 Cum Bull 308, adopts the methods of identification as well as the identification and replacement periods of the deferred exchange regulations. See Rev Proc 2000-37, §4.02(4)-(6); Reg §1.1031(k)-1(b)-(d). Thus, in an Exchange Last arrangement (see §5.8), the taxpayer has 45 days after the exchange accommodation titleholder's (EAT)'s acquisition of ownership of replacement property in which to identify a limited number of relinquished properties eligible to be sold and exchanged for the specific property held by the EAT. If the parked property is serving as relinquished property, there is no identification issue (because the exchange will be simultaneous or nearly simultaneous).

The IRS has allowed some flexibility in identifying relinquished property in an Exchange Last arrangement. In IRS Letter Ruling 200718028, the IRS held that valid identification of relinquished property had occurred when a taxpayer assigned its rights as seller to a qualified intermediary (QI) and the QI transferred the relinquished property to the buyer before the end of the reverse exchange identification period. The taxpayer did not make a formal identification of relinquished property to the EAT until after the end of the reverse exchange identification period. In a deferred exchange, replacement property acquired within the 45-day identification period is deemed to be identified. Reg §1.1031(k)-1(c)(1). See §4.19. The IRS held that this same reasoning should apply to relinquished property transferred by a QI in accordance with a valid assignment agreement (see §4.56) before the end of the 45-day reverse exchange identification period.

The maximum duration of a qualified exchange accommodation arrangement (QEAA) is 180 days. This period also applies to a combination of an Exchange Last arrangement and an Exchange First arrangement.

EXAMPLE: If a taxpayer commences an Exchange Last parking arrangement and after 90 days decides to effect a simultaneous exchange of identified relinquished property for parked replacement property, the same EAT (or a different one) can hold the relinquished property in an Exchange First parking arrangement, but that arrangement must terminate within 90 days to comply with the overall 180-day limitation of the revenue procedure.

The 180-day time limit for completing a QEAA is a substantial obstacle for most build-to-suit reverse exchanges. A taxpayer cannot exceed the 180-day period by combining a QEAA for the replacement property with a QEAA for the relinquished property. Rev Proc 2000-37, §4.02(6). Apparently, in an Exchange Last build-to-suit transaction, the taxpayer cannot extend the 180-day period by having the qualified intermediary (QI) obtain title to the parked property from the EAT and then continue construction for another 180 days. See Rev Proc 2000-37, §4.02(5) (the EAT must transfer the parked property to the taxpayer within 180 days). For a detailed discussion of construction and build-to-suit reverse exchanges, see §§5.35-5.39.

PRACTICE TIP: Certain transactions may utilize a "white knight" who is willing to buy a relinquished property from a taxpayer (to conclude an Exchange Last QEAA transaction) or from an EAT (to conclude an Exchange First QEAA transaction) before the 180-day time period expires. Presumably, the white knight would lease the property back to the taxpayer but retain sufficient benefits and burdens of ownership to be regarded as being the tax owner of the property under general tax principles.

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§5.21 5. Arrangements Permitting Taxpayer Control of Parked Property

In reverse exchanges predating Rev Proc 2000-37, 2000-2 Cum Bull 308, the most difficult issues for tax advisers involved balancing the need for the accommodator to satisfy the benefits and burdens test while providing the type of financing arrangements and exit strategy protections that accommodators typically seek.

Under Rev Proc 2000-37, §4.03, taxpayers can ignore normal tax analysis rules on who is treated as the owner of property, by permitting the exchange accommodation titleholder (EAT) and the taxpayer to enter into various agreements to protect the EAT against risk of loss and to shift virtually all potential profit to the taxpayer without violating the safe harbor. The agreements need not contain typical arm's-length terms, and are generally intended to assure that the taxpayer retains control of the parked property during the parking arrangement. The types of permissible arrangements cited in this revenue procedure are the following (Rev Proc 2000-37, §4.03):

- The EAT may serve as the taxpayer's intermediary in a simultaneous or deferred exchange of the parked property;
- The taxpayer or a disqualified person may guarantee some or all of the EAT's obligations, including secured or unsecured debt incurred to acquire the parked property;
- The EAT may be reimbursed for all costs and expenses incurred on behalf of the parked property during the accommodation arrangement;
- The taxpayer or a disqualified person may advance the funds necessary for the EAT to acquire the parked property;
- The taxpayer or a disqualified person may lease the parked property from the EAT during the accommodation arrangement;
- The taxpayer or a disqualified person may manage the property, may supervise improvement of the property, may act as a contractor in building improvements, or may provide other services to the EAT regarding the parked property;
- The taxpayer and the EAT may enter into various agreements related to the purchase or sale of the property, including fixed or formula "puts" (which gives the EAT the right to sell and the taxpayer the obligation to buy the property) and calls (which gives the taxpayer the right to buy and the EAT the obligation to sell the property), as long as the period during which these fixed price provisions apply does not exceed 185 days after the date the property is acquired by the EAT; and
- In an Exchange First transaction (see §5.9), the taxpayer may agree to make the EAT whole if the proceeds from the sale of the relinquished property are less than the estimated value on the date the EAT acquired the parked property.

The importance of this list is that it constitutes a comprehensive list of factors the courts and the IRS typically analyze to determine whether a party has sufficient benefits and burdens of ownership to be regarded as the property's owner for income tax purposes. In a safe harbor transaction, these factors are irrelevant to the tax outcome. In a non-safe-harbor transaction, the list serves as a checklist of factors that the taxpayer must consider when a parking arrangement reverse exchange is being planned outside the protection of Rev Proc 2000-37. See §§5.27-5.39.

WARNING: A taxpayer who elects to effect all of the permissible arrangements under Rev Proc 2000-37 will face an uphill battle establishing the qualification of a transaction under IRC §1031 if the exchange fails to meet all the safe harbor requirements (for example, if the parked property is not transferred within the 180-day period). Accordingly, taxpayers who are not sure they can satisfy the 180-day limitation may wish to build more substance into their arrangements with the EAT than the safe harbor otherwise requires.

Although Rev Proc 2000-37 permits various non-arm's-length arrangements between the EAT and the taxpayer, the parties need to consider any collateral tax consequences of such arrangements. Because the maximum term of a QEAA is 180 days, an interest-free loan for that period from the taxpayer to the EAT should not give rise to Original

Issue Discount under IRC §§1272-1273 owing to the exception for short-term (one year or less) obligations under IRC §1272(a)(2)(C). With a third party loan (guaranteed by the taxpayer), the EAT will want to avoid any loan amortization during the QEAA period so that lease payments can equal debt service without creating phantom income to the EAT.

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§5.22 6. Tax Reporting Requirements

For the exchange accommodation titleholder (EAT) to be treated as the beneficial owner of property subject to a qualified exchange accommodation arrangement, it must report ownership of the parked property on its federal income tax returns and the taxpayer must agree to file tax returns consistent with that ownership. Rev Proc 2000-37, §4.02(3), 2000-2 Cum Bull 308. Generally, this rule means that the EAT must report the acquisition, holding, and disposition of the parked property in the same manner as any other property owner would do.

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§5.23 a. Balance Sheet Issues

If the exchange accommodation titleholder (EAT) prepares financial statements according to accounting principles generally accepted in the United States (GAAP), it may not reflect ownership of parking assets on its statements owing to the operation of GAAP principles of consolidation. Consolidation principles require that, regardless of legal title, assets must be shown on the financial statements of the party who has all economic risk of profit and loss and has control of the use of the asset. The taxpayer will be that party in most qualified exchange accommodation arrangements (QEAAs) and even some non-safe-harbor reverse exchange parking arrangements. The fact that an EAT does not report ownership of a parked asset under GAAP, however, does not preclude application of the safe harbor of Rev Proc 2000-37, 2000-2 Cum Bull 308, because inconsistent accounting and tax treatments are expressly allowed. Rev Proc 2000-37, §4.04.

WARNING: If an EAT uses GAAP financial statements, the EAT cannot simply transfer its balance sheet information onto Schedule L of its IRS Form 1065 tax return, which is the balance sheet portion of the return. The EAT should reflect ownership of property held in QEAAs through modification entries to the tax return balance sheet; otherwise, it will not be reporting itself as the owner of the parked property. The attorney representing a client engaging in a QEAA transaction should obtain affirmative covenants from the EAT to report itself for federal income tax purposes as owner of the parked property. The same covenant should extend to state income tax filings if the client is attempting to engage in a like-kind exchange for state income tax purposes.

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.24 b. Income and Expense Items

§5.24 b. Income and Expense Items

Certain tax reporting requirements related to the treatment of assets vary based on the character of the asset. An asset's character will establish whether depreciation deductions are allowed or allowable during the exchange accommodation titleholder's (EAT's) holding period (IRC §1223), and if ordinary income versus capital gain or loss (if any) (IRC §§167-168) is recognized on the disposition of the parked property.

The relevant choices of asset characterization for EATs are the following:

- Inventory;
- Trade or business;
- Capital asset; or
- Dual-purpose property.

How an asset is characterized is based on all the facts and circumstances, but some of the factors to be considered are the following:

- The intent or purpose of the asset's use on acquisition, during the holding period, and on disposition;
- The amount and frequency of asset sales by the owner;
- The asset's holding period; and
- The amount of income earned while holding the asset in comparison to the amount of income earned on disposition of the asset.

See Rev Rul 80-37, 1980-1 Cum Bull 51; *Malat v Riddell* (1966) 383 US 569, 16 L Ed 2d 102, 86 S Ct 1030; *International Shoe Mach. Corp. v U.S.* (1st Cir 1974) 491 F2d 157, cert denied (1974) 419 US 834, 42 L Ed 2d 60, 95 S Ct 59; *Continental Can Co. v U.S.* (Ct Cl 1970) 422 F2d 405, cert denied (1970) 400 US 819, 27 L Ed 2d 46, 91 S Ct 35; *Recordak Corp. v U.S.* (Ct Cl 1963) 325 F2d 460. Assets held by an EAT in a qualified exchange accommodation arrangement (QEAA) under Rev Proc 2000-37, 2000-2 Cum Bull 308, are likely to be characterized as property held primarily for sale or inventory because the maximum holding period is 185 days and there is generally clear evidence of the EAT's lack of intent to hold a parked property other than as an accommodation to the taxpayer. Under these circumstances, no depreciation deduction is generally allowable under IRC §168 during the period the EAT holds qualified indicia of ownership (QIO), and any gain or loss realized by the EAT on disposition of the property would be considered ordinary in nature.

Property held in a QEAA usually has some associated expenses during the parking arrangement, such as interest on acquisition debt lent from third party lenders, property taxes, maintenance expenses, and similar items. Certain of these expenses should be reported on the EAT's income tax returns, even if the expenses are ultimately paid by the taxpayer, either as part of the purchase price of the property or reimbursed through a net lease arrangement. In a typical QEAA, the two categories of expenses to which this rule applies are debt service payments and property taxes. Because allowable interest deductions must be taken by the debtor, the EAT must treat a client's payment of debt service as receipt of rent and a corresponding expenditure of the same amount for interest. The same treatment applies to real property taxes, because only the property owner is entitled to a deduction under IRC §164. If property taxes are paid by the taxpayer under the terms of a net lease, the EAT should report both revenues and expenses associated with the parked property. The same treatment should not be required for the taxpayer's payment of insurance premiums or property operating expenses, because these items become direct tenant responsibilities under most net leases.

PRACTICE TIP: Attorneys should advise clients to seek competent advice on the tax reporting obligations for the period of a QEAA to ensure that both the client and the EAT understand each party's obligations.

If the parked property is under construction, most direct and indirect costs, interest expense, and property taxes incurred during construction are required to be capitalized by an EAT into the basis of the property under construction. Only indirect or overhead costs that directly benefit or are incurred by reason of construction need be capitalized. For example, costs that may be subject to capitalization include the following (see IRC §263A; Reg §1.263A-1(e)(4)(C)(iii)):

- Administration and coordination of construction projects;
- Personnel operations;
- Purchasing operations;
- Materials handling;
- Accounting services;
- Legal services; and
- Security services.

Once construction is complete, expenses need not be capitalized but can be deducted by the EAT for income tax purposes. These rules usually affect only QEAAs that span two separate tax years because, if the QEAA is begun and concluded in the same year, the difference between the EAT deducting and capitalizing expenditures during the QEAA period should not matter. However, in a multiyear non-safe-harbor Exchange Last parking arrangement (see §5.8), the EAT should be alert to a potential for accelerated income without offsetting deductions if items being capitalized are funded with rent payments.

Other EAT tax reporting requirements may include the following:

- Information reporting requirements for payments of $600 or more made to noncorporate payees for services rendered during the operation or construction of the parked property;
- Sales, use, and gross receipts tax reporting on rental income earned during the parking period;
- Personal property taxes;
- Transfer taxes on the disposition of the parked property; and
- Local business taxes.

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§5.25 7. Effect of Rev Proc 2000-37 on Non-Safe-Harbor Transactions

In adopting Rev Proc 2000-37, 2000-2 Cum Bull 308, the IRS was forced to confront the effect of the newly issued safe harbor on two types of transactions: those occurring before the September 15, 2000, effective date, and those that failed to meet the newly promulgated rules on establishing qualified exchange accommodation arrangements (QEAAs). With respect to both, the IRS specifically provides that "no inference" is intended with respect to the federal income tax consequences of reverse exchanges that were entered into before or outside the scope of the QEAA safe harbor. Rev Proc 2000-37, §3.02. This no-inference language is somewhat unusual in its bluntness; indeed, the IRS goes beyond standard no-inference language and assures taxpayers that "the Service recognizes that 'parking' transactions can be accomplished outside of the safe harbor." This statement should properly be taken as a directive to IRS field agents that non-safe-harbor reverse exchanges using parking mechanisms must be analyzed under existing principles, including those set out in *Donald DeCleene* (2000) 115 TC 457 and other cases discussed in §§5.12-5.14, as well as in IRS Letter Rulings 200111025, 200148042, rather than on the basis of any bright-line test established by the rules on QEAAs.

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§5.26 8. Effective Date of Rev Proc 2000-37

Revenue Procedure 2000-37, 2000-2 Cum Bull 308, is effective only for accommodation arrangements entered into on or after September 15, 2000 (Rev Proc 2000-37, §5) and does not apply to transactions that were underway or completed before that date. See §5.25.

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III. SPECIAL ISSUES IN CONSTRUCTION AND OTHER NON-SAFE-HARBOR REVERSE EXCHANGES

§5.27 A. Introduction

Revenue Procedure 2000-37, 2000-2 Cum Bull 308, is particularly important for taxpayers intending to acquire replacement property on which improvements are to be constructed. As noted in §5.13, *Bloomington Coca-Cola Bottling Co. v Commissioner* (7th Cir 1951) 189 F2d 14 held that taxpayers cannot prepay for construction services to be completed after the exchange, which effectively forces taxpayers to use an accommodation parking structure so that replacement property under construction is not owned by the taxpayer desiring to effect a like-kind exchange as to that property. In essence, the practical effect of *Bloomington Coca-Cola* is that a cooperating party must own the property while it is being improved to the taxpayer's specifications. If circumstances permit taxpayers to avail themselves of the safe harbor of Rev Proc 2000-37, the cooperating party can be an exchange accommodation titleholder (EAT).

Unfortunately, it is often difficult to qualify for safe harbor protection under Rev Proc 2000-37 when new improvements are to be made part of the replacement property. In many cases, 180 days is simply too short a period to complete improvements, but that is the maximum duration of a qualified exchange accommodation arrangement (QEAA).

Other instances will also arise in which one or more of the limitations of Rev Proc 2000-37 will force taxpayers into structuring reverse exchange transactions outside the boundaries of the safe harbor created by this procedure. The most common problem is likely to be a taxpayer's inability to be certain that the sale of relinquished property will occur within 180 days after the purchase of replacement property. Another problem may arise if potential relinquished properties associated with one replacement property exceed the limits for identification established by Rev Proc 2000-37, §4.02(4)-(6). These limitations require consideration of the potential for completing a non-safe-harbor accommodation parking arrangement outside the confines of Rev Proc 2000-37.

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B. Significance of Recent Authorities

§5.28 1. IRS Letter Ruling 200111025

On March 19, 2001, the IRS publicly released IRS Letter Ruling 200111025, which had been issued to the taxpayer in December 2000. In an extraordinarily rapid response (the taxpayer's request was submitted on October 11, 2000), the IRS sanctioned a non-safe-harbor Exchange Last parking arrangement (see §5.8) between a commercial real estate owner and the subsidiary of an exchange intermediary company. Both the structure (see §5.30) of the transaction and the IRS analysis (see §5.31) are instructive.

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§5.29 a. Facts

The taxpayer in IRS Letter Ruling 200111025 (see §5.28) owned property (the Park) that it had apparently held for some time as an investment and rental. The Park consisted primarily of open space, which an IRC §501(c)(3) conservation organization wished to acquire for use as public parkland. Interested in selling, the taxpayer granted the conservation organization an option to purchase the Park for cash at 96 percent of its appraised value. The option was conditioned, among other things, on passage of a state bond measure providing funding for the purchase. At the time of the letter ruling application, the conservation organization had paid an undisclosed amount of cash to the taxpayer to retain and extend its rights under the option agreement but had not yet exercised the option. Ultimate exercise of the option was subject to several contingencies relating to the public funding and approval of the purchase.

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§5.30 b. Structure of the Transaction

In IRS Letter Ruling 200111025, the accommodation party was a single-member limited liability company wholly owned by an exchange company. As such, the accommodator was disregarded for federal income tax purposes under Reg §301.7701-3. Neither the exchange company nor the accommodator were disqualified persons as defined in the deferred exchange regulations.

Under a real estate acquisition agreement, the accommodator acquired property intended by the taxpayer as replacement property in a like-kind exchange for the Park. This purchase was funded by (1) a bank loan to the accommodator secured by the replacement property and guaranteed by the taxpayer, and (2) a separate loan from the taxpayer to the accommodator. The accommodator apparently did not use any of its own capital to purchase replacement property, and the letter ruling does not discuss whether the accommodator had any capital at risk regarding the replacement property. The accommodator, however, agreed to pay the taxpayer a loan guaranty fee of an unspecified amount in return for the guaranty. Both the bank loan and the taxpayer loan to the accommodator carried market interest rates.

Concurrent with its acquisition, the accommodator leased the replacement property to the taxpayer on a triple-net lease basis on terms typical of triple net leases, for one-year term, with a one-year extension option. The rent payments exceeded the accommodator's costs of ownership, including debt service, resulting in positive net cash flow to the accommodator. The replacement property apparently consisted of multitenant income-producing real estate (the letter ruling refers to an assignment by the accommodator to the taxpayer of certain leases and contracts acquired by the accommodator on its purchase).

Under the acquisition agreement, the taxpayer had an option to acquire the replacement property from the accommodator at its fair market value, which for the first 18 months of the arrangement was defined as the accommodator's cost of acquiring the replacement property. If this option was terminated, the accommodator could sell the replacement property according to specified procedures. If it did not follow the procedures, the accommodator was exposed to risk of loss, but if it did follow the procedures, the taxpayer was still obligated to reimburse the accommodator for a portion of the net selling costs. The accommodator was entitled, however, to retain the replacement property, or all profit on any sale of the replacement property, if the taxpayer's option was terminated.

The acquisition agreement specifically referred to the taxpayer's desire to acquire the replacement property in a like-kind exchange. There is no indication that the Park is specifically described in the acquisition agreement as the intended relinquished property in an exchange for the replacement property.

The taxpayer represented to the IRS that since the inception of the transaction it had intended to exchange the Park for "all or a portion of the [Replacement] Property" and that this would occur "as soon as the Conservation Organization is in a position to acquire the Park under the Option." The exchange transaction was to be effected through a qualified intermediary as a deferred or simultaneous exchange transaction within the time limits of IRC §1031(a)(3).

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§5.31 c. IRS Analysis

Internal Revenue Service Letter Ruling 200111025's analysis of like-kind exchange authority provides a valuable review of the authorities discussed in §§5.12-5.15 and is particularly interesting for its extended discussion of *Biggs v Commissioner* (5th Cir 1980) 632 F2d 1171 (see §5.12). Despite the facts that *Biggs* never uses the term "reverse exchange" and that the IRS did not raise the issue of agency on appeal of the *Biggs* Tax Court decision (*Franklin B. Biggs* (1978) 69 TC 905, aff'd (5th Cir 1980) 632 F2d 1171) to the Fifth Circuit, the IRS concluded that the taxpayer's exchange was upheld at both levels because (1) the taxpayer always intended "and evidenced its clear and consistent intent" to enter into a tax-deferred exchange, (2) the various transfers were all interdependent and integrated parts of a single overall plan, and (3) the taxpayer's attorney's title company was not acting as the taxpayer's agent. The IRS also focused on the same finding of lack of an accommodator's agency in *J. H. Baird Publ'g Co.* (1962) 39 TC 608, acq 1963-2 Cum Bull 4 (discussed in §5.12).

In addressing the impact of *Donald DeCleene* (2000) 115 TC 457, decided just weeks before issuance of its letter ruling, the IRS focused on the lack of "any steps to evidence" an integrated plan in DeCleene's attempt to effect a like-kind exchange, as well as the Tax Court's determination that DeCleene never transferred benefits and burdens of ownership of the replacement property to the buyer (see §5.13). This issue does not arise when the accommodation party acquires parked property from a third party instead of the taxpayer.

Ultimately, according to IRS Letter Ruling 200111025, there are three general requirements for an exchange to be recognized as a like-kind exchange under IRC §1031 in similar situations:

- The taxpayer must demonstrate an intent to achieve an exchange and the properties to be exchanged must be of like-kind and for a qualified use;
- The steps in the various transfers must be part of an integrated plan to exchange the relinquished property for the replacement property; and
- The party holding the replacement property must not be the taxpayer's agent.

On the issue of agency, the IRS Letter Ruling 200111025 analysis focuses on the test established by the United States Supreme Court in *National Carbide Corp. v Commissioner* (1949) 336 US 422, 93 L Ed 779, 69 S Ct 726:

- Whether the party in question operates in the name and for the account of the principal;
- Whether the party binds the principal by its actions;
- Whether the party transmits money received to the principal;
- Whether receipt of income is attributable to services of employees of the principal and to assets belonging to the principal; and
- Whether the business purpose of the party is the carrying on of an agent's normal duties.

In addition, the agency-principal relationship cannot be based solely on the fact that the principal owns the agent. For example, a corporation is usually treated as a taxable entity separate from its sole stockholder.

In applying these tests to the transaction and the relationship created by the taxpayer and the accommodator, the IRS found that all the necessary bases for a valid like-kind exchange were present. The taxpayer demonstrated its "clear and consistent intent to exchange the Park for the [relinquished] property in a transaction qualifying under IRC §1031." Further, the taxpayer had entered into a series of interdependent steps as part of an overall plan to exchange the Park for the relinquished property. Finally, under the *National Carbide* agency analysis, the accommodator was not the taxpayer's agent because it failed all factors determinative of agency:

- It operated in its own name and for its own account;
- It was not authorized to bind the taxpayer by its actions;
- It did not transmit money received for its account to the taxpayer, but received rent from the taxpayer under a lease;
- Its rental income under the lease resulted from a formal lessor-lessee relationship with the taxpayer, and the taxpayer's income from the relinquished property resulted from an assignment of rights and responsibilities

relating to the underlying leases;

- Its business purpose was not to carry on the duties of an agent, but to engage in the business of "acquiring, owning, holding, leasing, financing, refinancing, and disposing of real property and its associated personal property;" and
- The taxpayer did not own or control the accommodator.

The letter ruling specifically noted that "the Tax Court has consistently held that the fact that an accommodator is used to facilitate a like-kind exchange does not mean that the accommodator is the agent of the taxpayer," citing *J. H. Baird Publishing Co., supra,* and *Fred L. Fredericks,* TC Memo 1994-27.

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§5.32 d. Implications of IRS Letter Ruling 200111025 for Non-Safe-Harbor Transactions

The IRS's approach taken in IRS Letter Ruling 200111025 may or may not have broad-ranging implications for reverse exchanges outside the safe harbor of Rev Proc 2000-37, 2000-2 Cum Bull 308. One reading of the approach is to conclude that the traditional benefits and burdens of ownership analysis does not apply to an exchange accommodation titleholder (EAT) and that only the *National Carbide Corp. v Commissioner* (1949) 336 US 422, 93 L Ed 779, 69 S Ct 726 (*National Carbide*) agency test matters as long as there is a clearly demonstrated intent to exchange and an integrated plan shown in written documentation. This interpretation could mean that the question of whether an EAT needs capital at risk is irrelevant. If that is true, completion of reverse exchanges outside Rev Proc 2000-37's safe harbor will be almost as easy and inexpensive as completing transactions within the safe harbor.

In contrast, the arrangements analyzed in this letter ruling at least paid lip service to creating arm's-length arrangements between the taxpayer and the EAT. The EAT executed loan arrangements on market rate terms. The formal lease of the parked property created positive income to the EAT. A complex exit strategy provision gave the EAT theoretical risk of loss and potential benefit from owning the parked property. The taxpayer was not indefinitely protected from having to pay for any appreciation in the parked property's value, because its purchase price was capped at cost for only 18 months after the EAT's acquisition of the property. Each of these elements is referred to in the letter ruling. Failure to incorporate similar arrangements into a non-safe-harbor reverse exchange parking arrangement could lead to a different result.

Further, the parking arrangement analyzed did not involve property that the taxpayer had previously owned or controlled. In distinguishing *Donald DeCleene* (2000) 115 TC 457, the letter ruling observed that the Tax Court never analyzed whether a parking transaction entered into as part of an integrated exchange plan could qualify under IRC §1031, because the court concluded that DeCleene had neither parted with beneficial ownership of his property nor taken any steps to evidence an intent to enter into an exchange at the time the accommodator acquired his property. It is reasonable to conclude that the letter ruling does not simply push aside the issue of benefits and burdens analysis in this type of transaction. Rather, the letter ruling involves facts and circumstances in which a benefits and burdens analysis is not relevant, because the taxpayer did not previously own or control the property.

Finally, and probably most apposite, this is only a private letter ruling. Taxpayers and their advisers might be well advised to heed the concluding warning: "This ruling is directed only to the taxpayer(s) requesting it. Internal Revenue Code §6110(k)(3) provides that it may not be used or cited as precedent." The IRS has been known to modify views expressed in private letter rulings after further reflection.

WARNING: Taxpayers and their advisers must initially decide whether the transaction can be completed within the time limits of Rev Proc 2000-37. If the transaction might extend beyond 180 days, the safe harbor provisions will be ineffective, thus requiring non-safe-harbor parking arrangements of a substantially different sort.

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§5.33 e. Remaining Questions

There are, however, many unanswered questions in the wake of Rev Proc 2000-37, 2000-2 Cum Bull 308, and IRS Letter Ruling 200111025, such as these:

- How much equity or liability for recourse debt will an EAT need to demonstrate that it bears the benefits and burdens of ownership?
- Will all other economic arrangements between the taxpayer and the EAT (*i.e.,* loans, leases, options) be required to be negotiated on an arm's-length basis to demonstrate benefits and burdens of ownership?
- Is a benefits and burdens analysis relevant, or can taxpayers rely exclusively on the *National Carbide Corp. v Commissioner* (1949) 336 US 422, 93 L Ed 779, 69 S Ct 726, agency tests applied in IRS Letter Ruling 200111025?
- Must the EAT, as the beneficial owner of the property during the parking period, take cost recovery deductions if the property is subject to depreciation?
- What is the character of the gain, if any, recognized by the EAT on the transfer of the property to the taxpayer?

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§5.34 2. Ongoing Significance of *DeCleene*

The Tax Court's opinion in *Donald DeCleene* (2000) 115 TC 457 (discussed in §5.13) is the first thorough judicial evaluation of an attempted reverse exchange using a parking mechanism. Furthermore, *DeCleene* represents a rare government victory in litigated IRC §1031 cases in which the transaction analyzed, at least in form, amounts to an exchange of properties. Nevertheless, the implication of the opinion for other parking arrangements, particularly non-safe-harbor transactions outside the scope of Rev Proc 2000-37, 2000-2 Cum Bull 308, should not be overstated. Several peculiar factors occurred in *DeCleene* that will not appear, or can be cured, in most reverse exchanges, including build-to-suit transactions:

- The taxpayer's prior acquisition and ownership of the replacement property was a key element in the court's conclusions. The court viewed the taxpayer as never having relinquished ownership of the replacement property. This issue simply will not arise in the vast majority of transactions when the taxpayer has never owned the property intended to serve as replacement property. Moreover, if an accommodator (unlike the cooperative buyer in *DeCleene*) truly obligates itself in connection with the purchase of potential replacement property owned by the taxpayer (*e.g.,* by supplying its own funds), then *DeCleene* may be distinguishable.
- The two-party nature of the transaction in *DeCleene,* with all of the cooperative buyer's economic outlay attributable to the unimproved value of the replacement property (the fair market value of which exactly equaled that of the relinquished property), is unusual. In fact, the court implied that use of an accommodator could have changed the outcome.
- The taking of certain shortcuts that hindered the taxpayer in *DeCleene* can be easily avoided in most parking arrangements. For example, the court mentioned that the taxpayer in *DeCleene* paid real estate taxes on the replacement property while the cooperative buyer owned it.
- The cooperative buyer had no equity risk with respect to its ownership of the replacement property. Many non-safe-harbor parking arrangements require accommodators to invest some of their own funds or use recourse debt to finance acquisition of property or construction of improvements.
- The binding agreement between the parties and the short time frame to complete the parking arrangement made the transaction more susceptible to a step transaction challenge. The cooperative buyer was obligated to complete the improvements and convey the property back to the taxpayer within four months and the taxpayer was obligated to accept the property in that time. A longer-term arrangement with various puts or calls that fall short of creating a binding agreement should minimize this risk. For discussion of puts and calls, see §5.21.

Despite the differences between the facts in *DeCleene* and more comprehensively structured parking arrangements, the case does sound a warning that the Tax Court simply will not respect the form of parking arrangements when their substance is deficient. Planners who venture outside the safe harbor of Rev Proc 2000-37 must keep this in mind.

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§5.35 C. Construction and Build-to-Suit Reverse Exchange Structures

In many situations, a taxpayer needs to have an accommodator acquire replacement property and begin construction of improvements before disposing of the relinquished property. If these tasks can be completed (and the relinquished property can be sold) within 180 days, the taxpayer may engage an exchange accommodation titleholder (EAT) to effect a safe harbor parking exchange. Normally, however, the time required to obtain permits, financing, and construction contracts (let alone the time for the actual construction), will exceed 180 days.

The validity of a build-to-suit exchange outside of the qualified intermediary (QI) or qualified exchange accommodation arrangement (QEAA) safe harbors depends on whether the party owning the land and constructing the improvements has sufficient burdens and benefits of ownership with respect to the parked property to be deemed the tax owner rather than the taxpayer's agent. There is ample authority for these exchanges with cooperative buyers or accommodators. See §§5.11-5.15.

In Rev Rul 75-291, 1975-2 Cum Bull 332, a cooperative buyer acquired land from a third party and built a new factory solely for the purpose of exchanging it for the taxpayer's land and factory. The ruling concludes that the cooperative buyer was not the taxpayer's agent in constructing the building.

Courts have been flexible in allowing build-to-suit arrangements. See *Coastal Terminals, Inc. v U.S.* (4th Cir 1963) 320 F2d 333; *J. H. Baird Publishing Co.* (1962) 39 TC 608, acq 1963-2 Cum Bull 4; and *Boise Cascade Corp.,* TC Memo 1974-315, all discussed in §5.12. See also IRS Letter Rulings 9428007, 9413006, 9149018, 9110007, 8701015, 8304022, 8217106, 8035049, 7929091, 7823035. The foregoing authorities permit the taxpayer to supervise construction, approve invoices, and bear the risk of cost overruns on construction carried out by a cooperative buyer or an accommodator. Certain of these cases were distinguished by the Tax Court in *Donald DeCleene* (2000) 115 TC 457. As discussed in §5.34, the distinctions relate largely to a fact pattern in *DeCleene* that is not likely to be replicated in other parking exchanges.

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§5.36 1. Construction by Qualified Intermediary

If the relinquished property can be sold first (through a qualified intermediary (QI) to the cash buyer) and if sufficient improvements to the replacement property can be completed within the 180-day exchange period, then the construction is typically done by a QI. Note, however, that the QI must do the following (Reg §1.1031(k)-1(e)):

- Acquire a fee or fee equivalent interest in the replacement property;
- Pay for the construction of improvements during the 180-day period; and
- Transfer the replacement property as improved to the taxpayer before the end of the exchange period to complete the exchange.

Regulation §1.1031(k)-1(e)(2) has specific identification requirements for property to be constructed during the deferred exchange period. Under this regulation, a taxpayer may acquire partially completed replacement real property to be constructed if the replacement property received constitutes real property under local law.

PRACTICE TIP: In a build-to-suit exchange, the taxpayer should consider designating the QI as its agent as permitted by Reg §1.1031(k)-1(g)(4). In some jurisdictions, doing so may eliminate a second transfer tax on the deed from the intermediary to the taxpayer. It may also facilitate any construction financing required during the period of the QI's ownership.

PRACTICE TIP: The QI may pay for construction costs incurred during the 180-day exchange period, if the work billed for is incorporated into real property before the end of the exchange period even if an invoice is not received until after the exchange period ends. The QI, however, cannot merely pay for construction materials delivered to the site and not yet incorporated into the real property, *e.g.,* lumber, spools of wire, copper pipe, etc. The latter is generally considered to be personal property under state law. See, *e.g.,* CC §§14, 663.

See IRS Letter Ruling 9428007 for an example of a build-to-suit deferred exchange in which the QI used exchange proceeds to acquire land and partially complete a golf course to the taxpayer's specifications during the exchange period.

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§5.37 2. Agency Issue Outside QI or QEAA Safe Harbor

In *Fred L. Fredericks,* TC Memo 1994-27, the taxpayer's wholly owned corporation acted as an accommodator and built improvements on the replacement property before conveying it to the taxpayer. The Tax Court found that the corporation was not the agent of the related taxpayer, because the corporation was a licensed contractor and a real estate developer. Note that this case was based on law before the enactment of the limitation on related party exchanges under IRC §1031(f) and the regulations on qualified intermediaries. See §§2.67-2.83, 4.53-4.57.

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§5.38 3. Risk of Loss Outside QI or QEAA Safe Harbor

It is important that the accommodator have some risk of loss and some obligations in a non-safe-harbor build-to-suit exchange. In IRS Letter Ruling 9149018, the IRS listed the following risks of ownership assumed by the accommodator in a build-to-suit exchange held to qualify under IRC §1031:

- The obligation to construct a building according to the taxpayer's plans;
- Obligations under the construction loan;
- An obligation to spend a minimum amount before disbursement under the construction loan;
- Liability for claims that may be asserted with respect to construction;
- Liability on the construction contracts; and
- Obligations under the ground lease (the accommodator leased the land on which it constructed the building under a long-term lease).

Most accommodators resist putting their own equity into a parked property; for nonqualified exchange accommodation arrangement (QEAA) transactions, however, this issue may now become more significant, particularly after the *Donald DeCleene* (2000) 115 TC 457 decision (discussed in §§5.13, 5.34). The taxpayer in *DeCleene* cited IRS Letter Ruling 9149018 as authority in its favor, but the court refused to place any precedential value on the letter ruling as mandated by IRC §6110(j)(3).

WARNING: In IRS Field Service Advice 20050203F the IRS addressed a reverse construction exchange transaction. The transaction was outside of the 180-day limits, thereby making it a non-safe harbor transaction.

Utilizing the seven factors outlined in *Grodt & McKay Realty, Inc.* (1981) 77 TC 1221, the advice from the National Office places emphasis on the need to ascertain the beneficial owner of property nominally held by an exchange accommodation party. In the analysis, the IRS reasoned that if beneficial ownership rested in the taxpayer, the taxpayer could not effectuate a tax deferred exchange. Whether courts will agree with this analysis and the conclusions drawn remains to be seen. A case pending in Tax Court is expected to provide the court's views, but as of June 2009 no decision in the case had been announced. See *Bartell v Commissioner,* Tax Court Dockets 22709-05, 22829-05, and 22891-05.

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.39 4. Related Party as Contractor

§5.39 4. Related Party as Contractor

Internal Revenue Code §1031(f) appears to preclude a related party from acquiring the replacement property land and building the improvements for the taxpayer. See IRS Letter Ruling 9748006 (taxpayer's acquisition of replacement property from his mother violates §1031(f)). A party related to the taxpayer may act as a construction contractor, however, and may enter into a construction contract with the accommodator. See IRS Letter Ruling 9413006. Apparently, a related party may also receive construction draws from the exchange proceeds without constituting constructive receipt by the taxpayer. See IRS Letter Ruling 9413006.

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.39A 5. Using Leases to Build Improvements on Land Owned by Taxpayer or Related Party

§5.39A 5. Using Leases to Build Improvements on Land Owned by Taxpayer or Related Party

The IRS has issued several favorable letter rulings to taxpayers that used a leasing structure to build improvements on land controlled by parties related to the taxpayers in transactions structured to comply with the requirements of Rev Proc 2000-37, 2002-2 Cum Bull 208. The rulings are significant for two reasons. First, they demonstrate a solution to the limitations created by *Bloomington Coca-Cola Bottling Co. v Commissioner* (7th Cir 1951) 189 F2d 14. Second, they illustrate methods that avoid violation of the IRC §1031(f) related-party restrictions.

In IRS Letter Ruling 200251008, the IRS sanctioned a reverse/build-to-suit exchange when the replacement property consisted of improvements to be constructed on a sublease estate. The taxpayer's relinquished property consisted of land and improvements that were used in the taxpayer's business and sold to an unrelated party. Proceeds from the disposition were received and held by a qualified intermediary (QI) under an exchange agreement between the QI and the taxpayer. A corporation related to the taxpayer (as determined under §1031(f)) held a long-term lease on undeveloped land on which the taxpayer wanted to build a replacement facility. The corporate lessor subleased the land to another entity and the sublessee then sub-subleased a portion of the overall parcel (for a 32-year term at fair market rent) to a limited liability company (LLC) whose sole member was an exchange accommodation titleholder (EAT). Within five days thereafter, the taxpayer, the EAT, and the LLC entered into a qualified exchange accommodation arrangement (QEAA) under Rev Proc 2000-37, 2000-2 Cum Bull 308. The LLC (referred to in the letter ruling as "Titleholder") hired an entity related to the taxpayer to act as construction manager and supervise the construction of improvements. (See IRS Letter Ruling 9413006 for a similar result.) The improvements were constructed within the 180-day "safe harbor" period under Rev Proc 2000-37 and cost more than the selling price of the replacement property.

Before the end of both the 180-day "safe harbor" period under Rev Proc 2000-37 and the end of the 180-day exchange period which commenced on disposition of the replacement property, the taxpayer assigned its rights under the QEAA to acquire the 32-year sub-sublease interest in the replacement property and the newly constructed improvements to the QI, the QI then transferred taxpayer's net exchange proceeds to the EAT (which applied them to pay off the loans), and the EAT transferred its membership interest in the LLC to the taxpayer.

Internal Revenue Code §1031(f) did not apply, because no proceeds were paid to the related party (*i.e.,* the related party corporation, as sub-sublandlord, did not receive any consideration and had no involvement other than to incur a change in the membership interest of the single-member LLC that was its subtenant). Under this structure, no basis was shifted from the taxpayer's property to any property owned by a related party. The IRS concluded:

> Since both Taxpayer and the related parties continue to be invested in the exchange properties and are not otherwise cashing out their interest, Section 1031(f)(1) is not a concern for this transaction unless and until Taxpayer or the related parties dispose of their interests in the exchanged property within two years after the last transfer that was part of the exchange.

IRS Letter Ruling 200251008 n5. Citing *Coastal Terminals, Inc. v U.S.* (4th Cir 1963) 320 F2d 333, *Earlene T. Barker* (1980) 74 TC 555, *Leslie Q. Coupe* (1969) 52 TC 394, acq in result 1970-2 Cum Bull xix, *J. H. Baird Publ'g Co.* (1962) 39 TC 608, acq 1963-2 Cum Bull 4, *Franklin B. Biggs* (1978) 69 TC 905, aff'd (5th Cir 1980) 632 F2d 1171, Rev Rul 75-291, and other cases in IRS Letter Ruling 200251008 n2, the IRS had no difficulty in concluding that a taxpayer could actively involve itself in locating suitable property and arranging for construction of improvements that would serve as replacement property in a like-kind exchange. See also §2.78.

In IRS Letter Ruling 200329021, the IRS approved a leasing structure similar to the structure used in Letter Ruling 200251008 to build improvements on land controlled by a related party. The parent corporation (Parent) of a taxpayer held a leasehold interest in land owned by an unrelated party. The lease was for a period of 20 years with four 5-year renewal options, on arm's-length commercially reasonable terms. The Parent assigned its leasehold estate to a single-member limited liability company (LLC) whose sole member was an exchange accommodation titleholder (EAT). Within 5 days, the taxpayer, EAT, and LLC entered into a qualified exchange accommodation arrangement (QEAA) under Rev Proc 2000-37. The taxpayer sold the real property and a QI received the proceeds.

Under Parent's supervision, and within 180 days after the LLC's acquisition of the leasehold interest, the LLC constructed improvements on the leased property according to plans and designs provided by Parent. The QI made monthly disbursements to the LLC from the net exchange proceeds (which it received on the sale of the relinquished property), to permit the LLC to make payments to the general contractor constructing the improvements. The LLC also reimbursed Parent for the cost incurred in planning the construction of the improvements.

Before the end of the 180-day period, the taxpayer assigned its rights under the QEAA to the QI. The QI then transferred the taxpayer's net exchange proceeds to the LLC, and the LLC transferred the leasehold interest and improvements to the taxpayer to complete its exchange. Not only did this avoid the problems created by *Bloomington Coca-Cola Bottling Co. v Commissioner* (7th Cir 1951) 189 F2d 14 (see §2.45), but according to the IRS:

> Since both taxpayer and Parent continue to be invested in exchange properties, both will remain so invested for a period of not less than two years following the exchange, and neither is otherwise cashing out its interest, gain recognition is not triggered under §1031(f)(4).

Some commentators have questioned whether this conclusion is, in fact, correct.

In Rev Proc 2004-51, 2004-2 Cum Bull 294, the IRS states that it is continuing to study parking transactions, like those discussed in IRS Letter Rulings 200329021 and 200251008, in which a person related to the taxpayer transfers a leasehold in land to an accommodation party and the accommodation party makes improvements to the land and transfers the leasehold with the improvements to the taxpayer in exchange for other real estate.

It remains unclear whether the IRS would approve a transaction in which the EAT acquired a leasehold interest in land owned by the taxpayer and then constructed improvements. The IRS may assert that on the merger of the fee and leasehold interest in the property, the taxpayer has constructed improvements on land it owns in violation of the decision in *Bloomington Coca-Cola Bottling Co. v Commissioner, supra*.

NOTE: In May 2004, the ABA Tax Section issued a report arguing that improvements constructed on land owned by a taxpayer and leased to an EAT should be like-kind to other real estate that the taxpayer relinquishes. The report reasoned that a long-term lease should be respected as a fee-equivalent interest when received by the taxpayer notwithstanding the fact that the lease will terminate on its merger with the fee. Alternatively, the report argued that the long-term leasehold interest should not be considered the equivalent of a fee interest, but that the taxpayer should only recognize taxable "boot" to the extent, if any, of the fair market value of the EAT's interest in the lease. See ABA Comments Regarding Rev. Proc. 2000-37 Safe-Harbor Build-to-Suit Exchanges Involving Leasehold Improvements, 2004 TNT 90-85 (May 10, 2004), available at the website in the Directory.

In IRS Letter Ruling 200901004, the IRS held that a facility to be constructed on a taxpayer's right-of-way easements could qualify as valid replacement property. The taxpayer proposed to exchange an old facility it owned as part of its trade or business, which was to be sold to a third party, for a new facility. The new facility was to be constructed by LT. LT and taxpayer had a common parent but were not related for purposes of IRC §267 or §707. See §2.71. The taxpayer owned the right-of-way easements necessary to construct the new facility. The taxpayer proposed to assign these right-of-way easements to LT for cash in amount equal to their fair market value. Using a combination of equity from its common parent with the taxpayer and nonrecourse loans from third party lenders, LT would construct the new facility. During the construction period LT would be responsible for all property taxes associated with and damage that occurred on the right-of-way easements assigned by the taxpayer. Despite being constructed on right-of-way easements owned by the taxpayer and assigned to LT, the IRS held that the new facility could serve as replacement property for the old facility.

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§5.40 IV. FORM: INTRODUCTORY LETTER TO CLIENT REGARDING SAFE HARBOR REVERSE EXCHANGE

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5.40-1 Introductory letter to client

_ _[*Client name*]_ _
_ _[*address*]_ _

Re: Reverse Exchange Transaction

Dear _ _[*name*]_ _:

The following is a discussion of the transaction that we propose to structure to implement the reverse exchange transaction for you (referred to in this letter as the Exchanger).

This transaction will be structured as described below, in order for the Exchanger's disposition of the property owned by the Exchanger (the Relinquished Property) to be subject to tax-deferral under Internal Revenue Code §1031, in exchange for the acquisition of the new like-kind property (the Replacement Property). This transaction is structured using an Exchange Accommodation Titleholder (the EAT) and is intended to comply with the requirements of the IRS safe harbor set out in Revenue Procedure 2000-37.

As we discussed, for this transaction to qualify as a reverse exchange transaction under the IRS guidelines, certain time limitations must be followed. First, the Exchanger must identify to the EAT the specific Relinquished Property(ies) within 45 days after the EAT acquires the Replacement Property; second, the Exchanger must complete this exchange within 180 days after the earlier of (i) the date that the EAT acquires the Replacement Property, to hold in anticipation of the exchange, or (ii) the date the Exchanger transfers the Relinquished Property to a buyer.

Once the Exchanger enters into a contract to purchase the Replacement Property and has removed all property-related contingencies, the Exchanger and the EAT will enter into a Qualified Exchange Accommodation Arrangement (the QEAA), which sets forth the rights and obligations of the EAT and the Exchanger to complete the reverse exchange. One of the terms of the QEAA is the Exchanger's assignment to the EAT of all of the Exchanger's rights to acquire the Replacement Property.

Basically, the role of the EAT is to purchase, and park, the Replacement Property until the Exchanger has sold the Relinquished Property and is ready to complete the tax-deferred exchange under Internal Revenue Code §1031. Therefore, the Exchanger will be responsible for providing to the EAT all funds to purchase the Replacement Property (including all closing costs), either by loans made to the EAT by the Exchanger or by third-party loans, all of which will be secured by liens against the Replacement Property. Loans made to the EAT by the Exchanger are usually made without any interest charge. Generally, third-party loans require that the Exchanger either guarantee the debt or provide additional collateral to the lender, because the EAT will not be investing any equity to purchase the Replacement Property and will not put any of its funds at risk. It is important that we become involved, at an early stage, if you anticipate obtaining third-party institutional loans to ensure that the lender understands the transaction.

The EAT will enter into a triple-net lease of the Replacement Property (the Lease) with a tenant, who usually is the same person as the Exchanger (the Tenant). The Lease places the responsibility for managing (and paying all costs incurred in connection with) the Replacement Property on the Tenant, and entitles the Tenant to collect all rental income (if any). The Tenant pays to or for the benefit of the EAT, as rent, all normal and customary operating expenses, taxes, insurance, any homeowners' association dues and assessments, the costs of all maintenance and repairs on the Replacement Property, and all debt service on all loans secured by the Replacement Property (if the loans are amortizing loans, any payments made on the principal will be treated

as a loan made by the Tenant to the EAT).

At closing by the EAT of its purchase of the Replacement Property, the EAT will require evidence of the issuance of insurance coverage, naming the EAT as an insured (or additional insured), insuring the Replacement Property for full replacement fire and other hazard coverage, and general comprehensive liability coverage. The Lease will also place on the Tenant the obligation to pay for any casualty loss or damage to the Replacement Property which is not covered by insurance (*e.g.,* any deductible in any insurance coverage, and any uninsured loss).

At such time as the Exchanger is ready to sell the Relinquished Property, and after the Exchanger has entered into an appropriate exchange agreement with a qualified intermediary to facilitate the actual exchange, the EAT will transfer the Replacement Property to the Exchanger in exchange for the transfer, by the Exchanger, of the Relinquished Property. In connection with these transactions _ _[*name of qualified intermediary*]**_ _ (QI) will act as the qualified intermediary under Internal Revenue Code §1031. If, by the end of the 180th day, the Exchanger has been unable to dispose of the Relinquished Property, the EAT will convey the Replacement Property to the Exchanger as an outright purchase, and the Exchanger will receive title subject to all permitted liens and encumbrances.**

We look forward to working on this transaction with you, and are here to answer any questions that may arise as this transaction progresses.

Sincerely,
__[*Signature of attorney*]__

Comment: Any unique aspects of the transaction that are not usually found in reverse exchange transactions should also be described in this introductory letter to the client.

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§5.41 V. REAL ESTATE ACQUISITION AND QUALIFIED EXCHANGE ACCOMMODATION ARRANGEMENT

The form real estate acquisition and qualified exchange accommodation arrangement in §§5.42-5.62 is for use in an Exchange Last reverse exchange. See §5.8. This form is intended to meet the safe harbor requirements of Rev Proc 2000-37, 2000-2 Cum Bull 308. See §§5.16-5.26.

WARNING: The form in §§5.42-5.62 is not sufficient to effectuate an exchange transaction that does not meet the safe harbor requirements of Rev Proc 2000-37. Taxpayers undertaking exchanges outside the safe harbor must conform the transaction to the complexities of the law on reverse exchanges, and, because the facts and circumstances of these transactions can vary widely, it is virtually impossible to develop a "one size fits all" form.

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.42 A. Form: Title and Introductory Paragraph

§5.42 A. Form: Title and Introductory Paragraph

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5.42-1 Title and introductory paragraph

REAL ESTATE ACQUISITION AND QUALIFIED EXCHANGE ACCOMMODATION ARRANGEMENT

THIS REAL ESTATE ACQUISITION AND QUALIFIED EXCHANGE ACCOMMODATION ARRANGEMENT (Agreement) is made and entered into as of _ _[*date*]_ _ (Effective Date), by and between _ _[*name of exchanger*]_ _ (Exchanger), whose notice address is _ _[*address*]_ _, Attention: _ _[*name/title*]_ _, Facsimile Number _ _[*number*]_ _, and _ _[*name of exchange accommodation titleholder*]_ _ (EAT), acting as exchange accommodation titleholder, whose notice address is _ _[*address*]_ _ Attention: _ _[*name/title*]_ _, Facsimile Number _ _[*number*]_ _. Capitalized terms used in this Agreement that are not defined in this paragraph are defined in _ _[*e.g., Section 1*]_ _.

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.43 B. Form: Background Facts

§5.43 B. Form: Background Facts

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5.43-1 Background facts

BACKGROUND FACTS

A. Exchanger presently owns and holds for investment certain real property to be identified by Exchanger in accordance with _ _[*e.g., Section 3.1*]_ _ of this Agreement and referred to in this Agreement as the "Relinquished Property."

B. Exchanger has transferred, or anticipates transferring, the Relinquished Property to a third party buyer (Transferee) in accordance with a purchase and sale agreement to be entered into between Exchanger and Transferee (the Relinquished Property Transfer Agreement) and acquiring the Replacement Property from EAT, both transactions to be completed using a qualified intermediary (QI) within the meaning of Regulation §1.1031(k)-1(g)(4) to effect a like-kind exchange (Exchange) within the meaning of Internal Revenue Code §1031.

C. EAT is willing to assist and cooperate with Exchanger and QI in completing Exchange if Exchanger, in its sole discretion, decides to effect the same. Exchanger intends that EAT will act as an Exchange Accommodation Titleholder, as that term is defined in the Rev Proc, and EAT is willing to act in such capacity and to carry out its obligations in accordance with this Agreement and the Rev Proc. Exchanger acknowledges that it intends that the transactions set forth in, and contemplated by, this Agreement will comply with the requirements and limitations of Internal Revenue Code §1031 and the Rev Proc. To that end, contemporaneously with Effective Date of this Agreement, EAT is accepting an assignment of Exchanger's rights under the Replacement Property Purchase Agreement and, under that assignment, EAT will acquire from Seller certain real property located at _ _[*address*]_ _, in the City of _ _ _ _ _ _, County of _ _ _ _ _ _, State of _ _ _ _ _ _, as described in more detail in Exhibit A attached to this Agreement (the Replacement Property).

D. EAT is also willing to lease the Replacement Property to Tenant under the Lease in the form attached to this Agreement as Exhibit B.

E. EAT will (a) arrange financing under the terms and conditions of the Loan Documents with Lender(s) for the purpose of acquiring the Replacement Property; (b) acquire title to the Replacement Property; and (c) enter into the Lease of the Replacement Property with Tenant and act as lessor under the Lease.

F. Exchanger's bona fide intent is that the Replacement Property is replacement property in an exchange intended to qualify for deferral of gain under Internal Revenue Code §1031. Accordingly, Exchanger identifies the Replacement Property as replacement property (within the meaning of Regulation §1.1031(k)-1(a)) in connection with Exchange, provided, however, that Exchanger may affirmatively revoke that identification, in writing, in the manner and time as required under Regulation §1.1031(k)-1(c)(6). As set forth in _ _[*e.g., Section 3*]_ _, Exchanger will (a) direct QI to accept an assignment from Exchanger of Exchanger's rights and obligations to sell the Relinquished Property under the Relinquished Property Transfer Agreement in order to receive QI Credit Amount; (b) assign to QI the right to acquire the Replacement Property from EAT; and (c) authorize QI to pay QI the Credit Amount on account of the purchase price (as established in this Agreement) for the Replacement Property and then transfer, or cause the transfer of, title to, and ownership of the Replacement Property to Exchanger in order to complete the Exchange.

Comment: See §5.18 for discussion of using different legal entities to perform QI services. See also §4.46 on use of qualified intermediaries in deferred exchanges.

NOW, THEREFORE, in consideration of the mutual premises set forth in this Agreement, the parties agree as follows:

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§5.44 C. Form: Definitions

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5.44-1 Definitions

1. Definitions. For purposes of this Agreement, the following terms have the meanings provided below:

1.1 "Acquisition Cost" has the meaning provided in _ _[*e.g., Section 3.3.4.2*]_ _.

1.2 "Code" means the Internal Revenue Code of 1986, as amended.

1.3 "Environmental Statutes" has the meaning provided in _ _[*e.g., Section 11.3.2*]_ _.

1.4 "Exchange" means the like-kind exchange to be consummated by Exchanger as provided in this Agreement.

1.5 "Exchange Period" means the period of 180 calendar days commencing with the earlier of (a) EAT's acquisition of title to the Replacement Property, or (b) Exchanger's disposition of the Relinquished Property.

1.6 "Excluded Costs" has the meaning provided in _ _[*e.g., Section 3.3.4.3*]_ _.

1.7 "Expiration Date" means the date that EAT files its dissolution documents with the appropriate state agency in its state of formation, after dissolving under _ _[*e.g., Section 7.5*]_ _.

1.8 "Fair Market Value" has the meaning provided in _ _[*e.g., Section 3.3.4.1*]_ _.

1.9 "Forum State" means the State of _ _[*name*]_ _.

1.10 "Hazardous Substance" has the meaning provided in _ _[*e.g., Section 11.3.1*]_ _.

1.11 "Identification Period" means the 45-day period beginning on the same date as the Exchange Period.

1.12 "Indemnified Parties" has the meaning provided in _ _[*e.g., Section 11.1.1*]_ _.

1.13 "Lease" means the lease of the Replacement Property by EAT to Tenant, which will commence simultaneously with EAT's acquisition of the Replacement Property.

1.14 "Lender(s)" means _ _[*name*]_ _, _ _[*name*]_ _, and, when applicable, Exchanger and/or QI.

1.15 "Loan(s)" means the loans being made by Lender(s) to EAT.

1.16 "Loan Documents" means the loan agreements between Exchanger and EAT and/or (when applicable) QI.

1.17 "Option Notice" has the meaning provided in _ _[*e.g., Section 4*]_ _.

1.18 "Promissory Note(s)" means the evidences of EAT's indebtedness to Lender(s).

1.19 "Purchase Price" has the meaning provided in _ _[*e.g., Section 3.3.2*]_ _.

1.20 "QI" means any qualified intermediary (as defined in Regulation §1.1031(k)-1(g)(4)) employed by

Exchanger in connection with the Exchange.

1.21 "QI Assignment" has the meaning provided in _ _[*e.g., Section 3.2*]_ _.

1.22 "QI Credit Amount" means the net proceeds received by QI from the sale of the Relinquished Property.

1.23 "Regulations" means the Treasury Regulations promulgated to interpret the Code, as they may be amended from time to time.

1.24 "Relinquished Property" means one or more real properties identified and described in the Relinquished Property Identification Form.

1.25 "Relinquished Property Identification Form" means the form set forth in Exhibit C attached to this Agreement, to be completed by Exchanger and delivered to EAT, as more fully set forth in _ _[*e.g., Section 3.1*]_ _ of this Agreement.

1.26 "Relinquished Property Transfer Agreement" means the agreement that Exchanger intends to enter into with a purchaser of the Relinquished Property to sell the Relinquished Property.

1.27 "Replacement Property" means the real property located at _ _[*address*]_ _, City of _ _ _ _ _ _, County of _ _ _ _ _ _, State of _ _ _ _ _ _, and more particularly described in Exhibit A attached to this Agreement.

1.28 "Replacement Property Deed" means the instrument conveying the Replacement Property that EAT will deliver under _ _[*e.g., Section 3.3.1*]_ _.

1.29 "Replacement Property Purchase Agreement" means the written agreement between Exchanger and Seller, as amended to date, providing for purchase of the Replacement Property by Exchanger.

1.30 "Rev Proc" means Revenue Procedure 2000-37 issued by the Internal Revenue Service and appearing in Internal Revenue Cumulative Bulletin 2000-2, page 308.

1.31 "Seller" means _ _[*name*]_ _.

1.32 "Shortfall" has the meaning provided in _ _[*e.g., Section 3.3.3*]_ _.

1.33 "Subject Properties" means the Relinquished Property and the Replacement Property.

1.34 "Tenant" means _ _[*name*]_ _.

1.35 "Transferee" means the purchaser of the Relinquished Property.

1.36 "Unrelated Liens" has the meaning provided in _ _[*e.g., Section 3.4.3*]_ _.

Comment: See §5.20 for a discussion of the time restrictions in a safe harbor reverse exchange defined as the exchange period (section 1.5 of this form) and the identification period (section 1.11 of this form).

Generally, the forum state (section 1.9 of this form) will be the state in which the replacement property is located, because the EAT's obligations intrinsically involve the specific property. Contrast this to the role of the QI, which merely holds fungible funds. If the exchange transaction involves personal property, such as aircraft or similar items, then the forum state could be where the property is located (or licensed), or where either the EAT or the exchanger has its principal place of business.

Because the revenue procedure permits all economic burdens and benefits of owning the property to accrue to someone other than the EAT, the EAT customarily leases the replacement property to the exchanger, or some third party, for a nominal rent on a triple-net lease basis. See section 1.13 of the form. The tenant is responsible for paying all costs of operation and ownership (including debt service, taxes, and insurance premiums), any deductible (if there is any insured damage to the property), and all uninsured property damage. If the debt service includes loan amortization, the lease must be structured to avoid having the EAT inadvertently develop equity in the property while the tenant is paying debt service. To do this, the same level of outstanding principal loan balances must be maintained. Thus, the

lease must reflect that, as between the EAT and the tenant, the tenant's principal payments included in debt service to the lender are a loan from the tenant to the EAT, which will be repaid when the EAT transfers the property.

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/ D. Acquisition of Replacement Property; Financing; Lease/§5.45 1. Form: Assignment of Replacement Property Purchase Agreement

D. Acquisition of Replacement Property; Financing; Lease

§5.45 1. Form: Assignment of Replacement Property Purchase Agreement

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5.45-1 Assignment of replacement property purchase agreement

2. <u>Assignment of Replacement Property; Financing</u>.

2.1 *Assignment of Replacement Property Purchase Agreement*.

2.1.1 On execution of this Agreement, Exchanger assigns to EAT, and EAT accepts the assignment of, Exchanger's rights and obligations to purchase the Replacement Property from Seller under the terms of the Replacement Property Purchase Agreement and any other written agreements between Exchanger and Seller with respect to the purchase and sale of the Replacement Property.

2.1.2 Subject to the terms of the Replacement Property Purchase Agreement and this Agreement, EAT will acquire title to the Replacement Property.

2.1.3 The assignment provided in _ _[*e.g., Section 2.1.1*]**_ _ is null and void if EAT does not acquire title to the Replacement Property by means of the closing procedures provided in the Replacement Property Purchase Agreement.**

2.1.4 Despite anything in this Agreement to the contrary, at any time before the end of the Identification Period, Exchanger may assign to any other person its rights under _ _[*e.g., Section 3*]**_ _ (only), to acquire all or any part of the Replacement Property, provided, however, that in such event Exchanger will notify EAT in writing by the earlier of (a) 2 days after execution of such assignment or (b) 2 days before the end of the Identification Period, and Exchanger will also notify QI before the end of the Identification Period of the change of identified property to comply with Regulation §1.1031(k)-1(a). Any such assignee will also be responsible for complying with _ _**[*e.g., Section 3.1*]**_ _, and Exchanger and all assignees will be jointly and severally liable for the performance of all of Exchanger's obligations under this Agreement.**

Comment: By giving the exchanger the right to assign a portion of the agreement, the exchanger obtains the ability to tie up a replacement property, anticipating that before the 45th day (the end of the identification period), the exchanger may find others who also wish to acquire a tenancy-in-common interest in the replacement property. For example, the exchanger needs to acquire only 60 percent to defer taxes from the disposition of its relinquished property, but because the EAT will generally have to purchase 100 percent from the seller, the exchanger will want to be able to assign out the rights to acquire the other 40 percent. One must be careful in structuring co-ownership arrangements in an IRC §1031 exchange, however. See chap 7.

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.46 2. Form: Financing; Lease

§5.46 2. Form: Financing; Lease

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5.46-1 Financing; Lease

2.2 *Financing*.

2.2.1 To finance the acquisition of the Replacement Property, EAT will borrow funds from Lender(s) under and in accordance with the Loan Documents, provided that EAT will not be obligated to pay any interest on funds advanced by Exchanger or QI. EAT will comply with all terms and conditions of the Loan Documents and enter into such other agreements and assignments required by the Loan Documents that are commercially reasonable.

2.2.2 EAT has no obligation to advance any funds toward acquisition of the Replacement Property in excess of funds supplied by Lender(s).

2.3 *Lease*. Before and as a condition precedent to EAT's obligation to acquire the Replacement Property, Tenant will have duly executed the Lease.

Comment: See §5.21 for income tax treatment of interest-free loan.

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E. Exchange Cooperation

§5.47 1. Form: Identification of Relinquished Property

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5.47-1 Identification of relinquished property

3. Exchange Cooperation. If Exchanger elects to consummate the Exchange, then:

3.1 *Identification of Relinquished Property*.

3.1.1 Before the end of the Identification Period, Exchanger will give written notice to EAT, using one of the Relinquished Property Identification Notices, attached to this Agreement as Exhibit C, of all property that may constitute the Relinquished Property. Any such identification may be revoked and a different property identified as the Relinquished Property on written notice from Exchanger to EAT before the end of the Identification Period. Following the end of the Identification Period, Exchanger may not revoke any identifications.

3.1.2 Exchanger will establish, with Transferee(s) of one or more of the Relinquished Properties, the terms of sale of the Relinquished Property(ies) and will enter into the Relinquished Property Sale Contract with Transferee(s).

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.48 2. Form: Assignment to QI

§5.48 2. Form: Assignment to QI

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5.48-1 Assignment to QI

3.2 *Assignment to QI of Rights To Sell Relinquished Property and Rights To Purchase Replacement Property*.

3.2.1 After Exchanger has timely identified one or more properties as its Relinquished Property, then Exchanger will:

3.2.1.1 Assign to QI all of Exchanger's rights and obligations to dispose of the Relinquished Property in accordance with the Relinquished Property Transfer Agreement, under a form of QI Assignment described in Regulation §1.1031(k)-1(g)(4)(iv);

3.2.1.2 Assign to QI all of Exchanger's rights under this Agreement to acquire the Replacement Property under a form of QI Assignment described in Regulation §1.1031(k)-1(g)(4)(iv), which will provide for EAT to deliver title to the Replacement Property directly to Exchanger without QI's taking title to the Replacement Property; and

3.2.1.3 Then, direct QI to deliver to EAT an amount equal to the lesser of (a) the QI Credit Amount or (b) the Purchase Price (less amounts already advanced by QI, as a loan, which will be deemed an advance on account of the QI Credit Amount), in exchange for the transfer of the Replacement Property to QI, or as directed by QI, to Exchanger.

3.2.2 Exchanger will give EAT written notice of the assignment to QI of its rights under this Agreement, as described in _ _[*e.g., Section 3.2.1.2*]_ _, within 2 business days after the assignment of this Agreement by Exchanger to QI.

Comment: See chap 4, which describes the deferred exchange process and the QI's role.

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§5.49 3. Form: Transfer of Replacement Property

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5.49-1 Transfer of replacement property

3.3 *Transfer of Replacement Property by EAT; Purchase Price*.

3.3.1 On payment of all closing costs, and receipt of the Purchase Price paid as described below, and consistent with QI Assignment described in _ _[*e.g., Section 3.2.1.1*]_ _, EAT will apply the QI Credit Amount and any other cash consideration received to repay the Loan(s), in the order of recorded lien priority, and will deliver the Replacement Property Deed conveying title to the Replacement Property to QI or, on the direction of QI, to Exchanger.

3.3.2 The Purchase Price for the Replacement Property will equal its Fair Market Value as defined in _ _[*e.g., Section 3.3.4*]_ _.

3.3.3 If, in connection with the Exchange, or the exercise of Exchanger's Purchase Option under _ _[*e.g., Section 5*]_ _, the Purchase Price for the Replacement Property exceeds the aggregate amount of the QI Credit Amount paid by QI to EAT, including previous advances on account of the QI Credit Amount (such difference being the Shortfall), Exchanger will simultaneously with delivery of the Replacement Property Deed either (a) pay EAT the Shortfall amount in immediately available funds; (b) assume or take title to the Replacement Property subject to indebtedness in the amount of the Shortfall owed to Lender(s); or (c) any combination of (a) and (b) chosen by Exchanger.

3.3.4 For purposes of this Agreement, the following definitions apply:

3.3.4.1 Fair Market Value of the Replacement Property means the Acquisition Cost.

3.3.4.2 "Acquisition Cost" means the sum of (a) the purchase price paid by EAT to Seller to acquire the Replacement Property; (b) all sales, transfer, or similar taxes, and all charges and closing costs paid by EAT in connection with its purchase of the Replacement Property; (c) all capitalized financing costs incurred in connection with the Loan(s); and (d) any and all unreimbursed costs, liabilities, and expenses of any kind incurred by EAT in connection with the acquisition, ownership, and operation of the Replacement Property and the completion of the Exchange, except for the Excluded Costs as defined in _ _[*e.g., Section 3.3.4.3*]_ _.

3.3.4.3 "Excluded Costs" means the sum of (a) professional and administrative costs and fees (including overhead costs) incurred by EAT in connection with the transactions contemplated by this Agreement or its organization or operation; (b) any claims or losses incurred by EAT for which Exchanger need not reimburse EAT under _ _[*e.g., Section 13.9*]_ _ of this Agreement; and (c) any income taxes and similar taxes based on or measured by EAT's income. Despite the foregoing, any professional or administrative fees and costs incurred by EAT in connection with, or as a result of, Exchanger's default under or breach of this Agreement or Tenant's default under or breach of the Lease, or if Exchanger fails to timely cure any Termination Event (as described in _ _[*e.g., Sections 4.1 and 4.2*]_ _), will not be considered Excluded Costs under this Agreement.

3.3.5 To the extent that, before the transfer date of the Replacement Property to Exchanger, either (a) QI or (b) Exchanger has advanced funds to EAT to purchase (or construct improvements that constitute a part of) the Replacement Property, the amounts advanced will be evidenced by a credit on the closing statement of Exchanger prepared in connection with the transfer of the Replacement Property to Exchanger.

Comment: See §§2.62-2.64 discussing direct deeding (section 3.3.1 of the form). See §5.21 for a discussion of the

impact of using a fixed price for the consideration to be paid by the exchanger to the EAT on acquisition of the replacement property. Using the acquisition cost as the price at which the EAT transfers the replacement property to the exchanger results in no taxable gain or loss to the EAT (see section 3.3.4.1 of the form). See §§5.22-5.24 for a discussion of the EAT's tax-reporting issues on disposition. This form anticipates that the QI may be a lender to the EAT and, in that case, the QI may have lent the EAT all of the QI credit amount before the time that the EAT is ready to transfer the replacement property to the exchanger. This happens most often when the relinquished property has already sold (or the QI has received option consideration or nonrefundable deposits from the buyer), and the EAT is required to make additions to the replacement property before the date of transfer to the exchanger. In this situation, the QI will have made a loan to the EAT, and the amount of the loan will be credited, at closing, to the QI credit amount. The QI may (and probably should) require both that (1) the exchanger authorize the QI to make the loan (as generally such action is not permitted under a deferred exchange agreement between the QI and the exchanger), and (2) the EAT provide security for its loan which is senior to any loan made by the exchanger.

With respect to any other financing provided to EAT to purchase (or construct improvements that constitute a part of) the replacement property, the exchanger will either assume such financing, take title to the replacement property subject to the lien securing such financing, or pay off such financing on its acquisition of the replacement property.

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.50 4. Form: Additional Delivery; Liens

§5.50 4. Form: Additional Delivery; Liens

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5.50-1 Additional delivery; liens

3.4 *Additional Delivery; Liens*.

3.4.1 At such time as EAT delivers the Replacement Property Deed to Exchanger under _ _[*e.g., Section 3.3.1*]**_ _ of this Agreement, EAT will also deliver to Exchanger (a) any insurance or condemnation proceeds pertaining to the Replacement Property that EAT may have received, except to the extent such proceeds have been applied as required under the Loans, or applied in accordance with the Lease; (b) assignments of any insurance or condemnation proceeds pertaining to the Replacement Property that EAT may be entitled to receive but has not received; (c) assignment of the Lease (unless Exchanger is also Tenant, in which event the Lease will be deemed terminated); and (d) assignment of all representations, warranties, and covenants from Seller pertaining to the Replacement Property that have been obtained by EAT.**

3.4.2 The Replacement Property delivered by EAT in accordance with _ _[*e.g., Section 3.3.1*]**_ _ of this Agreement will be subject to all liens, encumbrances, and restrictions other than Unrelated Liens.**

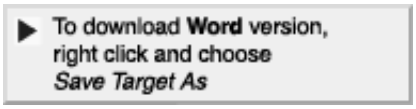
3.4.3 "Unrelated Liens" means any liens, encumbrances, or restrictions created or suffered to exist by EAT with respect to the Replacement Property *except for* any lien specifically authorized by this Agreement or otherwise authorized by Exchanger, the lien of the Lease, or any lien authorized by the Lease, or any lien that results from Tenant's default under, or breach of, the Lease. Without limiting the generality of the foregoing, the term "Unrelated Liens" includes any liens, encumbrances, or restrictions created by EAT for money borrowed *other than* the Loans, or created or suffered by EAT in connection with its activities in any respect *not* pertaining to the Replacement Property or this Agreement, or created by EAT in violation or breach of this Agreement, the Loan Documents, or the Lease.

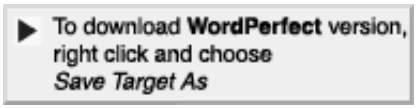
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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.51 5. Form: Representations and Warranties; Title

§5.51 5. Form: Representations and Warranties; Title

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5.51-1 Representations and warranties; title

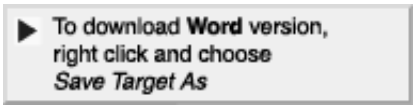
3.5 *Representations and Warranties; Title*. Except as expressly provided in this Agreement, EAT will not be obligated to make any representations and warranties to Exchanger in connection with the transfer of title to the Replacement Property under _ _[*e.g., Sections 3.3-3.4*]_ _ of this Agreement. Without limiting the generality of the foregoing and except as prohibited by law, Exchanger will be required to accept title to the Replacement Property under _ _[*e.g., Sections 3.3 and 3.4*]_ _ of this Agreement regardless of (a) defects in title or encumbrances, other than Unrelated Liens; (b) the absence of any required permits or approvals; (c) any changes to the Code, or unfavorable tax rulings; or (d) any other matter or condition affecting or relating to the Replacement Property or the right or power of Exchanger to take or maintain possession of and operate the Replacement Property, except for Unrelated Liens.

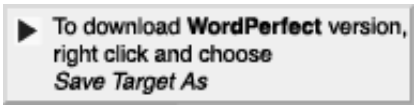
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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.52 6. Form: Termination of Exchange Cooperation Requirement

§5.52 6. Form: Termination of Exchange Cooperation Requirement

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5.52-1 Termination of exchange cooperation requirement

3.6 *Termination of Exchange Cooperation Requirement*. Unless this Agreement is earlier terminated by the parties, EAT's obligation to cooperate in completing the Exchange under this _ _[*e.g., Section 3*]**_ _ terminates on the first to occur of (a) the date on which Exchanger, through QI, completes the acquisition of the Replacement Property and pays or assumes the obligation to pay any Shortfall under _ _**[*e.g., Section 3.3*]**_ _ of this Agreement or (b) the date on which EAT transfers the Replacement Property to Exchanger under _ _**[*e.g., Section 4 or 5*]**_ _ of this Agreement. Despite the foregoing, if any further action on EAT's part is necessary or desirable to carry out the purposes of this Agreement after Exchanger acquires the Replacement Property, EAT will take such commercially reasonable actions (including execution and delivery of further instruments or documents) as Exchanger may reasonably request, at Exchanger's sole cost and expense (other than EAT's internal administrative costs, including overhead _ _**[*but not the cost of EAT's legal counsel*]**_ _, which costs will be borne by EAT).**

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.53 F. Form: Exchanger's Purchase Option

§5.53 F. Form: Exchanger's Purchase Option

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5.53-1 Exchanger's purchase option

4. Exchanger's Purchase Option. Exchanger has the option to purchase the Replacement Property from EAT on the terms and conditions set forth in this Agreement.

4.1 *Option Period.* The Option Period is the period commencing on the date that EAT acquires the Replacement Property and terminating on the date that is 185 days later and including the date Exchanger acquired the Replacement Property.

4.2 *Exercise of Option.* At any time before expiration of the Option Period, Exchanger will have the option to acquire the Replacement Property for an amount equal to the Fair Market Value as determined by _ _[*e.g., Section 3.3.4.1*]_ _ (the Acquisition Cost). Exchanger must exercise this option by delivering written notice to EAT (Option Notice) no later than the end of the Option Period. The Option Notice must set forth the date for the closing of the acquisition of the Replacement Property, which may be no later than 30 calendar days after the date of the Option Notice. Exchanger will pay the Acquisition Cost in cash and/or by assuming existing Loans or taking title to the Replacement Property subject to existing Loans, and Exchanger will pay all costs of escrow, recording, title insurance, transfer taxes, and all other related charges in connection with the transfer of the Replacement Property from EAT to Exchanger. At the closing, EAT will deliver title to the Replacement Property subject to the requirements of _ _[*e.g., Sections 3.4 and 3.5*]_ _.

Comment: Even if the exchanger cannot complete the transaction as an IRC §1031 exchange (*e.g.,* the exchanger was unable to sell the relinquished property), then, to avoid stranding the EAT with the replacement property, the exchanger will want the option to purchase it from the EAT at the price at which the EAT initially purchased it from the seller. Revenue Procedure 2000-37, 2000-2 Cum Bull 308, includes within the list of permissible arrangements any arrangement for fixed-price puts and calls as long as these provisions are in effect for only 185 days after the date the EAT acquires the replacement property. What this seems to require is that to qualify the arrangement as a "safe harbor," *even if* ultimately the exchanger does not consummate the exchange, the agreement cannot have a fixed-price put/call beyond 185 days. For example, if the arrangement is structured so that (1) if the exchanger acquires the replacement property through an exchange, and within 180 days, it will get the fixed price, and (2) if the exchanger blows the exchange, and has an outright purchase, after more than 185 days, and still gets to purchase on a fixed-price basis, the arrangement itself (regardless of what the exchanger actually does) does not meet the requirements of Rev Proc 2000-37. This arrangement has not proved to be flexible enough for most exchangers, who want to have the ability to acquire the replacement property—and complete their exchange—at the fixed price. In addition, they are realistic in their expectations of their ability to complete the exchange and want to be able to purchase the replacement property—at the same price—even if they cannot do so in the context of a §1031 exchange, and usually, owing to simple closing logistics, these acquisitions cannot be made to close on only 5 days' notice. Exchangers do not want to allow the EAT to have the benefit of the appreciation in value even after the 185th day, and the EAT does not want to have the risk of a loss during that time period.

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.54 G. Form: EAT Sale Option

§5.54 G. Form: EAT Sale Option

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5.54-1 EAT sale option

5. EAT Sale Option. EAT has the option to require Exchanger to purchase the Replacement Property from EAT on the terms and conditions set forth in this _ _[*e.g., Section 5*]_ _.

5.1 *Option Period.* The Option Period is the 5-day period commencing on the 180th day after and including the date that EAT acquires the Replacement Property and terminating at the end of this 5-day period.

5.2 *Exercise of Option.* EAT will be deemed to have *automatically* exercised the option in this _ _[*e.g., Section 5*]_ _ if Exchanger does not timely exercise its option to purchase the Replacement Property under _ _[*e.g., Section 4*]_ _. In that event, the closing of the transfer of the Replacement Property to Exchanger may occur no later than 30 days after the end of the Exchange Period. The price that Exchanger pays will be deemed the Acquisition Cost, and it will be paid by Exchanger in cash and/or by assuming existing Loans or taking title to the Replacement Property subject to existing Loans, and Exchanger will pay all costs of escrow, recording, title insurance, transfer taxes, and all other related charges in connection with the transfer of the Replacement Property from EAT to Exchanger. At the closing, EAT will deliver title to the Replacement Property subject to the requirements of _ _[*e.g., Sections 3.4 and 3.5*]_ _.

Comment: Although the exchanger may not want to purchase the replacement property, in order to ensure that the EAT is not stranded with the replacement property, the EAT will want the option to "put" the replacement property to the exchanger, and force the exchanger to purchase it from the EAT.

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.55 H. Form: EAT's Failure to Complete Exchange

§5.55 H. Form: EAT's Failure to Complete Exchange

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5.55-1 EAT's failure to complete exchange

6. <u>EAT's Failure to Complete Exchange</u>. If (a) EAT or any successor is dissolved or liquidated, makes an assignment for the benefit of creditors, files a petition in bankruptcy, is adjudicated insolvent or bankrupt, petitions or applies to any tribunal for any receiver or trustee, commences any proceeding relating to itself under any bankruptcy, reorganization, readjustment of debt, dissolution, or liquidation law or statute of any jurisdiction, has commenced against it any such proceeding that remains undismissed for 90 days, indicates its consent to, approval of, or acquiescence in any such proceeding or suffers the appointment of any receiver of or trustee for it or any substantial part of its property and that appointment continues undischarged for 90 days, or if (b) EAT fails to consummate its obligations as provided in _ _[*e.g., Section 3*]_ _ regarding the transfer of the Replacement Property to Exchanger, then in each such event Exchanger will be entitled, in its sole discretion, by written notice to EAT, to enforce the remedies in _ _[*e.g., Section 10*]_ _ of this Agreement.

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.56 I. Form: Representations, Warranties, and Covenants of EAT

§5.56 I. Form: Representations, Warranties, and Covenants of EAT

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5.56-1 Representations, warranties, and covenants of EAT

7. Representations, Warranties, and Covenants of EAT. EAT hereby represents, warrants, and covenants to Exchanger as follows:

7.1 *Due Organization; Authority; Enforceability*. EAT is an entity of the form specified in the preamble to this Agreement, duly organized, and validly existing under the laws of the state of its formation and authorized to conduct business in the state where the Replacement Property is located. EAT has the power and authority to make, execute, deliver, and perform its obligations under this Agreement and all of the transactions contemplated under this Agreement and has taken all necessary action to authorize the execution, delivery, and performance of this Agreement. This Agreement constitutes a valid and binding obligation of EAT, enforceable against EAT in accordance with its terms, subject, as to enforcement of bankruptcy, insolvency, reorganization, moratorium, and other laws of general applicability relating to or affecting creditors' rights, to general equitable principles. EAT is not a disqualified person within the meaning of the Rev Proc. EAT is subject to federal income tax.

7.2 *Conflict With Existing Laws or Contracts*. The execution and delivery of this Agreement, and all related documents, and the performance by EAT of its obligations under this Agreement and all related documents (a) does not conflict with or result in a breach of or constitute a default under any of the terms, conditions, or provisions of the articles of incorporation or bylaws (or, as applicable, the certificate of formation or operating agreement) of EAT or of any agreement or instrument to which EAT is a party or by which EAT is bound or any order or decree applicable to EAT, or (b) will not result in the creation or imposition of any lien (except for those liens contemplated by the Lease and Loan Documents) on any of EAT's assets or property, which would materially and adversely affect the ability of EAT to execute and deliver this Agreement and perform its obligations under it. EAT has obtained all consents, approvals, authorizations, or orders of any court or governmental agency or body, if any, required for the execution and delivery by EAT of this Agreement.

7.3 *Legal Action Against EAT*. There are no judgments, orders, or decrees of any kind against EAT unpaid or unsatisfied of record nor any legal action, suit, or other legal or administrative proceeding pending or to EAT's knowledge threatened against EAT, before any court or administrative agency that has, or is likely to have, any material or adverse effect on the business or assets or the condition, financial or otherwise, of EAT or that prevents EAT's ability to perform under this Agreement.

7.4 *Bankruptcy or Debt of EAT; Financial Condition*. EAT has not filed any petition seeking or acquiescing in any reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any law relating to bankruptcy or insolvency, nor has any such petition been filed against EAT. No general assignment of EAT's property has been made for the benefit of creditors, and no receiver, master, liquidator, or trustee has been appointed for EAT or any of its property. EAT is not insolvent and the consummation of the transactions contemplated by this Agreement will not render EAT insolvent. EAT will have as of the time of execution of this Agreement sufficient financial resources to meet its obligations under it.

7.5 *Limited Purpose*. EAT has not engaged in the conduct of any business before the transactions described in this Agreement. During the time in which any obligations of EAT remain outstanding under this Agreement, EAT will not acquire any asset nor conduct any business that is unrelated to the ownership of the Replacement Property or other properties that are the subject of written agreements between EAT and Exchanger. Despite the foregoing, after the earlier of (a) the completion of the Exchange and the transfer of the Replacement Property to Exchanger; (b) 1 year after any Termination Event; or (c) the sale of the Replacement

Property after delivery of a Termination Sale Notice (under _ _[*e.g., Section 4.3*]_ _), EAT may by its member(s) be dissolved and its assets liquidated.

7.6 *No Liens, Encumbrances of Other Transfers*. Until the delivery of a Termination Sale Notice, EAT will not voluntarily permit anyone to place any lien or encumbrance against the Replacement Property to secure any obligation of EAT, nor will EAT lease, convey, transfer, assign, sell, or otherwise dispose of the Replacement Property except in accordance with this Agreement.

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§5.57 J. Form: Representations and Warranties of Exchanger

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5.57-1 Representations and warranties of exchanger

8. Representations and Warranties of Exchanger. Exchanger hereby represents and warrants to EAT as follows:

8.1 *Due Organization; Authority; Enforceability*. If Exchanger is an entity of the form specified in the preamble to this Agreement, it is duly organized, validly existing, and in good standing under the laws of the state of its formation. Exchanger has the power and authority to make, execute, deliver, and perform its obligations under this Agreement and all of the transactions contemplated under this Agreement and has taken all necessary required action to authorize the execution, delivery, and performance of this Agreement. This Agreement constitutes a valid and binding obligation of Exchanger, enforceable against Exchanger in accordance with its terms, subject as to enforcement to bankruptcy, insolvency, reorganization, moratorium, and other laws of general applicability relating to or affecting creditors' rights and to general equitable principles.

8.2 *Conflict With Existing Laws or Contracts*. The execution and delivery of this Agreement, and all related documents and the performance by exchanger of its obligations under this Agreement, and all related documents (a) does not conflict with or result in a breach of or constitute a default under any of the terms, conditions, or provisions of the formation and governance documents of Exchanger or of any agreement or instrument to which Exchanger is a party or by which Exchanger is bound or any order or decree applicable to Exchanger, or (b) will not result in the creation or imposition of any lien on any of Exchanger's assets or property, which would materially and adversely affect the ability of Exchanger to perform its obligations under this Agreement. Exchanger has obtained all consents, approvals, authorizations, or orders of any court or governmental agency or body, if any, required for the execution and delivery by Exchanger of this Agreement.

8.3 *Legal Action Against Exchanger*. There are no judgments, orders, or decrees of any kind against Exchanger unpaid or unsatisfied of record nor any legal action, suit, or other legal or administrative proceeding pending or to the knowledge of the principals or executives of Exchanger threatened against Exchanger, before any court or administrative agency that has, or is likely to have, any material or adverse effect on the business or assets or the condition, financial or otherwise, of Exchanger or that prevents the ability of Exchanger to perform under this Agreement.

8.4 *Bankruptcy or Debt of Exchanger; Financial Condition*. Exchanger has not filed any petition seeking or acquiescing in any reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any law relating to bankruptcy or insolvency, nor has any such petition been filed against Exchanger. No general assignment of Exchanger's property has been made for the benefit of creditors, and no receiver, master, liquidator, or trustee has been appointed for Exchanger or any of its property. Exchanger is not insolvent, and the consummation of the transactions contemplated by this Agreement will not render Exchanger insolvent. Exchanger will have as of the time of execution of this Agreement sufficient financial resources to meet its obligations under it.

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§5.58 K. Form: Survival

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5.58-1 Survival

9. Survival. Except for the release in _ _[*e.g., Section 11.1*]_ _ and indemnities in _ _[*e.g., Sections 11.2 and 13.9*]_ _, each and every representation and warranty made by EAT or Exchanger survives the execution and delivery of this Agreement for _ _[*e.g., 2*]_ _ years after the Expiration Date.

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.59 L. Form: Remedies of Exchanger

§5.59 L. Form: Remedies of Exchanger

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5.59-1 Remedies of exchanger

10. Remedies of Exchanger. If, as provided in _ _[*e.g., Section 6*]_ _ of this Agreement, EAT fails to perform its obligations under this Agreement and such failure continues without correction, then Exchanger, on delivery of written notice to EAT, may terminate its obligation to complete Exchange and (a) have recourse to a suit in equity for specific performance of the obligation of EAT to transfer the Replacement Property to it, in exchange for QI Credit Amount and the payment, if any, required under _ _[*e.g., Section 3.3*]_ _ of this Agreement, free and clear of all Unrelated Liens, and/or (b) recover any damages against EAT as provided under law. The parties agree that the Replacement Property is unique.

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.60 M. Form: Environmental Release and Indemnity

§5.60 M. Form: Environmental Release and Indemnity

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5.60-1 Environmental release and indemnity

11. Environmental Release and Indemnity.

11.1 *General Release.* Exchanger releases EAT and its managers, officers, directors, members, owners, successors, heirs, and assignees (Indemnified Parties) from any and all claims, causes of action, and liabilities of any and every kind and character, whether known or unknown, existing, contingent, or hereafter arising, which Exchanger may have now or in the future, that arise in connection with any contamination of any of the Subject Properties by any Hazardous Substance, except those caused by the gross negligence or willful misconduct of any of Indemnified Parties.

11.2 *Indemnity*. Exchanger indemnifies and holds harmless each of Indemnified Parties of, from, and against any and all expense, loss, or liability suffered by Indemnified Parties in connection with any contamination of any of the Subject Properties by any Hazardous Substance, including, but not limited to (a) any and all reasonable expenses that any Indemnified Party may incur in complying with any of the Environmental Statutes; (b) any and all reasonable costs that any one of Indemnified Parties may incur in studying or remedying any contamination; (c) any and all fines or penalties assessed on any of Indemnified Parties because of such contamination; (d) any and all loss of value of any of the Subject Properties or improvements on them because of such contamination; and (e) any and all legal fees and costs incurred by any of Indemnified Parties in connection with any of the foregoing (Environmental Claim). For purposes of this _ _[*e.g., Section 11*]_ _, "contamination" means the presence of Hazardous Substances on, in, under, or about either of the Subject Properties or any improvement on those properties that requires any remedial action under any of the Environmental Statutes.

11.3 *Certain Definitions:*

11.3.1 As used in this Agreement, "Hazardous Substance" means any substance that (a) constitutes a hazardous waste or substance under any applicable federal, state, or local law, rule, order, or regulation now or hereafter adopted; (b) constitutes a hazardous substance under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (42 USC §§9601 et seq.) and the regulations promulgated under that Act; (c) constitutes a hazardous waste under the Resource Conservation and Recovery Act (42 USC §§6901 et seq.) and the regulations promulgated thereunder; (d) constitutes a pollutant, contaminant, chemical, or industrial, toxic, or hazardous substance or waste; (e) exhibits any of the characteristics enumerated in 40 CFR §§261.20-261.24; (f) is one of the extremely hazardous substances listed in §302 of the Superfund Amendments and Reauthorization Act of 1986 (Pub L 99-499, 100 Stat 1613) that are present in threshold planning or reportable quantities as defined under such Act; (g) is a toxic or hazardous chemical substance that is present in quantities that exceed exposure standards as that term is defined in §§6 and 8 of the Occupational Safety and Health Act, as amended (29 USC §§655, 657; 29 CFR pt 1910 subpt 7); (h) contains any asbestos; or (i) is a petroleum-based product or is an underground or aboveground storage tank.

11.3.2 As used in this Agreement, "Environmental Statutes" means the statutes, laws, rules, orders, and regulations referred to in (a) through (i), inclusive, in _ _[*e.g., Section 11.3.1*]_ _. As used in this Agreement, contamination by a Hazardous Substance includes contamination arising from the presence, creation, production, collection, treatment, disposal, discharge, release, storage, transport, or transfer of any such substance.

11.4 *Warranties of Exchanger*. Exchanger warrants that as of the Effective Date there are no known adverse environmental or archeological conditions on in or under the Replacement Property and that, if any

such become known, Exchanger will immediately give EAT all information about such conditions and will immediately, at its sole expense, remedy them.

11.5 *Survival of Provisions*. The provisions of this _ _[*e.g., Section 11*]**_ _ survive the termination of this Agreement.**

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.61 N. Form: Miscellaneous

§5.61 N. Form: Miscellaneous

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5.61-1 Miscellaneous

12. Miscellaneous.

12.1 *Waiver*. No failure or delay by either party in exercising any right, power, or remedy under this Agreement may operate as a waiver of this Agreement, nor may any single or partial exercise of any such right, power, or remedy preclude any other or further exercise of the same or the exercise of any other right, power, or remedy under this Agreement. The remedies provided under this Agreement are cumulative and not exclusive of any remedies provided by law.

12.2 *Amendments*. No amendment, modification, termination, or waiver of this Agreement or any provision of it nor any consent to any departure from any provision of this Agreement is effective unless it is in writing and signed by the party to be bound by it and then any such waiver or consent will be effective only in the specific instance and for the specific purpose for which it is given. No notice to or demand on either party entitles that party to any other or further notice or demand in similar or other circumstances.

12.3 *Governing Law*. This Agreement and all rights and obligations of the parties under it are to be governed by and construed and enforced in accordance with the laws of the Forum State. Subject to the arbitration requirement in _ _[*e.g., Section 12.12*]_ _ of this Agreement, each party consents to the jurisdiction of the courts of the Forum State.

12.4 *Assignment*. This Agreement binds and inures to the benefit of the parties to it and their respective successors and assigns. EAT may not assign any of its rights or interests in this Agreement. Except as provided in _ _[*e.g., Section 2.1.4*]_ _, Exchanger may not, without the prior written consent of EAT, whose consent will not be unreasonably withheld, assign any of its rights or interests in this Agreement. No one who is not a party to this Agreement is intended to benefit by it. Exchanger's release and indemnity under _ _[*e.g., Section 11*]_ _ and its indemnity under _ _[*e.g., Section 12.9*]_ _ of this Agreement survives any assignment of this Agreement.

12.5 *Severability*. Any provision of this Agreement that is prohibited or unenforceable in any jurisdiction will, as to that jurisdiction, be ineffective to the extent of such prohibition or unenforceability without affecting the validity or enforceability of the remainder of this Agreement or the enforceability of such provision in any other jurisdiction.

12.6 *Captions*. Captions are included in this Agreement for convenience of reference only and do not constitute a part of the Agreement.

12.7 *Notices*. All notices, requests, demands, directions, declarations, and other communications provided for in this Agreement must be in writing and must, except as otherwise expressly provided, be mailed by registered or certified mail, return receipt requested, or be telegraphed, sent by facsimile transmission, or delivered by hand to the applicable party at the address set forth at the beginning of this Agreement.

Except as otherwise expressly provided in this Agreement, each notice, request, demand, direction, declaration, and other communication will be deemed delivered on the earlier of (a) _ _[*e.g., 3*]_ _ business days after deposit when deposited in the mail, postage prepaid, addressed as aforesaid; (b) _ _[*e.g., 1*]_ _ business day when sent by facsimile, as long as a confirmation of such facsimile transmission is retained in the sending party's file; (c) _ _[*e.g., 1*]_ _ business day after deposit when deposited with a nationally recognized overnight courier service; or (d) _ _[*e.g., 1*]_ _ business day after hand delivery. Either party may

change its address or facsimile number by a communication in accordance with this Agreement.

12.8 *Inconsistent Action by EAT*. EAT agrees that it will take no actions regarding the Subject Properties that are inconsistent with this Agreement, the Loans, or the Lease. EAT further agrees that at no time during the term of this Agreement will it make an assignment for the benefit of creditors, file a petition in bankruptcy, petition or apply to any tribunal for any receiver or trustee, or commence any proceeding relating to itself under any bankruptcy, reorganization, dissolution, or liquidation law or statute of any jurisdiction, or otherwise indicate its consent to, approval of, or acquiescence of any such proceeding.

12.9 *Indemnification*. If EAT or any other of the Indemnified Parties becomes involved in any claim, investigation, proceeding, or suit in connection with the ownership of the Subject Properties, the Exchange, or this Agreement, or any document or instrument entered into in connection with (a Claim), then on written notice from any of Indemnified Parties to Exchanger of such Claim, Exchanger agrees to indemnify and save EAT and Indemnified Parties harmless from all loss, cost, damages, expenses, and attorney fees suffered or incurred by EAT or any other of Indemnified Parties as a result of such Claim, except to the extent EAT or any other of Indemnified Parties is liable for such Claim as a result of its gross negligence, willful misconduct, or breach of its obligations under this Agreement or the Lease.

12.10 *Notice and Consultation*. EAT agrees that it will notify Exchanger of any Claim that may give rise to a right of indemnification under _ _[*e.g., Section 12.9*]_ _ or any Environmental Claim under _ _[*e.g., Section 11*]_ _ of this Agreement. After Exchanger has acknowledged in writing that it is indemnifying EAT (and any other Indemnified Parties) with respect to such Claim, Exchanger will be entitled to assume the defense of such Claim by counsel approved by EAT, whose approval will not be unreasonably withheld.

12.11 *Counterparts*. This Agreement may be executed in counterparts, each of which will be deemed an original and all of which constitute one and the same instrument.

12.12 *Arbitration of Disputes*. Any dispute arising from this Agreement, whether for interpretation or enforcement of its terms, will be determined and settled by arbitration under the then prevailing commercial rules of the American Arbitration Association, provided that each party will be entitled to engage in discovery to the same extent as would be permitted under California Code of Civil Procedure §§2016.010-2036.050, if arbitration were subject to the jurisdiction of the California courts. Arbitration will be held at _ _[*address*]_ _ in _ _[*city*]_ _. Any award rendered in such arbitration will be final and binding on each party and judgment may be entered in the appropriate Superior Court of the Forum State.

NOTICE: BY INITIALING IN THE SPACE BELOW YOU ARE AGREEING TO HAVE ANY DISPUTE ARISING FROM THE MATTERS INCLUDED IN THIS "ARBITRATION OF DISPUTES" PROVISION DECIDED BY NEUTRAL ARBITRATION AS PROVIDED BY _ _[*e.g., CALIFORNIA*]_ _ LAW, AND YOU ARE GIVING UP ANY RIGHTS YOU MIGHT POSSESS TO HAVE THE DISPUTE LITIGATED IN A COURT OR JURY TRIAL. BY INITIALING IN THE SPACE BELOW YOU ARE GIVING UP YOUR JUDICIAL RIGHTS TO DISCOVERY AND APPEAL, UNLESS SUCH RIGHTS ARE SPECIFICALLY INCLUDED IN THE "ARBITRATION OF DISPUTES" PROVISION. IF YOU REFUSE TO SUBMIT TO ARBITRATION AFTER AGREEING TO THIS PROVISION, YOU MAY BE COMPELLED TO ARBITRATE UNDER THE AUTHORITY OF THE _ _[*e.g., CALIFORNIA*]_ _ CODE OF CIVIL PROCEDURE. YOUR AGREEMENT TO THIS ARBITRATION PROVISION IS VOLUNTARY.

WE HAVE READ AND UNDERSTAND THIS PROVISION AND AGREE TO SUBMIT DISPUTES ARISING FROM THE MATTERS INCLUDED IN THE "ARBITRATION OF DISPUTES" PROVISION TO NEUTRAL ARBITRATION.

_____ EAT _____ EXCHANGER

12.13 *Entire Agreement*. This Agreement constitutes the entire agreement between the parties to this Agreement concerning the subject matter of it, and no other written or oral agreements exist between the parties concerning the subject matter of this Agreement that are not expressly set forth in this Agreement. This Agreement may not be modified, amended, or otherwise changed in any manner except by a writing executed by all parties to this Agreement.

12.14 *Time of the Essence*. Time is of the essence in this Agreement.

12.15 *Additional Documents*. All parties agree to execute any and all additional documents or instruments necessary to carry out the terms of this Agreement. The costs incurred in preparing any

documents needed to conclude the transfer of the Relinquished Property or the Replacement Property will be borne by the party on whose behalf the documents are prepared.

12.16 *Attorney Fees and Costs*. In the event of any litigation or arbitration (under _ _[*e.g., Section 12.12*]_ _) between the parties to enforce any provision of this Agreement or any right of either party to this Agreement, the unsuccessful party to such litigation or arbitration agrees to pay to the successful party all costs and expense (including reasonable attorney fees) at arbitration, trial, or on appeal, incurred by the successful party, all of which may be included in and as part of the judgment rendered in such litigation or arbitration.

12.17 *Joint and Several Rights and Obligations*. If more than one person is executing this Agreement as Exchanger, all representations, warranties, rights, obligations, and liabilities are joint and several, provided that, in such event, EAT has no obligation to follow any instructions unless given by all Exchangers (unless such other persons have, in writing, authorized one Exchanger to act on their behalf).

13. Tax Issues

13.1 *Tax Advice*. Neither party will assume responsibility, or be liable to the other, for the tax consequences to the other party arising from Exchange contemplated by this Agreement. Exchanger has consulted with its own advisers on the tax and legal aspects of Exchange transaction and has not relied on EAT or its principles or professional advisers for any tax or legal advice.

14.2 *Tax Reporting Requirements*. In accordance with the Rev Proc, the parties further agree that, despite anything in this Agreement to the contrary (a) EAT will acquire the Replacement Property and hold it for the benefit of Exchanger in order to facilitate an exchange under Internal Revenue Code §1031 and the Rev Proc; (b) each party will report the acquisition, holding, and disposition of the Replacement Property as provided in the Rev Proc; (c) EAT will be treated as the beneficial owner of the Replacement Property for all federal tax purposes; and (d) both EAT and Exchanger will report the federal income tax attributes of the Replacement Property on their respective federal income tax returns in a manner consistent with this Agreement.

Comment: On tax reporting requirements, see discussion in §§5.22-5.24.

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.62 O. Form: Signatures

§5.62 O. Form: Signatures

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5.62-1 Signatures

IN WITNESS WHEREOF, Exchanger and EAT each have caused this Agreement to be duly executed according to proper authorization as of the day and year first written above.

Exchanger: _ _[*NAME OF LIMITED LIABILITY COMPANY*]_ _,
a _ _[*state of organization*]_ _ **Limited Liability Company**

EAT:

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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Source: Real Property/Real Property Exchanges/5 'Reverse' and Construction Exchanges/§5.63 P. List of Exhibits

§5.63 P. List of Exhibits

The following are the exhibits to be attached to the form Agreement in §§5.42-5.62:

- Exhibit A—Replacement Property Description;
- Exhibit B—Copy of the Lease; and
- Exhibit C—Relinquished Property Identification Form.

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VI. ANCILLARY FORMS

§5.64 A. Form: Escrow Instructions: Acquisition by EAT

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5.64-1 Escrow instructions: acquisition by EAT

_ _[*Name of title company or settlement agent*]_ _
_ _[*address*]_ _
Re: Acquisition by _ _[*EAT name*]_ _ of Real Property Located at _ _[*address/other identification*]_ _ of Replacement Property
Our File No. _ _ _ _ _ _
Your Escrow No. _ _ _ _ _ _

Dear _ _[*Name of escrow or settlement officer*]_ _:

_ _[*Full name of exchange accommodation titleholder*]_ _ **(EAT) has entered into that certain Qualified Exchange Accommodation Arrangement (QEAA) with _ _[*full name of exchanger*]_ _ (Exchanger) under which Exchanger has assigned to EAT all of Exchanger's rights to acquire that certain property described as _ _[*address/other identification of Replacement Property*]_ _ (Subject Property).**

The following are EAT escrow instructions regarding this transaction. EAT will acquire the Subject Property at the price set forth in the purchase agreement entered into by and between Exchanger and _ _[*name of seller of replacement property*]_ _ (Seller), as this amendment may be amended, by mutual agreement, before the closing date.

EAT will acquire the Subject Property using loan proceeds from _ _[*name of lender, e.g., institutional lender/Qualified Intermediary/Exchanger*]_ _ (collectively, Lenders). A loan schedule of the amounts to be lent by each Lender to EAT will be provided to you by Exchanger before closing.

EAT will take title to the Subject Property, subject to all existing liens and encumbrances, other than those for taxes that are due and payable, and other liens and encumbrances that Seller has agreed to remove before closing. EAT will be charged all closing costs, transfer taxes, and other charges that Exchanger has agreed will be paid for by the purchaser under the purchase agreement.

Please create a Subescrow for an accounting of all credits and debits, as between Seller and EAT, with respect to: secured real property taxes, secured personal property taxes, security deposits, prepaid rent, homeowners' association dues, common area maintenance charges, and all other operating expenses with respect to the Subject Property. To the extent that there is a net credit in favor of the purchaser, you will apply this credit on account of the purchase price; to the extent that there is a net debit, you will charge EAT for this amount (and Exchanger will fund this additional amount, in addition to the amounts it is required to fund for the purchase price and closing costs). However, in order for EAT to properly book this transaction, these amounts must be segregated from the purchase price/closing cost escrow, and accounted for separately.

In connection with the acquisition, EAT is entering into a lease (the Lease) with _ _[*name of tenant*]_ _ (Tenant), and Tenant is responsible for obtaining insurance showing EAT as an insured party with respect to the Subject Property, and liability insurance. You must obtain the approval, by EAT, to the certificate of insurance *before* the closing of your escrow. In addition, it is a condition of closing that Tenant have executed the Lease; please provide to EAT, before closing, a signed copy of the Lease (if EAT has received this outside of escrow, EAT will waive this condition before closing).

At closing, you are to issue your Land Title Association Owner's Policy of Insurance (Policy), showing EAT as the named insured for the full amount of the purchase price, with endorsement Number _ _ _ _ _ _ (for 6-

month binder), and such other endorsements as required by Exchanger under the purchase agreement. Please send the Policy to the undersigned.

Please fax your proposed _ _[*escrow/settlement*]_ _ statement for approval to both (i) the undersigned and (ii) Exchanger; Exchanger's facsimile number is _ _[*number*]_ _. You may not close this transaction without both EAT and Exchanger approving your estimated _ _[*escrow/settlement*]_ _ statement.

To ensure that this transaction complies with Rev Proc 2000-37, both EAT and Exchanger require that you deliver to EAT your certified final _ _[*escrow/settlement*]_ _ statement *within 10 business days after* closing. Doing so will ensure that EAT properly reports the ownership of the Subject Property, on its books and records, in a manner consistent with Rev Proc 2000-37.

Please confirm your receipt of this letter and agreement to act in accordance with the instructions in it by executing a copy and returning it to the undersigned both by facsimile and mail. Please direct all preclosing questions and documents relating to this escrow to the undersigned at the telephone number and address indicated below.

Please be further advised that EAT will transfer the Replacement Property to Exchanger; it is Exchanger's intention to do so in a transaction using the services of a Qualified Intermediary to comply with Internal Revenue Code §1031 (to qualify the entire transaction as a tax-deferred exchange), and in such transaction we intend to use your company's services, and to consummate this second transfer with you, within 180 days after the closing date of this transaction. We look forward to working with you on that transaction, as well.

In the meantime, if you have any questions about this transaction, please do not hesitate to contact the undersigned.

Very truly yours,
__[*Signature*]__
_ _[*Typed name*]_ _

cc: Exchanger, by facsimile copier

_ _[*NAME*]_ _ **TITLE INSURANCE COMPANY ACCEPTS THE FOREGOING ESCROW INSTRUCTIONS.**

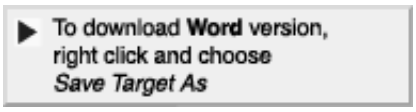
Date: _ _ _ _ _ _

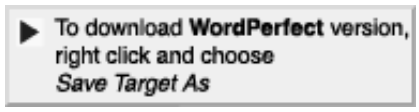
_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **Corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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§5.65 B. Form: Phase I Closing Letter





5.65-1 Phase I closing

_ _[*Exchange client name*]_ _
_ _[*Exchange client address*]_ _

Re: Property Located at: _ _[*replacement property address*]_ _
Owned by _ _[*name of EAT*]_ _ **(EAT)**
Our File No. _ _[*EAT file no.*]_ _

Dear _ _[*name of exchanger*]_ _**:**

This letter is to inform you that under the Qualified Exchange Accommodation Arrangement (QEAA) between you and the EAT, the EAT acquired the above-described real property (Replacement Property) on the acquisition date.

You have 45 days after the date of the EAT's acquisition to identify to the EAT, in writing, the property or properties that you intend to use as your "Relinquished Property" in this transaction. The 45th day is _ _[*date*]_ _**. If the Relinquished Property has been expressly identified in the QEAA, you need do nothing further unless you desire to revoke that identification and identify other Relinquished Property, also before the end of the 45th day. Once the 45th day has passed, you will not be able to identify any other or more properties as the Relinquished Property.**

Identification of the Relinquished Property can be made in either of the following ways: You may identify 3 properties, using the form titled "Relinquished Property Identification Form (3 Properties)" or the form titled "Relinquished Property Identification Form (200% Rule)" both of which are attached as Exhibits to the QEAA.

***Use only ONE of these types of forms; e.g., do not use both the "3 properties" form and the "200% Rule" form*. Complete the form that is relevant to your transaction, sign and date the form, and deliver it to the EAT no later than the 45th day.**

In addition, you have the earlier of 180 days after (i) the date of the EAT's acquisition of the Replacement Property (which is _ _[*date*]_ _**), or (ii) the date that you dispose of the Relinquished Property, to complete your exchange. If you do not acquire the Replacement Property from the EAT, as a part of your exchange, within that time period, you will not be able to have the EAT's acquisition of the Replacement Property qualify for the "safe harbor" treatment under Revenue Procedure 2000-37.**

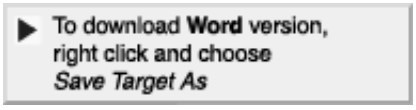
If you have any questions about the subject matter of this letter, or about the identification requirements, please contact the undersigned.

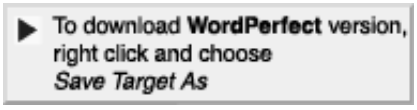
Very truly yours,
__[*Signature*]__
_ _[*Typed name*]_ _

Comment: For a copy of the Relinquished Property Identification Form (3 Properties) and the form titled Relinquished Property Identification Form (200% Rule), see §§4.105 and 4.106 respectively.

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§5.66 C. Form: Escrow Instructions—Transfer From EAT to Exchanger





5.66-1 Escrow instructions; transfer from EAT to exchanger

_ _[*Name of title or escrow company/settlement agent*]_ _
_ _[*address*]_ _

Re: Transfer of Property Located at _ _[A*ddress/other identification of replacement property*]_ _ **from** _ _[*name of exchange accommodation titleholder*]_ _ **to** _ _[*name of exchanger*]_ _

Your Escrow No. _ _[_ _ _ _ _ _]_ _
Our Reference No.: _ _[_ _ _ _ _ _]_ _

Dear _ _[*Name of escrow or settlement agent*]_ _**:**

We represent _ _[*name of Exchange Accommodation Titleholder)*]_ _ **(EAT), the current owner, and the seller (Seller) of the real property that is the subject of the above-referenced escrow (Subject Property). Seller has previously entered into that certain Qualified Exchange Accommodation Arrangement (Agreement) with** _ _[*name of exchanger*]_ _ **(Transferee), under which Seller agreed to transfer the Subject Property to Transferee for the sum of $**_ _[*dollar amount*]_ _ **(Price) to be paid for in the manner set forth below.**

Transferee is to be charged with all closing costs, including escrow fees, recording expenses, title insurance premiums, and any costs to pay off any loans. Note that Seller has previously entered into a lease (Lease) with respect to the Subject Property with _ _[*name of tenant*]_ _ **(Tenant), under which Tenant is entitled to all rental income with respect to the Subject Property and is responsible for the payment of all property taxes, insurance, interest payments on secured debt, and other costs of owning and operating the Subject Property. Therefore, these items should be shown as a Subescrow between Tenant and Exchanger and should not be shown as credits or debits as between Seller and Exchanger, provided that you are instructed to deliver to Seller, on closing, a copy of the Subescrow statement showing prorations of all of these items as between Exchanger and Tenant. You can contact Tenant at** _ _[*tenant's contact information*]_ _ **to obtain this information.**

The following paragraphs need to be deleted or modified, as the particular transaction requires:

A. In connection with Seller's ownership of the Subject Property, Seller obtained a loan from _ _[*name of qualified intermediary*]_ _ **(QI) in the outstanding principal amount of $**_ _[*dollar amount*]_ _**. Because the QI is also acting as the Transferee's qualified intermediary in connection with Transferee's tax-deferred exchange, and under that exchange QI is obligated to expend the sum of $**_ _[*dollar amount*]_ _ **as exchange proceeds on account of the previous sale and transfer of Transferee's relinquished property on the Seller's Settlement Statement, you will show that the loan is being deemed extinguished by the application of the same sum to be shown as exchange proceeds. Any additional money owed on account of the Price will be deposited by either QI or Transferee. Seller and QI have arranged for the original note to be marked canceled by and returned directly to Seller. If there currently is a lien against the Subject Property in favor of QI, you are to obtain a reconveyance of that lien from QI *before* transferring title to Transferee.**

B. The Subject Property is also subject to the following financing (the Loans): a _ _[*name of security instrument*]_ _ **in favor of** _ _[*name of institutional lender*]_ _**, which secures a promissory note in favor of** _ _[*name of institutional lender*]_ _ **with a current outstanding balance of approximately $**_ _[*dollar amount*]_ _**. Transferee will** _ _[*assume/take title subject to*]_ _ **this loan. You must request a current balance from** _ _[*name of institutional lender*]_ _ **before closing.**

C. You will be receiving Escrow Instructions and net exchange proceeds from _ _[*name of qualified intermediary*]_ _ **(QI) in connection with the transfer of the Subject Property to QI, or at the direction of QI**

directly to Transferee. If the net exchange proceeds, and any new financing being provided to Transferee by another lender, are not sufficient to pay the Price, Transferee will either assume the existing Loans or take title to the Subject Property subject to the existing loans. No loan made by Seller is to be canceled for less than the full amount owed.

If you have any questions about the foregoing, please do not hesitate to contact the undersigned. Thank you for your cooperation and assistance.

Very truly yours,
__[*Signature*]__
_ _[*Typed name*]_ _

cc: Exchanger, by facsimile copier

_ _[*NAME*]_ _ **TITLE INSURANCE COMPANY ACCEPTS THE FOREGOING ESCROW INSTRUCTIONS.**

Date: _ _ _ _ _ _

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **Corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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6

Planning and Implementing the Real Estate Exchange

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§6.1 I. INTRODUCTION

Like-kind exchange transactions vary from a simple simultaneous swap of property by two taxpayers to complex transactions involving the realignment of an entire real estate portfolio. A considerable amount of expertise is available in the form of institutional intermediaries and other exchange professionals who are well versed in the procedures necessary to comply with the relevant like-kind exchange safe harbors. This chapter assumes that the taxpayer will engage a competent and experienced intermediary to orchestrate the minutiae of the transaction. This assumption is not merely a matter of convenience. Because most taxpayers want to avail themselves of the advantages of the constructive receipt safe harbors of Reg §1.1031(k)-1(g) (see §§4.36-4.69), it is likely that most like-kind exchanges will involve a qualified intermediary (QI) who generally cannot be the taxpayer's usual attorney and who is usually a person or institution that regularly provides QI services. Accordingly, the purpose of this chapter is to highlight the key procedural mechanics of deferred exchanges and Rev Proc 2000-37, 2000-2 Cum Bull 308, parking transactions, rather than to provide a detailed guide applicable to every transaction.

The substantive rationale for the procedures is the central topic of chaps 1-5.

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§6.2 II. IMPLEMENTING THE SAFE-HARBOR DEFERRED EXCHANGE

Once the client decides to dispose of relinquished property and proceed with a deferred exchange, the attorney must identify the steps in this process and consider how to complete each one, because each bears on the other to some extent. Obviously, the threshold step is to decide whether to engage in an exchange at all. See §§1.23-1.35 for discussion of factors to be reviewed. Assuming that planning for a deferred exchange will proceed, the discussion in §§6.3-6.17 describes the steps in the process.

NOTE: Sections 6.3-6.17 assume that the taxpayer will engage a qualified intermediary to undertake the exchange. Attorneys or taxpayers undertaking like-kind exchanges either outside of the constructive receipt safe harbors or using a safe harbor other than the qualified intermediary safe harbor should review §§4.36-4.52, 4.58-4.69.

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A. Purchaser's Cooperation With Exchange

§6.3 1. Purchaser's Role in Exchange

The current practice of using a qualified intermediary (QI) (see §§4.53-4.57) to complete a like-kind exchange eliminates the need for the purchaser of the relinquished property to cooperate in the exchange transaction, because the QI is treated as acquiring the replacement property and then exchanging it for the taxpayer's relinquished property. See §2.60. The relinquished property purchaser must only receive notification of the taxpayer's assignment to the QI of the taxpayer's contract rights to sell the relinquished property. Reg §1.1031(k)-1(g)(4)(v). See §4.56. Because most sales contracts contain the seller's representations and warranties that are intended to survive the close of escrow and transfer of title to the purchaser, current practice is (1) to inform the purchaser that the client/seller intends to effect an exchange and (2) to obtain the purchaser's agreement, in the relinquished property purchase contract, to cooperate in completing that transaction, at no additional cost, expense, or liability. The provision in §6.4 is usually acceptable to all parties, but there are many acceptable variations.

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Source: Real Property/Real Property Exchanges/6 Planning and Implementing the Real Estate Exchange/§6.4 2. Form: Purchaser's Agreement to Cooperate

§6.4 2. Form: Purchaser's Agreement to Cooperate

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6.4-1 Purchaser's agreement to cooperate

Purchaser acknowledges that Seller is disposing of the subject property in a transaction intended by Seller to qualify as a like-kind exchange under Internal Revenue Code §1031 (Exchange), and that Seller will assign this Agreement to a qualified intermediary (QI) to complete the Exchange. Purchaser agrees to cooperate with Seller to effect such Exchange as long as (i) Purchaser incurs no additional expense or liability, and (ii) after the close of escrow and transfer of title to Purchaser, Seller shall remain liable for all of Seller's representations and warranties that will survive the close of escrow under this Agreement, notwithstanding the assignment of this Agreement to QI.

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§6.5 B. Engaging the Qualified Intermediary

As soon as the buyer has executed the agreement to purchase the relinquished property, depending on the number of contingencies to be removed and the length of the contingency removal period, the client should contact whomever it has selected to act as the qualified intermediary (QI). See §§4.53-4.57 for discussion of the issues surrounding the selection of the QI. The process and procedures for documenting the delayed exchange are now so uniform and streamlined that a QI generally needs only a few business days to complete the documentation and submit it to the escrow/closing agent. However, it is prudent to provide additional time in order to avoid misunderstandings and mistakes that can result from overly hasty preparation of exchange documents and instructions. If the QI will be required to handle any withholding and tax reporting for nonresident alien owners, the taxpayer's attorney must make further inquiries to ensure that the QI understands this process and that ample time is allowed to obtain the requisite exemptions. See §6.9. IRC §§897, 1445, 6045(e); Rev & T C §18662.

PRACTICE TIP: In light of several well-publicized QI failures in 2007 and 2008, advisors and taxpayers must consider how much assurance of a QI's stability and solvency they will require. Verifying those attributes is essential. Although the authors do not believe that only QIs owned by regulated financial institutions should be considered, they certainly believe that the taxpayer and advisor should undertake adequate due diligence regarding the stability of the QI and the assurance that exchange funds will be available to complete the exchange transaction. See Marques and Weller, *Security of Funds in 1031 Like-Kind Exchanges,* Journal of Passthrough Entities, CCH (Jan.-Feb. 2009). See also §4.68A.

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C. Closing Sale of Relinquished Property

§6.6 1. Assignment of Contract to Qualified Intermediary; Notice to Purchaser

The exchange agreement usually provides for the taxpayer's assignment of the purchase agreement to the qualified intermediary (QI). See section 3.3 of form 4.79-1. Typically, the taxpayer instructs the escrow agent to notify the purchaser of this assignment at closing. See form 4.108-1 (Phase 1 Escrow Closing Letter). Because the purchaser is not required to act, there is no need to notify the purchaser earlier (unless the purchaser is giving its own note toward the purchase price, and the taxpayer wants the payee to be the QI, rather than the taxpayer).

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§6.7 2. Separate Assignment of Contract to Qualified Intermediary; Consent of Purchaser

Some qualified intermediaries (QIs) do not provide in the exchange agreement with the taxpayer for the assignment of the relinquished property sales agreement—instead, they put the assignment in a separate document. Sometimes this assignment requires the purchaser's consent. This format reflects procedures that predate adoption of the deferred exchange regulations and is generally not desirable from the taxpayer's perspective, because it may require cooperation from the relinquished property buyer. See §6.8 for a form of assignment and consent.

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Source: Real Property/Real Property Exchanges/6 Planning and Implementing the Real Estate Exchange/§6.8 3. Form: Relinquished Property Contract Assignment Agreement

§6.8 3. Form: Relinquished Property Contract Assignment Agreement

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6.8-1 Relinquished property contract assignment agreement

THIS ASSIGNMENT AGREEMENT (Agreement) is entered as of _ _[*date*]_ _**, into by and between** _ _[*name of exchanger*]_ _**, (Exchanger) and** _ _[*name of qualified intermediary*]_ _**, a** _ _[*legal entity type and state of organization*]_ _ **(QI).**

Exchanger and QI have entered into an agreement for exchange of property by which QI will act as a "qualified intermediary," as that term is defined by Reg §1.1031(k)-1(g)(4) on Exchanger's behalf in connection with a like-kind exchange of property by Exchanger.

Exchanger and _ _[*name of purchaser of Relinquished Property*]_ _ **(Buyer) have entered into that certain** _ _[*title of purchase agreement for Relinquished Property*]_ _ **dated** _ _[*date of purchase agreement*]_ _**, as amended to date (Purchase Contract) in which Exchanger agreed to sell fee title to that certain real property, described in Exhibit A attached to and incorporated in this Agreement by this reference, located at** _ _[*description of property: street address, city, county and state/tax parcel number, city, county, state*]_ _ **(Relinquished Property).**

Exchanger desires to assign to QI all of Exchanger's rights in the Purchase Contract to transfer the property and to receive the proceeds from this transfer in connection with the exchange of property between Exchanger and QI.

Therefore, Exchanger transfers and assigns to QI all of Exchanger's rights in the Purchase Contract, and any consideration paid by Buyer to Exchanger or to the escrow agent handling this transaction, and QI accepts such assignment.

IN WITNESS WHEREOF, the parties to this Agreement have executed it as of the dates shown above. Despite the foregoing, this Agreement shall be null and void if Buyer does not purchase the Relinquished Property from QI under the terms of the Purchase Contract.

Exchanger:

Date: _ _ _ _ _ _

_ _[*NAME OF LIMITED LIABILITY COMPANY*]_ _,
a _ _[*state of organization*]_ _ **Limited Liability Company**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

QI:

Date: _ _ _ _ _ _

_ _[*NAME OF CORPORATION*]_ _,
a _ _[*state of incorporation*]_ _ **Corporation**

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

CONSENT OF BUYER

The undersigned party consents to this Assignment Agreement, *provided* that this consent shall in no way be deemed to release either Exchanger or the undersigned from any of Exchanger's or the undersigned's

agreements, representations, warranties, or indemnifications set forth in the Purchase Contract that are to survive the close of the escrow and the transfer of the Relinquished Property to Buyer, nor shall this Agreement be deemed to enlarge the rights, duties, or obligations of any party under the Purchase Contract.

BUYER:

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

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Source: Real Property/Real Property Exchanges/6 Planning and Implementing the Real Estate Exchange/§6.8A 4. Relinquished Property Sale Contract Deposits

§6.8A 4. Relinquished Property Sale Contract Deposits

A taxpayer who receives any deposit funds relating to the relinquished property and wishes to avoid having them treated as boot in the exchange must tender the equivalent amount of money to the qualified intermediary (QI) or the escrow agent before closing the transfer of the relinquished property to the buyer. Under normal tax principles that defer determination of the tax consequences of receiving deposits until the transfer occurs, this should avoid the taxpayer's deemed receipt of boot in the transaction. Rev Rul 69-93, 1969-1 Cum Bull 139. See §3.13.

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§6.9 5. Closing Mechanics

The escrow agent then prepares settlement statements for the seller/taxpayer, the QI, and the purchaser. After the taxpayer, purchaser, and QI approve and sign all statements, and the taxpayer signs and delivers the deed to the relinquished property naming the purchaser as the grantee (see §§2.62-2.64 for discussion of direct deeding), the escrow agent delivers the deed directly to the purchaser and delivers all exchange proceeds to the QI. The escrow agent delivers directly to the taxpayer any cash being "pulled out" at closing or any purchase money note.

The QI will hold the net exchange proceeds pending the taxpayer's direction to deposit them into the escrow for the replacement property. If the property being sold is real property and the seller is a nonresident alien of the United States, or if a partner or member of the seller is a nonresident alien of the United States (because such person is not subject to U.S. income tax and not required to file a U.S. tax return), both federal and California taxing authorities require either (1) the seller to obtain an exemption from withholding (on the ground that the proceeds will be reinvested in an IRC §1031 exchange) or (2) the escrow agent to withhold 10 percent (federal) and 3-1/3 percent (California) of the gross selling price to ensure that taxes are paid. IRC §§897(c), 1445(a), 1445(f)(4); Rev & T C §18662. These laws impose the withholding obligation on the escrow agent. Exemptions from withholding are available from both the federal government and the state tax agency involved, but they take some time to obtain (generally a few weeks). If the escrow agent is not given sufficient time to obtain the exemptions, the agent may require the QI to assume the liability for withholding as a condition to disbursement of the proceeds to the QI.

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§6.10 D. Locating, Identifying, and Contracting for Replacement Property

During the 45-day identification period following transfer of the relinquished property (see §4.16), the taxpayer must make some significant decisions, often without the comfort of sufficient information or time to process all of the information. Accordingly, the taxpayer should begin the search for the replacement property *before* the close of the sale of the relinquished property. This does not necessarily mean that the taxpayer should sign a purchase contract for the replacement property, but the process of looking for properties can reveal useful information about both general market conditions and specific properties, so that the taxpayer is better prepared when it must narrow its search and identify potential replacement properties. The taxpayer may also use this time to prequalify for financing for the replacement property, which is helpful when lenders are unable to give a quick response because of other business demands.

A replacement property acquired during the 45-day identification period qualifies as "replacement" property under IRC §1031(a)(3). See §4.19. Ideally, the taxpayer should be in a position to identify, contract for, and close on a property soon after closing escrow for the relinquished property. During the time after the sale of the relinquished property until the escrow for the acquisition of the replacement property is getting ready to close, the QI's tasks are minimal.

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§6.11 1. Deposits Toward Purchase of Replacement Property

Once the purchase contract for the replacement property has been signed (see §§6.12-6.13 for discussion of contract language), the qualified intermediary (QI) may be asked to make a deposit into the escrow for the replacement property. Strictly speaking, until the contract is assigned to the QI, the QI is not a party to the escrow, and thus any disbursement of funds in connection with a replacement property purchase could be deemed a disbursement to the taxpayer in violation of the limits imposed by Reg §1.1031(k)-1(g)(6). This is likely to cause the exchange to fail owing to the taxpayer's being deemed in constructive receipt of funds held by the QI.

Prudent practice is to have the taxpayer assign to the QI the purchase contract for the replacement property, so that the QI has privity of contract with the seller and the escrow agent. When the initial deposit is made, however (and perhaps at the time any required increase to the deposit is made), the taxpayer may still be completing its due diligence, obtaining financing, and otherwise removing contingencies. This may be too early to assign the contract to the QI, because once assigned, the QI (instead of the taxpayer) must "sign off" on all of these pending matters.

Another approach is for the taxpayer to make the deposits on the purchase price from nonexchange funds until all contingencies are removed. The contract can then be assigned to the QI without the QI's further involvement in negotiating the purchase terms. Then, when the QI delivers funds into escrow for acquisition of the replacement property, to the extent that the QI has sufficient funds, the QI can not only make the required deposit but can also fund sufficient additional amounts with instructions to the escrow agent to reimburse the taxpayer for deposits previously made by the taxpayer.

PRACTICE TIP: Escrow agents appreciate being told in advance that the property is being acquired in an IRC §1031 exchange. The taxpayer should provide the agent with the name and contact information of the QI. The escrow agent and the QI will work together to close the acquisition of the replacement property, and it is helpful if the two communicate with each other well in advance of the closing date.

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Source: Real Property/Real Property Exchanges/6 Planning and Implementing the Real Estate Exchange/§6.12 2. Seller's Cooperation With Exchange

§6.12 2. Seller's Cooperation With Exchange

The purchase contract for the replacement property should include specific language obligating the seller to cooperate with the taxpayer's IRC §1031 exchange. This is because, unlike the disposition of the relinquished property (which requires only that the escrow agent *notify* the buyer that the sales agreement has been assigned by the selling taxpayer to the qualified intermediary (QI)), the §1031 regulations require that, on the QI's acquisition of the replacement property, the seller of that property actually *consent in writing* to the assignment. See escrow letter, form 4.111-1, and consent to assignment, form 4.109-1. The language in §6.13 will suffice to obligate the seller to cooperate.

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§6.13 3. Form: Seller's Agreement to Cooperate

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6.13-1 Seller's agreement to cooperate

Seller acknowledges that Purchaser is acquiring the subject property in a transaction intended by Purchaser to qualify as a like-kind exchange under Internal Revenue Code §1031 (Exchange), and that Purchaser will assign this Agreement to a qualified intermediary (QI) to complete the Exchange. Seller agrees that, at closing, it shall sign a form acknowledging its consent to the assignment of this Agreement to QI. Seller further agrees to cooperate with Purchaser to effect such Exchange, provided that Seller incurs no additional expense or liability, and further provided that, after the close of escrow and transfer of title to Purchaser, both parties shall remain liable for all of their respective covenants, representations, and warranties that will survive the close of escrow under this Agreement, despite Purchaser's assignment of the Agreement to QI.

[*If applicable, add the following option*]

[*Option: Purchaser to sign purchase money debt instrument*]

Despite the foregoing, Seller shall only be required to accept, on account of Purchaser's purchase money obligation described in section _ _ _ _ _ _ of this Agreement, a _ _[*promissory note and deed of trust/mortgage/specified other collateral*]**_ _ duly executed by Purchaser.**

Comment: When the taxpayer is negotiating to pay a part of the purchase price by the taxpayer's own debt instrument (*e.g.*, a purchase money note), the optional language should be used to require the taxpayer to sign the debt instrument in order to allay any fears of the seller that the note might be executed by the QI instead of the taxpayer.

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§6.14 E. Closing Purchase of Replacement Property

When all contingencies under the purchase contract are removed and the parties are prepared to close the escrow on the replacement property, the taxpayer should inform the qualified intermediary (QI) that the taxpayer is ready to close the escrow. Generally, the QI will need a few days to prepare the documentation for the acquisition of the replacement property, consisting of the replacement property contract assignment agreement (see form 4.110-1), and the phase 2 escrow instructions (see form 4.111-1). The taxpayer must inform the QI if it expects to receive a refund of any deposits that the taxpayer previously made into escrow so that QI can revise the escrow instructions to provide for the refund. Other modifications to the escrow instructions might also be needed. For example, if the seller of the replacement property agrees to accept the note and collateral held by the QI from the sale of the relinquished property, then the QI must assign the note to the seller at closing and the taxpayer and seller must (1) agree on the value of the note (if other than face value, which is usually the case), (2) agree on the note's lien priority, and (3) describe any additional collateral that the taxpayer will provide to further secure the note.

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Source: Real Property/Real Property Exchanges/6 Planning and Implementing the Real Estate Exchange/§6.15 1. Overfunding Concerns

§6.15 1. Overfunding Concerns

Generally, at the time the relinquished property escrow is closing, the escrow agent cannot predict precisely the amount of funds that the qualified intermediary (QI) will need to deposit to complete the acquisition of the replacement property. Thus QIs usually overfund in order to ensure that the escrow will close without an additional call for funds. The QI must be careful to specifically instruct the escrow agent what to do if there are excess proceeds that belong to the taxpayer. If the taxpayer has not yet been reimbursed for all deposits and expenses the taxpayer made on account of the purchase of the property (excluding nonqualifying expenses), the excess proceeds may be disbursed to the taxpayer to reimburse those payments, because they are properly payable from exchange proceeds. Otherwise, the excess should be refunded to the QI, whose instructions should so provide. See escrow instructions in form 4.111-1. The QI will then treat the refund as a credit on account of the taxpayer's exchange credit, and will disburse that amount along with any other remaining exchange credit under the terms of the exchange agreement and Reg §1.1031.

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§6.16 2. Transfer of Title to Taxpayer

On the closing of the acquisition of the replacement property, title to the property may be deeded directly to the taxpayer. As with the disposition of the relinquished property, there is no need to have the deed or other instrument evidencing title (*e.g.,* bill of sale) pass through the name of the qualified intermediary.

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§6.17 3. Disbursement of Remaining QI Funds

After the purchase of all replacement properties to which the exchanger is entitled under the applicable exchange agreement, the qualified intermediary (QI) may disburse any remaining funds without causing the taxpayer to be treated as having constructively received any previously expended funds. Reg §1.1031(k)-1(g)(6)(iii)(A). When a taxpayer chooses not to proceed with an exchange, the issue of whether funds may be released before expiration of the 180-day exchange period is more problematic. QIs take different positions on whether to undertake an "early release of funds," but most will resist disbursing funds until expiration of the exchange period, because to do so would violate the contractual terms in exchange agreements that are designed to mirror the deferred exchange safe harbor requirements. This is an area in which advance planning and careful drafting may allow additional flexibility. See IRS Letter Ruling 200027028; Weller, *Early Distributions From 1031 Exchange Accounts—Another Look at a Strange New Ruling*, 93 J Tax'n (Aug. 2000).

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§6.18 III. IMPLEMENTING REVERSE EXCHANGE PARKING TRANSACTION UNDER REV PROC 2000-37

As discussed in chap 5, implementing a reverse exchange parking transaction under Rev Proc 2000-37, 2000-2 Cum Bull 308, is more complex than is executing a conventional deferred exchange because of the safe harbor requirements under this revenue procedure. For example, to qualify for the safe harbor for reverse exchanges, the exchange accommodation titleholder (EAT) must acquire "qualified indicia of ownership" (usually legal title) to the parked property and report ownership of the property on its own tax return. This process requires the exchanger and the intermediary to provide finance, management, and control mechanisms that are not necessary in a deferred exchange. Sections 6.18-6.32 briefly address the procedural mechanics of a parking transaction. For a complete discussion of the safe harbor under Rev Proc 2000-37, see §§5.16-5.26.

WARNING: Practitioners are forewarned that non-safe-harbor parking transactions and true reverse exchanges are possible, but variations in finance arrangements and timeframes render the creation of a pro forma transaction template nearly impossible. For that reason, the implementation discussion in this chapter focuses exclusively on parking transactions undertaken in accordance with Rev Proc 2000-37.

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§6.19 A. Negotiating Acquisition of Replacement Property

In a typical reverse exchange, the taxpayer negotiates the purchase terms for the replacement property. Doing so allows the taxpayer to maintain privity of contract with the seller and to negotiate with the seller directly, and not through the exchange accommodation titleholder (EAT), until all conditions are removed.

The taxpayer can undertake acquisition due diligence, execute purchase and sale agreements, and make earnest money, or deposit payments to the seller of the property to be parked with the EAT. In an Exchange Last transaction (see §5.8), the taxpayer's rights and obligations to acquire the property will then be assigned to the EAT before the EAT acquires the property. In an Exchange First transaction (see §5.9), the taxpayer's rights (but not obligations) to acquire the property will be assigned to a qualified intermediary (QI) so that the QI can be deemed to acquire and transfer this property in exchange for its acquisition and transfer of the relinquished property.

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§6.20 B. Engaging the Exchange Accommodation Titleholder (EAT) to Acquire Replacement Property

Although there is usually no need for the exchange accommodation titleholder (EAT) to execute a replacement property purchase and sale agreement as an original party, it is advisable to identify and engage the EAT as early as possible in the process of replacement property disposition. This is because the EAT can better serve the taxpayer if it has enough time to discuss with the taxpayer and its legal and tax counsel, and to arrange for handling, all details necessary to effect the transaction. Issues that need to be discussed and arranged include the following:

- Financing the EAT's acquisition of the replacement property (see §§6.21-6.23);
- Insurance protection for the EAT (see §6.29);
- Management and maintenance of the replacement property during the EAT's "parking" period (see §6.29);
- Any construction of improvements while the EAT owns the replacement property (see §§5.27-5.38); and
- The mechanism for acquiring the replacement property by the taxpayer from the EAT (see §§6.31-6.32).

In addition, pricing for EAT services may vary between service providers and if comparative shopping is in order it should be completed in time to allow implementation of the transaction to proceed without undue haste.

Even though Rev Proc 2000-37, 2000-2 Cum Bull 308, permits the taxpayer and the EAT to enter into the qualified exchange accommodation arrangement (QEAA) up to 5 days *after* the EAT acquires title to the replacement property (Rev Proc 2000-37, §2.03), the QEAA should preferably be created well before the date that the replacement property purchase closing will occur, regardless of whether an Exchange First or Exchange Last structure will be used. Most commercial EATs have developed forms of QEAA agreements that can serve as a basis for discussion, but the attorney should review any proposed form to assure consistency with the client's specific transaction. It is not safe to assume that the EAT's form is comprehensive from a real estate contract perspective or even that it automatically satisfies Rev Proc 2000-37 requirements. This may be particularly true for Exchange First transactions, which are less common than Exchange Last structures and with which some EATs have limited experience.

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§6.21 C. Arranging Financing for Exchange Accommodation Titleholder (EAT) to Acquire Replacement Property in Exchange Last Transaction

Structuring the financing of the replacement property purchase is often the most complex issue in an Exchange Last reverse exchange. Accordingly, the taxpayer, its attorneys, and the exchange accommodation titleholder (EAT) should discuss financing early and thoroughly. Lenders need substantial lead time to review and evaluate requests for financing and may be less cooperative if approached at the last minute. If the seller plans to finance a portion of the purchase price for the purchaser, the attorney must anticipate a way to handle the seller's concerns when the seller discovers that the actual obligor will be the EAT, and that the EAT's balance sheet shows no other assets and virtually no net worth.

Alternatively, if an institutional lender will provide financing, the attorney must ensure that the lender will permit an assumption of the loan (or transfer of the replacement property subject to the loan) when the EAT transfers the replacement property to the taxpayer at the closing of the exchange (when the taxpayer has disposed of the relinquished property). Generally, if the lender anticipates selling the loan to institutional investors, whether in a "conduit" loan program or otherwise, it may be difficult to convince the lender to both make the loan to an EAT (which has no other assets), and then permit the transfer of the property to the taxpayer at no additional cost. Counsel must keep in mind the two-step process of the Exchange Last transaction when creating all financing documentation relating to the initial step: the purchase of replacement property by the EAT.

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§6.22 1. Structuring Principal and Interest Payments

Loans from the taxpayer or the qualified intermediary can be structured to eliminate payments of both interest and principal during the time the exchange accommodation titleholder (EAT) owns the replacement property. Third party lenders, however, may require current payment of interest and, sometimes, principal. If such payments are required, the EAT must be able to make payments as they come due.

Amounts due for interest can be provided by the taxpayer as rent under a triple-net lease of the replacement property from the EAT to the taxpayer. When principal payments are due during the qualified exchange accommodation arrangement (QEAA) period, funds must generally be supplied in a manner that does not create income to the EAT, because it will not receive an offsetting deduction on making the loan principal payments.

One common solution is to provide that the taxpayer will advance loan principal owed to a third party lender as a loan to the EAT. In this way, when the EAT transfers replacement property to the taxpayer to complete the taxpayer's exchange, the taxpayer will be repaid all money lent to the EAT that was used to acquire, or pay down the loan on, the replacement property.

PRACTICE TIP: It is crucial that the taxpayer's attorney ensure that the QEAA, the loan agreement, and the lease are correctly integrated. If the taxpayer as lessee is the source of payments required to be made to a third party lender during the QEAA period, then the lease terms and the loan agreement terms must be consistent. The lease, in turn, should be consistent with both the timeframe and the management, control, and expenses of operation rights and obligations described by the QEAA. Although experienced EATs are familiar with these issues, they are not the party primarily responsible for contractual integration. Lenders and taxpayers, however, might be clear on their objectives, but might not easily comprehend how those objectives are reached when a QEAA and lease is imposed onto a loan agreement. The attorney should be sure that each agreement is effective both alone and in conjunction with any ancillary agreements.

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§6.23 2. Example of Exchange Last Reverse Exchange Financing

The following example illustrates the finances and structure of a typical Exchange Last reverse exchange: Taxpayer (T) arranges for the exchange accommodation titleholder (EAT) to purchase and "park" replacement property that T has negotiated to purchase for $1,200,000. Closing costs are $7,500 and include the buyer's escrow fees, recording costs, and the premium for title insurance policy (with a binder insuring both EAT and the qualified intermediary (QI)). The EAT is charged with $5,800 for property tax prorations and is credited with $3,900 for prorations of rent and security deposits, resulting in a net debit of $1,900. At closing, the EAT borrows $800,000 from an institutional lender (Bank), which requires principal and interest payments amortized over 30 years. T lends the EAT the remaining $409,400 ($400,000 + $7,500 + $1,900) needed to close escrow. The EAT acquires title to the replacement property for a total of $1,209,400 ($1,200,000 price + $7,500 closing costs + $1,900 net prorations), and has two liens against the property, one for $800,000 owed to Bank, and the other for $409,400 owed to T.

T then leases the replacement property under a triple-net lease from the EAT. Under the lease, T is entitled to any rent income received from tenants in possession of the replacement property and pays the EAT a nominal (or no) base rent. The lease also requires T to pay, as additional rent, the following:

- All maintenance and repair costs for the property;
- All premiums for property and liability insurance (with the EAT as a named, or additional, insured);
- Any deductible required under any insurance policy in the event of a claim;
- All property taxes (real and personal); and
- All interest on all secured loans (as a practical matter, T will pay interest only on the $800,000 Bank loan; T's loan to the EAT is interest-free, because it makes no sense for T to pay itself rent and receive interest).

The lease also requires T to make additional advances to the EAT, under their existing loan, in amounts sufficient to cover all principal payments due under the $800,000 Bank loan. Because the lease calls for T to treat all operating expense payments as additional rent, and entitles T to all subtenant lease income, when the EAT acquires the replacement property, T will immediately have rental income of $3,900 (the proration of rent and security deposits) and an additional rent payment (under the lease with the EAT) of $5,800 (the debit for property taxes). T must report payment of property taxes under the lease as additional rent, not as property taxes. Conversely, the EAT will have additional rental income of $5,800 and a corresponding deduction for $5,800, which the EAT will report on its tax return as the payment of property taxes.

Five months after the EAT has acquired the replacement property, T has advanced $4,385 as principal payments on the $800,000 Bank loan. The EAT is now ready to transfer the replacement property to T, to complete T's exchange. (By this time, T has disposed of the relinquished property, and the QI is holding net exchange proceeds of $376,483 for T's exchange.)

The EAT transfers the replacement property to T for $1,209,400 (Bank loan balance of $795,615 ($800,000 − $4,385) plus T's loan balance of $413,785 ($409,400 + $4,385)). T takes title subject to, or assumes, the Bank loan with an outstanding balance of $795,615; the QI deposits $376,483, which will be used to repay, in part, T's loan; and the remaining balance of $37,302 ($413,785 − $376,483) will go unpaid. This amount represents the additional cash consideration that T would have had to provide to acquire the replacement property initially, if T had done a conventional deferred exchange; *e.g.,* the $800,000 Bank loan plus the QI net exchange proceeds of $376,483 would have left a shortfall of $22,917 ($1,209,400 − $1,176,483) on account of the purchase price (plus costs and prorations). The $800,000 Bank loan and the $376,483 of net exchange proceeds deposited by the QI would not have fully covered the purchase price of $1,200,000 plus closing costs. The difference—$23,517 (plus virtually all of the initial closing costs incurred when the EAT acquired the replacement property)—is what T would have had to deposit into escrow if T had acquired the property from the seller in a "forward" delayed exchange. The additional costs are the second set of closing costs incurred by T when it acquires the property from the EAT, plus the EAT's fees and costs charged to T.

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§6.24 D. Financing Issues in Exchange First Transactions

Because the taxpayer will acquire the replacement property at the outset in an Exchange First transaction, the problem of third party reluctance to lend to the exchange accommodation titleholder does not arise, nor does the problem of the future transferability of the property subject to the newly created debt (see §5.9). Instead, the mechanical problems associated with Exchange First transactions relate to the need to balance exchange values and equities when the replacement property is purchased so that the terms of the taxpayer's exchange of relinquished for replacement property can be fixed.

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§6.25 1. Debt Structure

Typically the "down payment" portion of the replacement property purchase price in an Exchange First transaction must be lent to the qualified intermediary (QI) by the taxpayer so that this amount together with new financing can be used to purchase the replacement property. The QI supplies this amount in connection with its acquisition and transfer of this property to the taxpayer (deeding is generally direct from the seller to the taxpayer). Concurrently, the QI acquires the relinquished property from the taxpayer and transfers it to the exchange accommodation titleholder (EAT) (again, generally with deeding direct from taxpayer to EAT). In this transaction, the EAT assumes (or takes subject to) the newly created debt running from QI to taxpayer and also assumes (or takes subject to) preexisting debt encumbering the relinquished property.

Thus, in effect, the cash advance of the relinquished property equity that is needed to implement the Exchange First transaction is represented at the initial closing by a debt from the EAT to the taxpayer. Any equity not represented by this debt can be reflected by third party financing obtained by the EAT that is to be repaid on sale of the relinquished property.

The key to structuring financing of an Exchange First transaction is to make the EAT liable for all debt that will be retired with proceeds of the relinquished property sale, whether the creditor is the taxpayer or a third party.

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§6.26 2. "True-Up" Arrangements to Reflect Value Deviations

One major problem with Exchange First transactions is the potential for a change in the value of the relinquished property from the time the exchange occurs until the time the property is sold by the exchange accommodation titleholder (EAT). Because the balancing of equities must be established at the first step and will generally be represented in whole or part by a loan from the taxpayer, a decrease in the value of the relinquished property from the original estimate (and thus a decrease in equity) will leave the EAT unable to fully retire debt established at the level of the originally assumed equity. Conversely, an increase in the value of the relinquished property will benefit the EAT (as the property owner) unless it is obligated to pay the amount of the increase to the taxpayer as additional purchase price.

Revenue Procedure 2000-37, §4.03(7), 2000-2 Cum Bull 308, specifically allows qualified exchange accommodation arrangements(QEAAs) to provide for positive and negative adjustments on amounts that the EAT owes the taxpayer in an Exchange First arrangement. Unless circumstances dictate otherwise (and this would be unusual) all QEAA agreements for an Exchange First transaction should provide such adjustments of the amounts owing from the EAT to the taxpayer so that alteration of relinquished property value is borne entirely by the taxpayer.

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Source: Real Property/Real Property Exchanges/6 Planning and Implementing the Real Estate Exchange/§6.27 3. Example of Exchange First Reverse Exchange Financing

§6.27 3. Example of Exchange First Reverse Exchange Financing

The following example illustrates the finances and structure of an Exchange Last reverse exchange.

Assume that the taxpayer's relinquished property has an estimated fair market value of $1,000,000 and is subject to $600,000 mortgage. The replacement property is the same property described in §6.23, *i.e.,* it has a purchase price of $1,200,000 and will be financed with a new $800,000 loan from an institutional lender (Bank). The acquisition closing costs are $7,500 and there is a net proration debit of $1,900.

At closing, the taxpayer (T) advances $409,400 to the qualified intermediary (QI) in connection with acquisition of the replacement property and directly borrows $800,000 from Bank. This advance should be divided into two components: $400,000 representing the estimated equity in the relinquished property and evidenced by a non-interest-bearing note and the balance of $9,400 representing a direct payment toward the purchase. T transfers relinquished property to the exchange accommodation titleholder (EAT) under a qualified exchange accommodation arrangement (QEAA) agreement, which provides that the EAT will acquire the property subject to debt totaling $1,000,000 consisting of the existing $600,000 deed of trust and the lien of the new $400,000 debt to the taxpayer. The QEAA provides that, if net proceeds from EAT's sale of the property exceed $400,000, the excess will be paid to T and that, if net proceeds fall below this amount, the debt will be correspondingly reduced.

T then leases back the relinquished property under a triple-net lease from the EAT. Under the lease, T is entitled to any rent income received from tenants in possession of the relinquished property and pays the EAT a nominal (or no) base rent. The lease also requires T to pay, as additional rent, the following:

- All maintenance and repair costs for the property;
- All premiums for property and liability insurance (with the EAT as a named, or additional, insured);
- Any deductible required under any insurance policy in the event of a claim;
- All property taxes (real and personal); and
- All interest on all secured loans (as a practical matter, T will pay interest only on the existing $600,000; T's loan to the EAT is interest-free).

The lease also requires T to make additional advances to the EAT, treated as loans rather than rent, in amounts sufficient to cover all principal payments due under the $600,000 loan.

Five months after the EAT has acquired the relinquished property, T has advanced $5,000 as principal payments on the $600,000 mortgage. The EAT is now ready to sell this property but the gross proceeds after costs of sale will be $975,000. EAT retires the now $595,000 mortgage and applies $5,000 of the proceeds to the loan made by T as tenant, leaving $375,000 to apply to the $400,000 debt. Under the "true-up" clause of the QEAA, T receives this amount and the $25,000 balance is cancelled. EAT has income as a result, but offsets this with a $25,000 loss resulting from the sale.

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§6.28 E. Managing Replacement Property During EAT's Ownership

The taxpayer and the exchange accommodation titleholder (EAT) may enter into an arrangement placing all operational and management responsibility for the replacement property on the taxpayer during the EAT's ownership. Rev Proc 2000-37, 2000-2 Cum Bull 308. See §§5.16-5.26. This arrangement is usually structured as a triple-net lease, with the taxpayer (as tenant) responsible for all maintenance, repair, and restoration if the property is damaged and for payment of all taxes, insurance premiums, and debt service. Two items often needing particular attention are (1) the tenant's responsibility to self-insure the deductible amount under any insurance policy (see §6.29) and (2) the treatment of any "equity buildup" on any amortizing loans that the tenant is responsible for paying (see §6.30).

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§6.29 1. Self-Insurance

There are several ways to handle the self-insurance issue in the triple-net lease. The exchange accommodation titleholder (EAT) could require the taxpayer (tenant) to deposit with the EAT (landlord) the amount of any deductible, but such a requirement is usually seen as overprotective, especially if the EAT is a single-asset entity and the taxpayer has lent the EAT some, if not all, of the funds required to purchase the replacement property. Alternatively, some companies providing EAT services obtain their own supplemental insurance to cover the deductible in order to protect themselves if a claim for property damage is made. Such insurance also protects the EAT in the event of a tort claim, which is possible because the EAT, being thinly capitalized, is subject to having its "corporate veil" pierced, thus subjecting the parent/sole member to liability.

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§6.30 2. Amortizing Loans

The second issue for the drafter of the triple-net lease, amortizing loans, must be addressed to come to the correct result when the replacement property is transferred to the taxpayer in completion of the exchange. See §6.22 and examples in §§6.23, 6.27 for treatment of this issue.

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F. Closing Out the Qualified Exchange Accommodation Arrangement (QEAA)

§6.31 1. Exchange Last

In an Exchange Last reverse exchange, the qualified intermediary's (QI) acquisition of the replacement property on behalf of the taxpayer (with a direct deed from the exchange accommodation titleholder (EAT) to the taxpayer) is no different, in principle, than any QI acquisition of replacement property in a deferred exchange. The EAT, as the seller of the replacement property, receives notification of the assignment to the QI of the taxpayer's rights and obligations under the qualified exchange accommodation arrangement (the taxpayer's purchase agreement). As shown in the example in §6.23, to the extent that the taxpayer has lent money to the EAT to acquire the replacement property, that debt will be treated like any other debt to be paid off from the net exchange proceeds deposited by the QI. Also, because the tenant has received all rental income and paid all expenses, generally there will be no prorations of any operating items as between the taxpayer and the EAT. If the tenant is someone other than the taxpayer, however, issues involving the tenant's loan to the EAT for the principal payments on the amortized debt and prorations of items of income and expense will have to be settled between the tenant and the taxpayer.

Within a reasonable time after the EAT has transferred the replacement property to the taxpayer, the EAT is usually dissolved and its final federal (and where required, state) tax returns are filed.

Further, if the acquisition of the replacement property from the EAT is insufficient to fully defer gain on the relinquished property transferred by the QI, the taxpayer should be able to identify and receive (see §4.16) additional replacement property. In Chief Counsel Advice 200836024, the IRS approved an Exchange Last reverse exchange followed by a deferred exchange that commenced following the sale of relinquished property. Chief Counsel Advice 200836024 also implies, without analysis, that a taxpayer can be repaid the loan made to the EAT to purchase the replacement property during the pendency of the deferred exchange without the payment being characterized as taxable cash boot. See §3.13.

When the relinquished property is not sold and the qualified exchange accommodation arrangement (QEAA) period expires, the taxpayer normally receives title to the property held by the EAT in consideration for assumption of all debt associated with the EAT's acquisition.

NOTE: When the maximum allowable QEAA period of 180 days will expire before sale of relinquished property, the taxpayer may wish to consider whether to convert a Rev Proc 2000-37, 2000-2 Cum Bull 308, QEAA into a non-safe-harbor reverse exchange. There are several pitfalls in doing this at the end of the QEAA period, and is it advisable to decide at the outset of any reverse exchange using a parking arrangement whether to take advantage of the flexibility in arrangements between the taxpayer and the EAT afforded by Rev Proc 2000-37 or to organize a non-safe-harbor arrangement. See discussion in §§5.27-5.34.

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§6.32 2. Exchange First

In the Exchange First structure, sale of the relinquished property by the exchange accommodation titleholder (EAT) to a third party buyer completes the transaction. The taxpayer's involvement is to approve terms of the sale and to receive net proceeds. When no sale materializes within the maximum qualified exchange accommodation arrangement (QEAA) period, the EAT will generally hold a put right to transfer the property back to the taxpayer subject to all existing debt. In any event, the taxpayer will want to recover the relinquished property if it will not be sold, and the QEAA agreement must provide for this possibility.

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7

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§7.1 I. SCOPE OF CHAPTER

Arrangements in which property is co-owned by a group of taxpayers can present planning problems that complicate the analysis of a proposed exchange or sale transaction. Chapter 7 focuses on these issues in four parts. Sections 7.2-7.5 discuss exchanges by entities treated as partnerships for income tax purposes (general and limited partnerships and most multimember limited liability companies) when the entity continues to own and operate the replacement property. Sections 7.6-7.20 discuss exchanges by partnerships when the partners wish to separate their economic interests following the transfer of the relinquished property. Sections 7.21-7.43 discuss exchanges involving the acquisition of property by multiple owners, *e.g.,* transactions in which a partnership or partnership-like ownership of replacement property is desired. Finally, §§7.44-7.45 discuss issues unique to exchanges by corporations.

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§7.2 II. EXCHANGES BY PARTNERSHIPS

Although exchanges of partnership interests are excluded from nonrecognition treatment by IRC §1031(a)(2)(D), a partnership, as the owner of the property, may exchange the property with another partnership, individual, or other entity in a transaction qualifying for like-kind exchange treatment under IRC §1031.

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§7.3 A. Effect of Built-in Gain or Loss

Many partnerships hold appreciated property that one or more of the partners contributed to the partnership. If the value of such property at the time of its contribution was more than (or was less than) its adjusted basis in the hands of the contributing partner, the fair market value of the property is credited to the contributing partner(s) book capital account, and subsequent allocations of income, gain, loss, and deductions relating to the property are allocated among the partners to take into account this "built-in" gain or loss. Reg §1.704-1(b)(1)(vi). Property whose value differs at the time of contribution to a partnership from the contributing partner's adjusted tax basis (*i.e.,* which has built-in gain or loss) is referred to in the regulations as "section 704(c) property." Reg §1.704-3(a)(3)(i). Unless the built-in gain or loss has been cumulatively offset by depreciation deductions allocated to (or away from) the noncontributing partners, on disposition of IRC §704(c) property the contributing partner must be allocated gain or loss equal to the remaining precontribution built-in gain or loss that has not been offset. Reg §1.704-3(a)(2). The purpose of these rules is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss.

To preserve the integrity of this method, a partnership that disposes of IRC §704(c) property in a like-kind exchange under IRC §1031 is required to treat the replacement property as §704(c) property with the same amount of built-in gain or loss as the relinquished property. Reg §1.704-3(a)(8). Thus, future recognized gain on the sale of the replacement property must be allocated to the contributor of the relinquished property.

Any recognized gain in an exchange resulting from the partnership's receipt of boot in a partially deferred §1031 exchange must be allocated to the partners. This allocation must be made using a "reasonable method that is consistent with the purpose of IRC §704(c)." Reg §1.704-3(a)(1). In Letter Ruling 200829023, the IRS held that a "last in, first out" allocation method of taxable gain triggered in a partially tax-deferred exchange of §704(c) property was an appropriate adjustment under Reg §1.704-3(a)(8). IRS Letter Ruling 200829023 involved a real estate trust that elected to be taxed as a partnership for federal income tax purposes. Several partners contributed property to the trust when the property's fair market value exceeded its tax basis. Allocations of income, gain, loss, and deduction with respect to the property were made in accordance with IRC §704(c). As of the date of the proposed exchange, the precontribution built-in gain had not been fully allocated to the contributing partners. In addition, the property had appreciated significantly since its contribution, and several incidences of partner admissions had prompted the trust to increase or "book-up" partnership capital accounts to reflect revaluations in the property. See Reg §1.704-1(b)(2)(iv)(f). These book-ups created so-called "reverse" IRC §704(c) gain attributes.

The trust planned to exchange the property for both like-kind property and boot in the form of cash in a partially deferred exchange under §1031. The amount of taxable gain was expected to be greater than the amount of book gain recognized but less than the sum of the total book gain recognized in the §1031 exchange and the amount of book gain reflected in prior upward revaluations of the property since contribution. In addition, the fair market value of the replacement property acquired would exceed its adjusted carryover basis. Therefore, §704(c) attributes would be preserved in the replacement property in accordance with Reg §1.704-3(a)(8).

The trust proposed to allocate recognized gain first to those partners to whom corresponding book gain was allocated in the §1031 exchange, *i.e.,* in the partners' sharing ratio for postcontribution gain. Then to the extent the tax gain exceeded book gain, taxable gains would be allocated on a "last in, first out" basis to those partners whose capital accounts had been increased to reflect postcontribution gain resulting from prior revaluations, starting with the most recently created layer of postcontribution gain and working back in time until all such previous allocations of postcontribution gain had been matched by reverse §704(c) allocations of excess gain or all of such excess gain had been allocated. Finally, after all gain associated with postcontribution appreciation had been matched with an allocation of excess tax gain, any remaining excess tax gain (none was anticipated) would be allocated to the original contributing partners with respect to the precontribution gain credited to their book capital accounts at the time of contribution.

In Letter Ruling 200829023, the IRS ruled that both the book-equals-tax-gain methodology and the "last in, first out" methodology for allocating taxable gain when there were reverse §704(c) gain layers were appropriate under Reg §1.704-3(a)(8). Further, the ruling stated specifically that no inference should be drawn that there are no other appropriate methods to allocate taxable gain under Reg §1.704-3(a)(8).

As a consequence of IRC §704(c)(1), many partners who contribute built-in gain property to operating partnerships formed by real estate investment trusts will negotiate for "lock-in" provisions, prohibiting the operating partnership from disposing of the contributed property in transactions other than like-kind exchanges (or other nonrecognition transactions) before the point when allocation of the built-in gain to the contributor is no longer mandatory. See Loffman & Present, *Effective Tax-Free Property Contributions to UPREITS and Other Partnerships,* 2 J of Passthrough Entities 27 (May-June 1999).

A complete discussion of the operation of the rules on IRC §704(c) property is beyond the scope of this book. For further guidance, see 1-2 McKee, Nelson, & Whitmire, Federal Taxation of Partnerships and Partners (3d ed 1997).

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§7.4 B. Effect of Mortgage Boot Receipt

Many like-kind exchanges of partnership real property involve disposition of property that serves as collateral for a loan. The existence and ultimate retirement of debt has several consequences under general principles of partnership tax law. Under IRC §752(a), an increase in a partner's share of the liabilities of a partnership is treated as if the partner contributed an equal amount of money to the partnership. This increases basis in that partner's interest in the partnership. Under the mirror provision, IRC §752(b), a decrease in a partner's share of the liabilities of a partnership is treated as if the partnership distributed an equal amount of money to that partner. This treatment reduces the basis in the partner's interest in the partnership and, when the amount of the deemed distribution exceeds the remaining basis in that partner's partnership interest, causes a recognition of gain. IRC §731(a)(1). On how a partnership should account for offsetting "mortgage boot given" and "mortgage boot received" if these two events occur in different tax years, and on when partners should treat the reduction or increase in their share of partnership liabilities resulting from a tax-deferred exchange as occurring, see §3.32A.

Thus, whenever a partnership's debt is reduced or reallocated, it is treated as a distribution of money to the partner or partners to whom the debt had been allocated and may result in gain to that partner.

EXAMPLE 1: ABC, a limited liability company, owns property worth $100,000 that is subject to a nonrecourse debt of $75,000 allocated equally to members A, B, and C. ABC is taxed as a partnership. Each member has a $15,000 basis in his membership interest. A lends ABC $75,000 that is used to retire the old debt. Under IRC §752(a), each member is deemed to receive a $25,000 distribution, but under IRC §752(b) and Reg §1.752-2, only A is liable on the debt, so neither B nor C receives an allocation. Both B and C recognize a $10,000 gain, the amount by which the deemed distribution exceeds their basis in their interests in ABC.

If as a result of a single transaction a partner incurs both an increase in the partner's share of the partnership's liabilities and a decrease in the partner's share of the partnership's 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. Reg §1.752-1(f).

EXAMPLE 2: In Example 1, ABC obtains new nonrecourse financing to retire the old $75,000 debt. This amount is allocated equally to A, B, and C. The single transaction rule results in a netting of the deemed $25,000 distribution against the deemed $25,000 contribution by each member.

In any like-kind exchange of encumbered property, general principles of boot-netting under IRC §1031 provide that mortgage boot received can be offset by mortgage boot or cash boot given. See §§3.22-3.29. Thus, any exchange in which replacement property is purchased by incurring debt of equal or greater amount than was retired on relinquished property normally results in no net mortgage boot.

An exchange by a partnership of encumbered property brings both the rule under IRC §752 and the rule under IRC §1031 into play. The availability and application of the single-transaction netting concept to like-kind exchanges of encumbered property by partnerships under §752 has confused and troubled practitioners, because no published authority has specifically held that a like-kind exchange, particularly a deferred exchange under IRC §1031(a)(3), is treated as a single transaction for purposes of Reg §1.752-1(f).

The IRS has, in fact, taken the position that the nonrecognition rule under IRC §1033 does not override the application of the distribution rules of IRC §§731(a)(1) and 752(b). In Rev Rul 81-242, 1981-2 Cum Bull 147, the IRS concluded that, when a partnership's encumbered property was condemned and the debt paid off, the partners received a deemed distribution under §752(b) and were thus subject to tax to the extent that the distribution exceeded their basis in their partnership interests, even when IRC §1033 would have otherwise applied to defer gain realized on the transfer.

If this treatment applied to like-kind exchanges by partnerships, it would be impossible to complete a fully tax-deferred transaction whenever a partnership transferred encumbered property and was relieved of debt that exceeded the partners' basis in their partnership interests. The IRS has concluded that, in a deferred exchange that will be begun and completed in the same year, mortgage relief received should be offset for purposes of §752 by mortgage relief given. See IRS Letter Rulings 200019014-200019019.

With respect to partnership deferred exchanges that start in one year and conclude in another, the IRS has issued Revenue Ruling 2003-56, 2003-1 Cum Bull 985, which provides that when there is net mortgage boot given (*i.e.,* mortgages assumed exceed those of which the taxpayer is relieved), then an "open transaction" concept will apply and no §752(b) distribution will

occur in the first year. When there is net mortgage boot received, however, it will be deemed to occur in the first year. See §3.32A.

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§7.5 C. At-Risk Rules

Under IRC §465, losses by individuals and some C corporations may be taken only to the extent the individual or corporation is "at risk" with respect to the activity creating the loss. "At risk" means that the taxpayer can deduct losses from a real property investment only to the extent of the amounts actually invested and the amounts for which the taxpayer is deemed liable (*i.e.,* recourse debt and certain other types of qualified nonrecourse debt). Losses are suspended after the amount at risk reaches zero by the close of the taxable year. Distributions of cash, reductions in liabilities, and various other events that would otherwise result in a negative at-risk amount trigger income recognition under IRC §465(e), which requires the recapture of previously allowed losses when the amount a taxpayer has at risk in an activity is reduced below zero. A temporary reduction in the amount at risk within a single year, however, does not trigger income recognition under §465(e), because the amounts at risk are tested as of the end of each taxable year. IRC §465(e)(1).

The at-risk rules are applied to the separate "activities" of a taxpayer. The general rule is that activities are not aggregated. If a taxpayer actively participates in the management of a trade or business, however, all activities comprised by the trade or business are aggregated for purposes of the at-risk rules, as required by IRC §465(c)(2)(B)(ii), (3)(B)(i). The regulations do not address the calculation of a taxpayer's at-risk amount on a separate activity basis in the context of an exchange.

NOTE: The classification of activities under the passive activity loss limitation rules of IRC §469 may be different from their classification under IRC §465.

Partners of a partnership are deemed to be at risk with respect to their share of "qualified nonrecourse financing" of the partnership, with their share being calculated under IRC §752 principles. IRC §465(b)(6).

The at-risk rules create issues for exchanges by partnerships parallel to those created by IRC §752, described in §7.4. The two primary issues are whether

- owning a relinquished property will be treated the same as owning a replacement property, so that partners having negative capital accounts will not suffer recapture gain when the debt secured by the relinquished property is retired on its disposition; and
- in a deferred exchange that commences in one year and is completed the next year, the "end of taxable year" testing point for increases and decreases in amounts at risk will create a similar problem.

There is no published guidance on either issue. Just as with the issues under §752, there seems to be no policy reason to create income recognition under §465 when IRC §1031 permits full deferral of recognition. Further, the temporary regulations under §465 refer to adjustments in basis as being determinative of increases and decreases in amounts at risk. Temp Reg §7.465-2(b). Because basis from a relinquished property (*i.e.,* the old activity) is carried into a replacement property (*i.e.,* the new activity) under IRC §1031(d), and because there will be no basis decrease when a partnership completes a like-kind exchange with no boot, a strong argument can be made that §465(e) should not apply to completed like-kind exchange transactions without boot. This issue, however, is frequently ignored in planning for partnership exchanges, and advisers should be aware of the current uncertainty surrounding it.

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§7.5A D. "Tax-Exempt Use" Property

Internal Revenue Code §470 is a partnership level loss deferral provision that was enacted as part of the American Jobs Creation Act of 2004 (Pub L 108-357, 118 Stat 1418). Section 470 prohibits a partnership from deducting losses related to "tax-exempt use property" in excess of the income or gain from that property. Most "tax-exempt use property" is also excluded from exchange treatment. See §§2.18A-2.18D. A complete discussion of IRC §470 is beyond the scope of this book.

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III. EXCHANGES BY PARTNERSHIPS WHEN PARTNERS WISH TO SEPARATE

§7.6 A. Overview

When a partnership prepares to dispose of partnership property, the partners do not always share a desire to retain their business ties after the disposition. Sometimes all partners wish to take their share of the proceeds and separate, terminating the partnership. Sometimes one group of partners wishes to remain aligned and use the proceeds to acquire a common asset, while others wish to withdraw from the partnership and receive cash or other property for their partnership interests. When the remaining partners, the departing partners, or both wish to defer gain on a partnership property disposition by undertaking a like-kind exchange under IRC §1031, a number of collateral issues arise. The discussion in §§7.7-7.20 addresses these issues in general terms.

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B. Possible Approaches

§7.7 1. All Partners Wish to Separate

When all partners want to separate and apply their share of disposition proceeds independently, with some or all of them wishing to acquire replacement property through separate like-kind exchanges, they face the problem of not directly owning an asset to exchange. Instead, each owns a partnership interest, excluded from like-kind exchange treatment by IRC §1031(a)(2)(D). The partners' key problem is how to obtain treatment as owners of direct interests in property that may be the subject of a like-kind exchange. Three techniques are frequently used to accomplish this goal:

- **Drop and Swap:** A preexisting partnership is terminated before the transfer of its property, with partners acquiring direct fractional ownership of the property as tenants in common. Each former partner can then separately sell or exchange his or her tenant-in-common interest. If successful, this approach allows the parties to completely separate and independently decide whether to structure the disposition as a sale or an exchange.

- **Swap and Drop:** A preexisting partnership transfers its relinquished property and completes exchanges into multiple replacement properties, and subsequently distributes each replacement property to a specific partner, predetermined in liquidation. This structure avoids certain problems associated with the Drop and Swap method, but it requires the partners to act in concert until the exchange is completed. This technique creates its own set of problems resulting from the need to complete the exchange at the entity level.

- **Separation without divorce:** A preexisting partnership transfers its relinquished property and completes exchanges into multiple replacement properties, using postexchange leasing and allocation arrangements to direct the economic benefits of each property to particular predetermined partners. This approach avoids certain issues associated with the Swap and Drop method (*i.e.,* qualified use of the replacement properties), but it raises complex issues under partnership tax principles associated with the mechanisms used to allocate benefits and burdens of individual property ownership to individual partners.

- **Partnership division:** Under the rules of IRC §708(b)(2)(B), a preexisting partnership divides into multiple resulting partnerships that are treated as continuations of the preexisting partnerships for tax purposes. In certain instances, use of divisions may facilitate separation of partners at the time of relinquished property disposition.

Each of these techniques has advantages and disadvantages from business, legal, and tax perspectives, a discussion of which is beyond the scope of this book. See Feldman, Ryan, & Wagner, *Tax Free Exchanges of Property Contributed To or Distributed From a Partnership,* 18 CEB Real Prop L Rep 325 (Nov. 1995).

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§7.8 2. Some Partners Wish to Separate

When some partners want to stay together and invest in a common property but others wish to separate and either receive cash or property not like in kind to the partnership property, or to acquire independent like-kind property, other structural options are available:

- The simplest mechanism is for the remaining partners to purchase the partnership interest of a departing partner (DP) for cash, or have the partnership use available cash to redeem the DP, shrinking the partnership to the partners who wish to continue.

- Another relatively simple solution is for the partnership to receive cash boot in an exchange transaction, distribute the cash to the DP, and use a special allocation of gain to charge the DP with gain equal to the cash. Unfortunately, as discussed in §7.14, there is considerable doubt about whether this method is allowable under IRC §704(b) in a manner that shifts all recognized gain away from the continuing partners.

- A potentially preferable solution, but still not without risk, is for the partnership to require the property purchaser to provide an installment note as partial payment for the relinquished property. If the installment note is distributed to the DP before the partnership receives any payments, the DP should recognize all gain associated with payments on the note.

- A variation of the Drop and Swap technique (see §7.7) involves distributing fractional interests only to nonexchanging partners, who join with the partnership in the disposition transaction but apply their proceeds separately as sale proceeds or as independent exchange transactions.

- Another variation of the Swap and Drop approach (see §7.7) involves using all relinquished property proceeds to acquire replacement property, with a subsequent refinancing to provide sufficient cash to redeem the DP's partnership interest.

- A partnership division under IRC §708(b)(2)(B) may also apply when only some partners wish to split off. See §7.7.

There are doubtless unlimited combinations of these techniques. Sections 7.9-7.20 address some of the issues common to these transactions, with the objective of identifying those issues rather than supplying definitive solutions to the problems of a partnership whose partners wish to separate.

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C. Major Issues in Partnership Separation Transactions

1. Step-Transaction and Substance-Over-Form Doctrines in Preexchange Property Distributions

§7.9 a. Concepts

When planning or evaluating a complex, prearranged transaction that involves an exchange and one or more transfers to or from related entities, the attorney should consider whether the transactions might be challenged under the step-transaction doctrine or the substance-over-form doctrine as impermissible exchanges of or for partnership interests. On the step-transaction doctrine, see §3.55; on substance-over-form doctrine, see §§1.9, 3.17.

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§7.10 b. Application

Under the step-transaction doctrine, a series of separate steps is treated as a single transaction if the steps are "in substance integrated, interdependent, and focused toward a particular result." *Robert A. Penrod* (1987) 88 TC 1415, 1428; *Superior Coach of Fla., Inc.* (1983) 80 TC 895, 905. The tax significance of the intermediate steps is ignored, and the focus is on the tax consequences of the transaction considered as a whole. *Crenshaw v Commissioner* (5th Cir 1971) 450 F2d 472, 476.

Under the substance-over-form doctrine, the IRS and the courts decide the tax consequences based on the substance of a transaction rather than its form if the form chosen by the taxpayer is a fiction that does not reflect the economic realities of the transaction. *Commissioner v Court Holding Co.* (1945) 324 US 331, 334, 89 L Ed 981, 985, 65 S Ct 707. See §1.9.

Under the step-transaction doctrine, the IRS has successfully challenged a taxpayer's exchange of property shortly after acquiring it in a partnership distribution. See *Crenshaw v Commissioner* (5th Cir 1971) 450 F2d 472, 477. The IRS also raised the doctrine in its appeal of the Tax Court's decision in *Joseph R. Bolker* (1983) 81 TC 782, aff'd (9th Cir 1985) 760 F2d 1039. In *Bolker,* the taxpayer liquidated his wholly owned corporation and received the corporation's real property in redemption of his stock. He then transferred the property to a third party in a prearranged transaction intended to comply with IRC §1031. The IRS argued that the taxpayer's transactions, viewed as a whole under the step-transaction doctrine, constituted an exchange of corporate stock for a fee interest in real property. The Ninth Circuit Court of Appeals refused to address this argument because the IRS had failed to raise it in the Tax Court. 760 F2d at 1042.

The IRS has also challenged such a transaction under the substance-over-form doctrine, arguing that what is in substance a disposition by a corporation cannot be converted to a shareholder exchange by using the shareholder as a conduit through whom to pass title. See *Commissioner v Court Holding Co., supra*. The IRS argued this position unsuccessfully before the Tax Court in *Joseph R. Bolker, supra*. In *Appeals of Brookfield Manor, Inc.* (Jan. 11, 1989, No. 89-SBE-002), on facts similar to those of *Bolker,* the California State Board of Equalization (SBE) relied on the substance-over-form doctrine in finding that the corporation, rather than the shareholder who received the property on liquidation of the corporation, was the party to the transaction. The SBE also found that, under former Rev & T C §24941 (still applicable in pertinent part in current Rev & T C §24941), the corporation intended to liquidate the property, thus disqualifying the exchange.

In *Delwin G. Chase* (1989) 92 TC 874, the Tax Court applied the substance-over-form doctrine to a transaction that the taxpayer had attempted to structure as a distribution of partnership property followed by a like-kind exchange. The taxpayer was both a limited partner and a general partner in a partnership that owned an apartment building. While the partnership was searching for a buyer for the property, the taxpayer caused the partnership to deed to him an undivided interest in the property in liquidation of his interest as a limited partner. The partnership then accepted a purchase offer from a third party and executed an escrow agreement as the seller. At closing, the partnership and the taxpayer transferred the property to the buyer, and the share of the proceeds attributable to the taxpayer's undivided interest was paid to an intermediary, which ultimately used the funds to acquire like-kind property and transfer it to the taxpayer. The Tax Court concluded that the partnership's purported distribution of property to the taxpayer had been a fiction, based on evidence that the partnership and the taxpayer had continued to manage the property and to allocate economic benefits as though the distribution had not occurred. Thus, the court held that in substance the *partnership* had disposed of the entire property to the buyer and, because the taxpayer rather than the partnership acquired the replacement property, neither the partnership nor the taxpayer had made an exchange of like-kind property. 92 TC at 882.

The IRS reiterated its negative position on preexchange distributions of relinquished property by an entity to an exchanger in IRS Letter Ruling 9645005, which applied the doctrine established in *Commissioner v Court Holding Co., supra,* to bar individual partner elections under IRC §1033 following a distribution of partnership property. This ruling analyzed a transaction in which a joint venture partnership distributed a portion of its property to its partners 1 day before a sale in lieu of condemnation. One of the partners (a limited partnership) wanted to defer gain under §1033 while another partner (a corporation) did not. The IRS concluded that the partnership's preexisting contract to sell the property to the condemning public agency caused the transfer to be attributable to the joint venture and further held that, even if this were not true, the property would not be deemed to be held for trade, business, or investment purposes by a partner who had received its interest 1 day before a planned disposition.

WARNING: Although nominally applicable to §1033, IRS Letter Ruling 9645005 must be considered by any planner dealing with potential exchanges of partnership or limited liability company property when partners or members want to go their own ways.

However, in IRS Letter Ruling 9022037, the IRS ruled that partners could separately elect §1033 treatment when the following occurred:

- A partner negotiated a sale in lieu of condemnation;
- 30 days later the partnership distributed its sole asset to its partners as tenants in common;
- The partnership continued to exist as an operating entity; and
- 18 days later the owner/partners sold the property to the condemning agency on the agreed terms.

In *True v U.S.* (10th Cir 1999) 190 F3d 1165, the Tenth Circuit applied both the substance-over-form and step-transaction doctrines to overturn an exchange between related parties. The True family conducted a ranching business and an oil and gas production business. In the 1980s, they purchased five new ranch properties to add to their operations. For each purchase, the True family took the following steps: Oil Company A acquired the parcels of real property, while the ranching entity acquired the operating assets of each property. Oil Company A then engaged in a tax-free §1031 transfer of the ranchlands to Oil Company B in exchange for productive oil and gas leases that had been fully cost depleted. Thus, under the carryover basis rules of §1031, Oil Company A sought to convert nondepreciable land into cost depletable oil and gas leases. After the transfer was complete, Oil Company B immediately distributed the ranchlands to the True family member partners. The partners then contributed the ranchlands back to the ranching entity. The Tenth Circuit disallowed §1031 treatment and treated the transaction as a direct purchase of the entire ranching property by the ranching entity. While acknowledging that the taxpayers had introduced evidence of a business purpose and economic effects, the court ruled that the taxpayers "changed what would have been the natural result of a direct purchase of the ranchland by engaging in a series of steps designed from the outset to circumvent… the tax code." 190 F3d at 1179.

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§7.11 2. Attribution of Qualified Use When Property Is Transferred Before or After Exchange

Even if the step-transaction doctrine does not apply to recharacterize an exchange as involving the transfer or receipt of a partnership interest, the exchange will fail unless both the relinquished and replacement properties are considered to be held for trade, business, or investment purposes at the time of the exchange.

The IRS generally has been unwilling to attribute an entity's qualified use to the entity's owners before or after a tax-free transfer to or from the entity. In Rev Rul 75-292, 1975-2 Cum Bull 333, the IRS ruled that the taxpayer had not held the replacement property for qualified use, because, immediately after the exchange, the taxpayer contributed the replacement property to his wholly owned corporation. In Rev Rul 77-337, 1977-2 Cum Bull 305, the IRS ruled that the taxpayer had not held the relinquished property for a qualified use when he received that property as a liquidating distribution from his wholly owned corporation and immediately exchanged it for a replacement property.

Similarly, in Rev Rul 84-121, 1984-2 Cum Bull 168, the IRS ruled that property acquired by a taxpayer for purposes of acquiring another property on exercise of an option could not be transferred to the owner of the option property in an IRC §1031 exchange, because the taxpayer had not held the relinquished property for a qualified use. The IRS cited some of these rulings in a partnership context in IRS Letter Ruling 9645005, discussed in §7.10.

Some cases suggest that it may not be necessary to attribute a predecessor owner's purpose in holding a property to a subsequent holder of the same property to satisfy the qualified use requirement. In *Joseph R. Bolker* (1983) 81 TC 782, aff'd (9th Cir 1985) 760 F2d 1039, discussed in §7.10, the court held that if a taxpayer does not intend to liquidate the relinquished property or use it for personal pursuits, then the taxpayer satisfies the qualified use requirement. Under this analysis, the most appropriate interpretation of the qualified use requirement is one that facilitates like-kind exchanges that do not represent an effort to "cash in" the taxpayer's investment.

In *Bonny B. Maloney* (1989) 93 TC 89, a corporation exchanged real property and, at the time of the exchange, intended to liquidate and distribute the replacement property to its shareholders. One month after the exchange, the corporation did liquidate (tax-free under former IRC §333), distributing the replacement property to the shareholders. The court found that the exchange satisfied the qualified use requirement because there was continuity of investment even though there was a change in the form of ownership. The shareholders had not "cashed in" their investment and continued to have an economic interest in the same property. The court stated in a footnote that a §1031 exchange may be preceded or followed by a tax-free transfer under IRC §721.

Bolker and *Maloney* both involved corporate liquidations under former IRC §333. A corporation is always considered an entity separate from its shareholders. A partnership, however, is a pass-through entity and in many contexts is considered an aggregation of individual partners rather than an entity separate from its partners. For example, the partners of a partnership may elect under IRC §761(a) to be taxed as owners of undivided interests in the underlying assets of the partnership. No such election is available to a corporation or its shareholders. Under IRC §701, "persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." Certain elections under IRC §703 are also made at the individual partner level, rather than at the partnership level. Internal Revenue Code §731 generally allows tax-free distributions from a partnership; no similar provision exists for corporations. Given the aggregate nature of a partnership, the rationale that the exchanging partner is merely continuing its investment in another form is more convincing in the partnership context than in the corporate context.

Recent guidance seems to indicate a thaw in the IRS's previous unwillingness to attribute an entity's qualified use when property is transferred immediately before or after an exchange. In IRS Letter Rulings 200651030 and 200521002 (see also Letter Ruling 200812012), qualified use status was maintained even after the transfer of relinquished property and replacement property, respectively, from a private testamentary trust to a limited liability company with the same membership. See §2.28. These rulings, however, appear to have very little application to most taxpayers because the IRS relied on the involuntary nature of the trust termination and the fact that the termination was not part of a prearranged plan.

The position of the IRS on these issues is presently unclear. In July 2008 the IRS issued a revised Form 1065, which became final for reporting years 2008 and beyond. Form 1065 is the form used by partnerships (as well as by entities such as limited liability companies treated as partnerships for federal income tax purposes) to report income and losses. The revisions related to like-kind exchanges appear in Schedule B on the Form:

Question 13: Check this box if, 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 (including a disregarded entity).

Question 14: At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property?

Question 13 appears directed at Swap and Drop transactions. See first bullet in §7.7. Question 14 appears directed at Drop and Swap transactions. See second bullet in §7.7.

PRACTICE TIP: The authors surmise that the IRS likely adopted the changes to Form 1065 to track the distribution-contribution activities of partnerships engaging in like-kind exchanges (although this is not entirely clear). How the IRS intends to use this information is not yet evident. However, specific identification of these transactions may lead to increased risk of challenge on audit by the IRS or the California Franchise Tax Board for partnerships that have undertaken these transactions.

In the authors' view, there is no compelling policy reason why §1031 should be administered in a manner that imparts a vague or indefinite holding period requirement to IRC §1031(a)(1), particularly because the statute does not impose a durational requirement. In *124 Front St., Inc.* (1975) 65 TC 6, nonacq 1976-2 Cum Bull 3, the taxpayer borrowed funds from an unrelated corporation and used the proceeds to acquire a property on exercise of an option. The taxpayer transferred the property to the corporation (which had provided the loan) in exchange for like-kind real property 6 months after the option property was acquired. The Tax Court rejected the government's argument that the exchange failed to qualify for nonrecognition under §1031. For further discussion of holding periods, see §§2.23-2.37.

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3. Tenancy-in-Common Arrangements as Reconstituted Partnerships

§7.12 a. Factors Affecting Characterization as Partnership

To avoid application of IRC §1031(a)(2)(D) in Drop and Swap transactions (see §7.7), recipients of direct property interests in former partnership property must be treated as owners, not as partners, of the old or a new partnership. A partnership is broadly defined for tax purposes as a "syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation." IRC §7701(a). This broad definition is intended to encompass most unincorporated business associations.

Tenancies in common are common law relationships between co-owners of property that meet certain general requirements. *Taylor v Brindley* (10th Cir 1947) 164 F2d 235. Examples of such requirements include the following:

- Individual ownership interests must be freely alienable;
- Each co-owner must have a possessory right to the entire asset;
- The co-owners must hold a legal right to partition the asset;
- The co-owners must not contemplate a joint venture or profit;
- Each co-owner must have a right to an accounting of the property;
- Each co-owner should hold separate and distinct titles; and
- Co-owners generally do not have a right of survivorship; each co-ownership interest passes to the heirs of the deceased co-owner.

The common law requirements vary from state to state. *Swartzbaugh v Sampson* (1936) 11 CA2d 451, 54 P2d 73. See 5 Miller & Starr, California Real Estate §§12.34-12.35 (3d ed 2000); 12 Witkin, Summary of California Law, *Real Property* §§39-53 (10th ed 2005).

The level of managerial activity conducted by co-owners has a significant bearing on partnership status. Co-ownership of land or net leased property should not create business activity. See *Charles E. Tibbals,* TC Memo 1958-44. Providing services to tenants as co-owners or through an agent can create a partnership. IRC §761(a). See discussion in §7.25.

In Rev Rul 75-374, 1975-2 Cum Bull 261, the IRS ruled that use of an independent manager to provide customary services and manage an apartment property co-owned by two corporations did not raise their tenancy-in-common arrangement to the level of a partnership. Instead, the arrangement was treated as a tenancy in common. In *Estate of Appleby* (1940) 41 BTA 18, the court held that co-ownership of property merely to share expenses does not create a partnership. The regulations also state that co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a partnership. Reg §301.7701-1(a)(2).

As Rev Rul 75-374 suggests, however, the reach of this definition is limited. Case law and the regulations also support this limitation. A co-ownership may become a partnership for federal and state income tax purposes if it actively carries on a trade or business. "Trade or business" is a phrase used to indicate a level of business activity, but defining the level of trade or business activity that creates a partnership is difficult. The regulations and Rev Rul 75-374 provide some guidance, however, by focusing on distinguishing between a property owner's activities to maintain the property, such as exterior upkeep, and services provided to users of the property. For further discussion, see §7.25.

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§7.13 b. IRC §761(a) Election Out of Subchapter K

Some entities that would otherwise be treated as partnerships may elect treatment as a cotenancy. IRC §761(a). Thus, if the common law argument is lost (see §7.12) and the cotenancy structure is considered an organization that could be treated as a partnership, a valid IRC §761 election out of partnership treatment will ensure co-ownership status. Internal Revenue Code §1031(a)(2) provides that "an interest in a partnership which has in effect a valid election under IRC §761(a) to be excluded from the application of all of Subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership." Instead of receiving partnership treatment, the investors will be treated as co-owners. This presumption could be useful in Drop and Swap transactions (see §7.7) when the creation of a tenancy in common in the Drop precedes the Swap by a reasonable amount of time.

If investors make a §761 election to avoid partnership treatment, and it is determined that the co-tenancy structure is not a partnership at the time of election, then the election is technically not available. Reg §1.761-2(b)(3); *George N. Gabriel,* TC Memo 1993-524. If subsequent changes occur to the structure that result in possible partnership status, however, the cotenancy structure will be protected by the deemed §761 election. At the point of any significant changes in facts or structure, the cotenants should reaffirm the §761 election.

Although the §761 election sounds like a panacea, its availability is actually quite limited for real estate-owning partnerships. For an investment partnership to opt out of partnership treatment, the investors must do the following (IRC §761(a); Reg §1.761-2(a)(2)):

- Own the property as co-owners;
- Separately reserve the right to take or dispose of their shares of any property acquired or retained;
- Not actively conduct a trade or business or irrevocably authorize anyone to purchase, sell, or exchange the investment property; and
- Be able to adequately calculate their shares of income without computing partnership taxable income.

The first requirement means that the co-owners must actually hold title to the property and cannot do so through their partnership, limited liability company, or other title-holding vehicle.

The right to separately dispose of ownership interests apparently need not be unlimited. In IRS Letter Ruling 6711025580A, the IRS found that an arrangement in which "each participant waives its right, for … 40 years, to partition … , but each has the right to sell its interest to the other participants at its fair market value," satisfied the §761 requirement to elect out of partnership treatment. Similarly, IRS Letter Ruling 8011040 concluded that an arrangement in which the participants had the right to separately dispose of their shares (no mention is made of the right to partition) qualified for the §761 election out of partnership treatment.

The third regulatory requirement first requires that the organization be for investment purposes and not be a trade or business. This requirement is likely to be the hardest to satisfy for co-owners of improved income-producing property, because most such real estate is deemed to constitute the conduct of a trade or business. Co-owners of management-intensive forms of real estate operations, such as hotels or residential care facilities, are unlikely to have the IRC §761(a) election available. In less intensive business activities, such as shopping centers or commercial office buildings, the issue is less clear, but many analysts (including the authors) have concluded that under current law the §761(a) election is not available to owners of such properties who operate them directly or through an agent. One common means of solving the problem of owner involvement in property business operations is for co-owners to enter into a master lease with a separate entity tenant who will be responsible for the activities. Of course, this leasing arrangement must itself avoid characterization as a partnership. See discussion in §7.27.

The third regulatory requirement prevents owners from divesting themselves of the right to separately dispose of their interests through the irrevocable appointment of an agent. That is, the co-owners themselves must retain the right to sell the property. This right of exchange cannot be delegated for a period exceeding one year. See IRS Letter Ruling 8002111.

The fourth requirement, generally easy to satisfy in a "straight-up" sharing arrangement, means that tenants in common must receive their prorata shares of all items of property gross receipt and expense, such that an entity level profit and loss computation is unnecessary.

Elections under §761 can be made by filing IRS Form 1065 under Reg §1.761-2(b)(2). This procedure puts co-owners who have never filed Form 1065 in something of a quandary because their position is presumably that, because they are not partners, there is no need to file such a form in the first place. Alternatively, Reg §1.761-2(b)(2)(ii) authorizes a deemed election if it can be shown, based on all the facts and circumstances, that the co-owners intended to secure an exclusion from Subchapter K. In addition, Reg §1.6031(a)-1(c) provides that organizations making a deemed election do not need to file partnership returns. Such a deemed election can be achieved by either of the following:

- An agreement among the members to be excluded from Subchapter K; or
- Individual members owning capital in the co-owned property filing income tax returns in a manner consistent with the exclusion.

To provide evidence of this intent in an agreement, there must be clear language in a co-ownership agreement that the co-owners intend to avoid partnership tax treatment under Subchapter K. Further, the agreement itself should be clearly labeled a "tenancy-in-common agreement" and not a "partnership agreement" or "joint venture agreement."

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4. Special Issues Relating to Particular Transaction Formats

§7.14 a. Special Allocation of Gain to Partner Taking Cash

When a partnership receives cash boot on the disposition of property, gain is recognized to the full extent of the boot, unless the boot exceeds gain realized. See Reg §1.1031(d)-2, Example 1. Partners who take cash in retirement of their partnership interests are generally willing to accept an allocation of recognized gain at that time, but only to the extent that they would have recognized gain on a partnership sale of the property. Because of the boot recognition rules under IRC §1031, this approach usually creates a problem.

EXAMPLE: Partnership ABCD holds property X with an adjusted basis of $100,000 and a value of $200,000. Each of the four partners, A, B, C, and D, has a basis of $25,000 in his or her partnership interest. A disposition of X will create $100,000 realized gain, allocable $25,000 each to A, B, C, and D. A, B, and C wish to transfer X and effect a §1031 exchange, but D wants to exit with her $50,000 share of the proceeds. ABCD directs $150,000 in proceeds to qualified intermediary QI and takes $50,000 cash on closing of the transfer of X. Receipt of $50,000 in cash is permissible in ABCD's exchange, but it creates $50,000 of recognized gain under IRC §1031(b), or $25,000 more than D's share of the realized gain. Immediately before the closing of the exchange, A, B, C, and D agree to modify their partnership agreement (or operating agreement if ABCD is a limited liability company) to specially allocate to D $25,000 of the "boot" gain recognized in the exchange, thus increasing D's capital account to $50,000. The remaining $25,000 of boot gain is allocated equally to A, B, and C. D agrees to accept a cash distribution of $50,000 from ABCD in complete retirement of D's partnership interest. A, B, and C agree to continue the partnership (now named ABC) indefinitely as equal partners, and the QI acquires and transfers to ABC property Y at a cost of $150,000 as replacement property in the exchange.

Gain recognized by a partnership in a partially tax-deferred exchange under IRC §1031(b) may be specially allocated to one or more partners under IRC §704(b), but only when such recognized gain is appropriately reflected in the partners' respective capital accounts and such allocation has substantial economic effect. In this example, the disproportionate allocation of $25,000 of gain to D and $25,000 to A, B, and C should be recognized as a valid §704(b) allocation because the allocation has substantial economic effect and is consistent with the respective partner interests of A, B, C, and D under two alternative tax analyses. Note, however, that A, B, and C have been allocated recognized gain in a transaction that they wished to be completely free of current tax.

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§7.15 (1) Value Equals Basis Rule

The economic effect of the disproportionate allocation of boot gain to *A* in the example in §7.14 is substantial because the next to last sentence in Reg §1.704-1(b)(2)(iii)(c) (the so-called value equals basis rule) provides that

> for purposes of [Reg §1.704-1(b)(2)(ii)-(iii), (b)(3)(iii), and (d)(6)], the adjusted tax basis of partnership property… will be presumed to be the fair market value of such property, and adjustments to the adjusted tax basis of such property will be presumed to be matched by corresponding changes in such property's fair market value. Thus, there cannot be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by an allocation (or allocations) of gain or loss from the disposition of partnership property.

Accordingly, because at the time of the special gain allocation, neither the IRS nor ABCD could presume the existence of $50,000 of gain inherent in X to charge back to the continuing partners (*A*, *B*, and *C*), they are deemed to bear the burden of the disproportionate gain allocation to *D* in the form of a relatively smaller increase in their capital account balances. Objective facts indicating that X actually had a fair market value of $200,000 are thus ignored under the value-equals-basis analysis.

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§7.16 (2) Substantial Economic Effect

Alternatively, the special allocations to *A*, *B*, *C*, and *D* in the example in §7.12 have "substantial economic effect" within the meaning of Reg §1.704-1(b)(2)(i) because the allocations will be reflected in the capital accounts of *A*, *B*, *C*, and *D*, and *D*'s adjusted capital account balance of $50,000 will be reflected in the liquidating distributions made to *D*. See Reg §1.704-1(b)(2)(ii)(b)(2). The economic effect of the allocation made to *D* is "substantial" because, as an objective economic matter, *D* will not participate in future economic profits or losses attributable to X after *D*'s interest in ABCD is retired.

Under Reg §1.704-1(b)(2)(iii)(a), the economic effect of an allocation is "substantial" if a "reasonable possibility" exists that the allocation will affect substantially the dollar amounts the partners will receive from the partnership, independent of tax consequences. There is more than a "reasonable possibility" that the special allocation to *D* will affect the dollar amount received by *D* because *A*, *B*, and *C*, as the remaining partners, will incur all of the economic risk and potential profit associated with the replacement property.

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§7.17 (3) Allocation of Boot to Departing Partner

As noted in §7.14, the problem with this solution is that recognized gain has been allocated to the continuing partners, who wished to achieve full tax deferral. To correct this problem, consider the following:

EXAMPLE: Assume the same facts as those in the example in §7.14, but assume that ABCD amended its partnership agreement before the exchange to allocate all of the $50,000 boot gain to *D*, increasing *D*'s capital account to $75,000. On liquidation and retirement of *D*'s interest, however, *D* receives only $50,000 in cash. Because *D* has a resulting $25,000 loss on disposition of *D*'s partnership interest (by receiving $50,000 for the interest with a $75,000 basis), *D* has a net gain of $25,000, but there is no gain to allocate to *A*, *B*, or *C*.

The purported special allocation of the entire $50,000 of boot gain to *D* may not be recognized, however, because it violates the substantial economic effect test described in §7.16. Because *A*'s share of economic gain was 25 percent of $100,000, an allocation of $50,000 to *A* does not seem to be permissible. This issue, however, has yet to be directly addressed by any published authority.

NOTE: The problem of gain allocable to remaining partners would not exist if ABCD's basis in X was zero, because *D*'s share of the economic gain would be $50,000 and ABCD should thus be able to allocate the entire $50,000 of boot gain to *D*, creating a $50,000 capital account and entitling *D* to a $50,000 distribution in redemption of *D*'s interest in ABCD.

For further discussion, see Cuff, *1031 Exchanges Involving Partnerships and LLC's: Some Observations on an ABA Report,* 28 J Real Est Tax'n 203 (Spring 2001).

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§7.18 b. Installment Note Distribution Solution

Some commentators have suggested an alternative structure for a partnership exchange with boot that will permit allocating all recognized gain to a cash-out partner. In such an exchange, the partnership engages in an IRC §1031 transaction, receives boot in the form of an installment note receivable, and then redeems one (or more) of the partners' interests by distributing the installment obligation. See Egerton & Wiser, *Planning to Deal With the Recalcitrant Partner in a Code Sec. 1031 Exchange,* 2 J of Passthrough Entities 23 (Mar.-Apr. 1999).

EXAMPLE: Partnership ABCD described in the example in §7.14 negotiates with the buyer of X to receive $50,000 in the form of a promissory note secured by an irrevocable standby letter of credit, as permitted by Temp Reg §15A.453-1(b)(3)(iii). The note is payable $40,000 two weeks after closing and $10,000 on January 2 of the following year. Immediately after the closing, ABCD redeems *D*'s interest by distributing the note together with its associated collateral to *D*.

Under IRC §453(f)(6), if boot received is in the form of an installment obligation, then gain recognition is deferred under the installment method of accounting under IRC §453 until the payment is received. See §§3.43-3.45. Income recognition will occur earlier if the installment receivable is sold or otherwise disposed of before its settlement. IRC §453B. However, Reg §1.453-9(c)(2) provides in part that, except as provided in IRC §§736 and 751, the disposition of an installment obligation in an IRC §731 distribution from a partnership to a partner will not result in gain or loss under IRC §453B. (The reference in the regulations to IRC §453(d) is incorrect; the reference should be to IRC §453B.)

The distribution of the installment obligation is treated as a distribution of property in a liquidating distribution to the partner. Under IRC §732(b), the basis of the property distributed to a partner in a liquidating distribution is equal to the adjusted basis of that partner's interest in the partnership, reduced by any money distributed in the same transaction. Accordingly, the redeemed partner takes the installment obligation with a basis equal to the basis in the redeemed partnership interest under §732(b) and recognizes gain as payments are received on the installment obligation under §453 outside the partnership, as long as all payments are received after the redemption/distribution transaction. No gain is recognized by the partnership or the remaining partners.

To date, no published authority addresses this transaction or indicates the IRS's position. One potential concern might arise if the payment due in the year after the relinquished property transfer was insignificant (*e.g.,* in the preceding example, if the subsequent year payment was only $1000 instead of $10,000). This situation could lead to a challenge of the instrument as not being a legitimate installment note.

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§7.19 c. Swap and Drop Issues

An exchange by a partnership into multiple replacement properties followed by a distribution of the properties to individual partners has the advantage of not raising the *Court Holding* issue, which applies to a transfer by the entity owner of relinquished property. *Commissioner v Court Holding Co.* (1945) 324 US 331, 334, 89 L Ed 981, 985, 65 S Ct 707. See §7.10. Whether a partnership can acquire property in a like-kind exchange with the intent to distribute the property to its partners in a Swap and Drop transaction (see §7.7) raises the qualified use issue in much the same way as when a partner acquires property intending to immediately transfer it in a Drop and Swap exchange (see §7.7). In *Bonny B. Maloney* (1989) 93 TC 89, discussed in §7.11, a corporation undertook a Swap and Drop and the Tax Court rebuffed an IRS challenge to its qualified use of the replacement property. If the same principle applies to partnerships, *Maloney* should be dispositive, but because it was not appealed, there is currently no appellate authority ratifying this structure.

In *Appeal of Ahlers* (SBE 2005) CCH Cal Tax Rep 403-932, 2005 Cal Tax Lexis 360, the California State Board of Equalization (SBE) examined a Swap and Drop transaction. In *Ahlers,* two jointly filing individuals (Ahlers) held a 40-percent interest in a partnership (Terra Nova) that owned a multiple-family housing project. The balance of Terra Nova was owned by a separate partnership, TN Associates (TN), which was owned by Ahlers and three other partners. Terra Nova engaged in a like-kind exchange of its asset for three replacement properties plus cash boot. Immediately after the exchange, Terra Nova distributed the replacement properties and cash to its partners in liquidation of their interests. As a result of distributions from Terra Nova and TN, Ahlers received a 100-percent interest in one of the properties plus some cash. Cash was distributed to Ahlers from TN, but Ahlers did not receive a direct distribution of cash from Terra Nova. Two other partners received cash and promissory notes. The final partner received the remaining replacement properties. To balance the distributions of property and cash, Terra Nova and TN allocated shares of gain to each partner disproportional to their interests.

The California Franchise Tax Board (FTB) audited the partnerships' and Ahler's returns, but did not challenge the validity of the like-kind exchange, despite the immediate distribution of the replacement properties by the partnership. Instead, the FTB asserted that the allocations by Terra Nova and TN lacked substantial economic effect under IRC §704(b). On appeal, the SBE upheld the FTB's treatment and required the partnerships to reallocate the gain commensurate with IRC §704(b). The SBE did not raise the issue of the qualified use of the replacement property.

WARNING: The *Ahlers* decision should not be viewed as indicating a willingness by the FTB or SBE to accept the validity of Swap and Drop transactions generally. Decisions of the SBE do not have any precedential value. Exchangers and their advisors should proceed with caution when structuring Swap and Drop (or Drop and Swap) transactions in California.

Swap and Drop transactions that are undertaken as deferred exchanges suffer from a serious limitation under the identification rules of Reg §1.1031(k)-1(b). Because the partnership entity is doing the exchange, it is subject to the limitations on the number of identified replacement properties it can exchange (see §§4.19-4.25), which could significantly limit the partnership's flexibility in implementing the exchange.

EXAMPLE: Partnership ABCD transfers property X, valued at $200,000, in a deferred exchange. Each partner wishes to exchange X for separate replacement properties. ABCD identifies properties S, T, Y, and Z as possible replacements. Unless their aggregate value is $400,000 or less (owing to the 200 percent rule discussed in §4.24), ABCD will be forced to complete its acquisition of all identified properties in order to have a valid exchange, except for any of the properties acquired within 45 days after the transfer of property X. If a Drop and Swap structure is used instead, and 25 percent undivided interests are transferred to A, B, C, and D, then each partner may identify three alternative replacement properties, for a total of 12 properties.

Obvious conflicts can arise among partners attempting these transactions, because any excess value of any property could cause the aggregate values to exceed the 200 percent limit. Reg §1.1031(k)-1(b)(4)(i)(A). The failure of any property to close could create boot at the partnership level that may not be entirely allocable to the partner responsible for the failure of that exchange component. See discussion in §§7.14-7.17.

Further, if there are only two partners in a 50/50 partnership, and they are potentially able to rely on the three-property safe harbor identification rule (see §4.23), a question arises as to which of the two will get to choose an alternative property for identification.

Problems like these illustrate the difficulties of Swap and Drop transactions.

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§7.20 d. Exchanges Followed by Special Tracking Allocations

An alternative to the Swap and Drop is to continue operation of the partnership after an exchange into multiple replacement properties and to use special tracking allocations of economic benefits and burdens associated with the replacement properties.

EXAMPLE: Partnership ABCD acquires properties S, T, Y, and Z as replacements for property X. Each property is placed into a separate single member limited liability company (LLC-S, LLC-T, LLC-Y, and LLC-Z, respectively). Profits from LLC-S are allocated 91 percent to A and 3 percent each to B, C, and D. Profits from LLC-T, LLC-Y, and LLC-Z are similarly allocated 91 percent to B, C, and D, respectively, and 3 percent to each of the other partners not holding a 91-percent interest.

This structure avoids all the step-transaction, qualified-use, and other problems associated with Drop and Swap or Swap and Drop transactions (see §7.7), as long as the allocations are valid and ABCD is still considered a partnership. Several issues relating to the substantial economic effect of such allocations are present, however. A discussion of the principles associated with such tracking allocations is beyond the scope of this book. See Egerton & Wiser, *Planning to Deal With the Recalcitrant Partner in a Code Sec. 1031 Exchange,* 2 J of Passthrough Entities 23 (Mar.-Apr. 1999).

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§7.20A e. Partnership Divisions

The IRS has held that a midstream corporate reorganization will not prevent an IRC §1031 exchange from being completed. See IRS Letter Rulings 9850001, 9252001, 9152010, discussed in §7.45. This requires the application of IRC §381. There is no analogue to IRC §381, in Subchapter K, covering taxation of partnerships.

However, the IRS has approved a transaction in which successor partnerships under IRC §708(b)(2)(B) sought to acquire replacement property under IRC §1033 for property subject to an involuntary conversion held by the original partnership. IRS Letter Ruling 200921009. See §2.69A. This ruling may indicate an increasing willingness by the IRS to allow successor partnerships created as a result of a partnership division to complete an IRC §1031 exchange initiated by a former partnership.

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IV. EXCHANGES INVOLVING ACQUISITION OF PROPERTY BY MULTIPLE OWNERS

§7.21 A. Postexchange Partnership or Corporation Formations

The IRS and the courts sometimes apply the step-transaction doctrine when a taxpayer engages in an exchange of like-kind property and then, shortly after the exchange, contributes the replacement property to a corporation or partnership. In one case, the taxpayer exchanged real property for an undivided 10 percent interest in other real property and then contributed this tenant-in-common interest to a limited partnership in exchange for an interest as a general partner. See *Norman J. Magneson* (1983) 81 TC 767, 769, aff'd (9th Cir 1985) 753 F2d 1490, discussed in §2.31. The Ninth Circuit Court of Appeals applied a step-transaction analysis in *Magneson* and found that the transaction still qualified for nonrecognition treatment under IRC §1031.

The court began its analysis by questioning whether the step-transaction doctrine should apply at all, because it found that the transaction probably could not have been accomplished more directly. Without holding that the doctrine applied, the court found that the transaction was in substance an exchange of a fee interest in real property for a 10-percent general partnership interest. The court held that, under California law, a fee interest and a general partnership interest are of like kind, because the rights of a fee owner and a general partner to management and control are very similar. The court distinguished *Estate of Rollin E. Meyer* (1972) 58 TC 311, nonacq 1975-2 Cum Bull 3, aff'd per curiam (9th Cir 1974) 503 F2d 556, on the ground that the exchange of general and limited partner interests disallowed in *Meyer* involved a loss of management and control over the property.

The Ninth Circuit specifically limited its holding in *Magneson* to situations in which the taxpayer contributes the like-kind property received in the exchange to a partnership for an interest as a general partner.

NOTE: California's general partnership law in effect at the time of the *Magneson* decision has since been amended to eliminate the concept of a direct general partner interest in a partnership's assets. Under former Corp C §15008, a general partner's interest in a partnership included a direct interest in partnership property as a tenant by the entirety. Under current Corp C §16203, partners do not have a direct interest in partnership property. This is also true of limited partnerships. See Corp C §15671 (Corp C §15907.07, operative January 1, 2008, for new or electing limited partnerships and operative January 1, 2010, for all limited partnerships). This principle also applies to limited liability companies (Corp C §17300). Thus, *Magneson* is not authority for an exchange transaction in which the replacement property is contributed to a limited partnership for an interest as a limited partner. See *Estate of Rollin E. Meyer, supra*. In a footnote and without comment on its effect, the *Magneson* court noted that Tax Reform Act of 1984, §77 (TRA 1984) (Pub L 98-369, 98 Stat 494, 595) excluded exchanges of interests in a partnership from nonrecognition treatment under IRC §1031(a).

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§7.22 B. The Rise of Tenancy-in-Common Programs

In the 1990s taxpayers and promoters began exploring means by which syndicated group ownership of real estate could be structured to qualify co-ownership interests as relinquished or replacement property under IRC §1031(a)(1), despite IRC §1031(a)(2)(D)'s prohibition against tax-free receipt or transfer of partnership interests. Their focus was on use of undivided fractional interests, generally referred to as tenancy-in-common (TIC) interests, which are intended to permit owners of TIC interests (TIC interest owners) to treat themselves as direct owners of the underlying real property (TIC interest property).

Because by definition TIC interests involve common ownership and exploitation of an asset by multiple taxpayers, and because TIC interest owners frequently enter into agreements among themselves or with third parties in the operation of TIC interest property, the core question is whether a TIC arrangement should be characterized as a partnership under IRC §§761(a) and 7701(a)(2). If so, TIC interests should be characterized as partnership interests.

In response to a number of requests for private rulings and an internal debate about what rules should apply to these arrangements, the IRS announced in Rev Proc 2000-46, 2000-2 Cum Bull 438, that it would suspend issuing letter rulings addressing whether IRC §1031 applies to exchanges of TIC interests while it examines the issue. In describing the issues on which it intended to focus, the IRS clearly emphasized its concern about partnership characterization of TIC arrangements. The product of the Rev Proc 2000-46 examination was released as Rev Proc 2002-22, 2002-1 Cum Bull 733. It provides guidance on the conditions under which the IRS will consider a private letter ruling request that a TIC arrangement relating to rental real property, such as a tenancy-in-common interest, will not be treated as an entity separate from its owners (*e.g.,* a partnership or corporation) under Reg §301.7701-1(a). It clarifies the criteria that the IRS views as distinguishing a real estate TIC interest arrangement from a partnership arrangement and will enable sponsors (for definition, see §7.30) to create rental real estate ownership structures that have ownership units capable of being exchanged for other interests in real estate in a like-kind exchange.

Unlike the deferred exchange regulations issued in 1991, or the reverse exchange guidance released as Rev Proc 2000-37, 2000-2 Cum Bull 308, the IRS chose not to create a "safe harbor" for TIC arrangements. By its terms, the TIC revenue procedure "provides guidelines for requesting advance rulings solely to assist taxpayers in preparing ruling requests." Rev Proc 2002-22, §3. The IRS approach is similar in this regard to that previously used in Rev Proc 89-12 to specify the conditions under which the IRS would consider a ruling request on classification of an organization as a partnership for federal tax purposes. Rev Proc 89-12, 1989-1 Cum Bull 798. See also Rev Proc 95-10, 1995-1 Cum Bull 501, which modified Rev Proc 89-12 to include classification of limited liability companies as partnerships. The list of information to be submitted is quite comprehensive and, in many cases, includes information that will not be available to sponsors (for definition, see §7.30) of TIC programs before completion of the sale of TIC interests to ultimate co-owners. As with Rev Proc 89-12, the standards for rulings in Rev Proc 2002-22 have been used more often as a basis for structuring arrangements and as a touchstone for legal opinions than as criteria for submitting private ruling requests.

To date, only a limited number of rulings have been issued under Rev Proc 2002-22. IRS Letter Rulings 200327003 and 200513010 both deal with issues related to TIC interest structures to be packaged and marketed to no more than 35 persons (see §7.32). IRS Letter Rulings 200625009, 200625010, 200826005, 200829012, and 200829013 applied the criteria in Rev Proc 2002-22 to two-party TIC structures. In all three rulings, the IRS concluded that the TIC interest property did not constitute an interest in a business entity under Reg §301.7701-2(a) for purposes of qualification as replacement property under §1031(a).

As discussed in more detail in §§7.33-7.35, in all of these rulings the IRS accepted certain deviations from the default criteria imposed by Rev Proc 2002-22, including allowing the following:

- A sponsor to package and sell TIC ownership interests in a commonly held property for more than 6 months;
- Annual renewal of property management contracts to be accomplished through a "negative consent" procedure;
- Restrictions on alienation, *e.g.,* providing for a right of first offer when a TIC interest owner seeks to sell his or her interest;
- A loan on the property to be guaranteed by an affiliate of the co-owner; and
- A small percentage of leasable space in a property to be leased without concurrent owner approval as long as the management company follows preapproved leasing guidelines.

Revenue Procedure 2002-22, §3, expressly states that "the guidelines set forth in this revenue procedure are not intended to be

substantive rules and are not to be used for audit purposes" and reviews existing law relevant to the issue of entity characterization under IRC §761. Accordingly, practitioners analyzing a TIC arrangement should first be familiar with the law explained in §§7.23-7.28 in connection with planning the arrangement, in addition to understanding the IRS position on some key Rev Proc 2002-22 issues as described in §§7.29-7.43.

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§7.23 C. Tenancy-in-Common Interests as Securities

Another issue arises in tenancy-in-common (TIC) arrangements: Are the resulting TIC interests the "other securities" referred to in IRC §1031(a)(2)(C)? TIC interests are generally considered securities for federal securities regulatory purposes within the meaning of the Securities Act of 1933 (15 USC §§78a-78mm) and the Securities Exchange Act of 1934 (15 USC §§77-78). See, *e.g.,* National Association of Securities Dealers (NASD) Notice 05-18, which requires the sale of TIC interests to comply with the rules governing the sale of traditional securities. Despite this characterization, TIC interests, in the authors' opinion, are unlikely to be subject to §1031(a)(2)(C). Throughout its history, beginning with former §112(b)(1) of the Internal Revenue Code of 1939 and continuing to the present, the "other securities" exclusion from IRC §1031 has consistently referred to the general concept of securities as monetary instruments and stocks, not as direct interests in real property or other tangible assets. Nowhere in any of the uses of the term "securities" in the Internal Revenue Code does a direct interest in real estate appear to be included. See, *e.g.,* IRC §§351(e)(1)(B), 368(a)(2)(F)(vii), 402(e)(4)(E)(i), 409(*l*)(1), 475(c)(2), 851(b)(2); Reg §1.165-5(a).

When the concept of an interest regulated by the federal securities laws is addressed in the Internal Revenue Code, a specific cross-reference is made. See, *e.g.,* IRC §§368(a)(2)(F)(iv)-(vii), 731(c)(2)(B)(i)-(ii), 851(b)(2), 1246(b)(2)(A), 1296(e)(1)(A).

Thus, it appears that the scope of the term "security" for purposes of the Internal Revenue Code would need to be expanded before TIC interests become subject to IRC §1031(a)(2)(C).

NOTE: There is continued debate whether syndicated TIC interests must always be considered "securities" for federal and state regulatory purposes. The NASD Notice 05-18, referred to above, suggests this will almost always be the case but stops short of taking an absolute position. In 2009 the Securities and Exchange Commission (SEC) issued a "No-Action Letter" stating that it considers TIC interests in real estate in two common investment models to be "securities" under the Securities Act of 1933. This No-Action Letter put the two sponsors to which it was addressed (as well as other sponsors using similar structures) on notice that the SEC reserves the right to impose the registration and anti-fraud requirements of the Securities Act of 1933 on these types of offerings. See *Omni Brokerage, Inc.*, SEC No-Action Letter (Jan. 14, 2009) 2009 SEC No-Act Lexis 21. Further, at least one state has enacted legislation that exempts the sale or exchange of certain qualifying TIC interests from the definition of "securities." See Utah C Anno §61-1-13(1)(x)(ii)(C)(III).

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§7.24 D. Tenancy-in-Common Classification Issues

Because they are not organized as separate business entities under state law, tenancy-in-common (TIC) interest (arrangements should never be classified as "associations" taxable as corporations unless the TIC interest owners affirmatively elect such treatment). See Reg §301.7701-3(a). If deemed to be a business entity, a TIC arrangement would almost certainly be classified as a partnership under Reg §301.7701-3(b) because the alternative of classifying the arrangement as a trust is unsatisfactory given the lack of any formal trustee/beneficiary relationships in the typical TIC arrangement. The Internal Revenue Code generally defines a partnership as an organization (other than a corporation, trust, or estate) by which parties carry on a business activity. See IRC §7701(a)(2) (defining partnership as a "syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not … a trust or estate or a corporation"). See also IRC §761(a), which defines a partnership to include any organization (other than a corporation, trust, or estate) "through or by means of which any business, financial operation, or venture is carried on."

In the leading cases of *Commissioner v Culbertson* (1949) 337 US 733, 93 L Ed 1659, 69 S Ct 1210, and *Hubert M. Luna* (1964) 42 TC 1067, the Supreme Court and the Tax Court focused on the parties' intent to join together to conduct a business, as contrasted to establishing another form of relationship such as a filial arrangement (*Culbertson*) or an employer-employee termination arrangement (*Luna*). Another leading case, *Madison Gas & Elec. Co. v Commissioner* (7th Cir 1980) 633 F2d 512, aff'g (1979) 72 TC 521, involved three utility companies' co-ownership of an operating nuclear power plant in which each utility shared expenses equally and received a prorata portion of the plant's electricity output for sale into its own market. This arrangement was held to be a tax partnership despite the "take-in-kind" structure. The utilities argued that no partnership existed, because there was no sharing of profits from the plant operations, but the Seventh Circuit rejected this reasoning.

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1. Ownership Versus Business Activities

§7.25 a. Generally

Co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a partnership. Reg §301.7701-1(a)(2). In determining the nature of activity that would characterize a co-ownership as a partnership, courts have concluded that mere co-ownership of land or net leased property should not create business activity. See *Charles E. Tibbals,* TC Memo 1958-44. In *Estate of Appleby* (1940) 41 BTA 18, the court held that the co-ownership of property simply to share expenses does not create a partnership. The level of management activity conducted by the owners or their agent is crucial in determining partnership status. Thus, if no management activities are provided, then co-ownership of property should not be a partnership.

The IRS has also suggested that, when some management activities are provided for a co-owned real estate, but the activities are limited in nature, the co-ownership will not be deemed a partnership. The key pronouncement is Rev Rul 75-374, 1975-2 Cum Bull 261, which considered whether a two-party tenancy-in-common ownership of an apartment complex should be treated as a partnership. The IRS ruled that the use of an independent manager to provide customary services in managing a residential apartment project did not raise a two-party tenancy-in-common (TIC) interest arrangement to the level of a partnership. The manager's services, which were considered customary for a residential project manager, were as follows:

- Collecting rents;
- Paying real property taxes and insurance premiums; and
- Supervising and paying for maintenance and repairs.

The project furnished customary services to residential tenants (unattended parking, heat, air conditioning, hot and cold water, trash removal, common area maintenance), for which the owners paid their prorata share of costs. The manager furnished other services (attendant parking, cabanas, utilities) for which the manager received payments and bore expenses.

Revenue Ruling 75-374 makes clear that provision of *customary* services by owners will not make them partners, but that performance of noncustomary services by the manager as agent for the owners would be attributed to the owners. Accordingly, the question presented is: What are customary services in the context of varying types of property? The Internal Revenue Code and the regulations use the terms "customary services" and "services customarily furnished" for purposes of tests affecting qualification of real estate investment trusts (see IRC §856; Reg §1.856-4(b)(1)) and "services other than those usually or customarily rendered" for the determination of unrelated business taxable income for tax-exempt entities (see IRC §512; Reg §1.512(b)-1(c)(5)). The application of these tests to determine partnership classification, however, is questionable.

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§7.26 b. Single-Tenant Net Lease Arrangements

Because tenancy-in-common (TIC) interest owners of property subject to a single-tenant net lease do not provide services to the lessee, the level of tenant service is not an issue in single-tenant transactions. Although the management activity and supplying of tenant services by TIC interest owners under a single-tenant net lease should not cause the TIC arrangement to be characterized as a partnership, TIC interest owners must still conduct themselves with regard to each other in a way that is consistent with the co-ownership of property to avoid partnership characterization. Internal Revenue Code §761(a) and Reg §1.761-2 provide a set of guidelines on certain elements of the relationship between TIC interest owners necessary to avoid partnership status. For an investment partnership to elect out of partnership treatment, the investors must (IRC §761(a); Reg §1.761-2(a)(2)(i)-(iii))

- own the property as co-owners;
- separately reserve the right to take or dispose of their shares of any property acquired or retained;
- not actively conduct a trade or business or irrevocably authorize anyone to purchase, sell, or exchange the investment property; and
- be able to adequately calculate their shares of income without computing partnership taxable income.

In addition to *Commissioner v Culbertson* (1949) 337 US 733, 93 L Ed 1659, 69 S Ct 1210, and *Hubert M. Luna* (1964) 42 TC 1067, case law suggests that the presence or absence of these requirements should be analyzed based on the parties' written or oral tenancy-in-common agreement. See, *e.g., Helper v Burnham* (NC 1975) 210 SE2d; *Kayann Props., Inc. v Cox* (1966) 149 SE2d 553; *Ortmann v Kraemer* (1963) 378 P2d 26; *Arnold v Arnold* (Ill 1923) 139 NE 592; *Hill v Reno* (1883) 112 Ill 154.

Most advisers conclude that, for real estate TIC arrangements, the election out of partnership treatment under IRC §761(a) is available only if the common property is unimproved land or net leased property. See discussion in §7.13. This is because any depreciable property is considered to constitute trade or business property and thus precludes the availability of the election. When all requirements are met, however, electing out provides clear relief for TIC arrangements as a result of IRC §1031(a)(2). There is no limit to the number of co-owners who may join in a §761(a) election under Reg §1.761-2(a).

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§7.27 c. Master Lease Arrangements

The simplicity of the single-tenant tenancy-in-common (TIC) interest arrangement (see §7.26) is potentially compromised in a structure that uses a master lease to insulate owners from the day-to-day operations of multiple-tenant property. In this structure, because a master lessee is interposed between TIC interest owners and the property's users, the following issues arise:

- Will the separate status of the master lessee be respected, or will this party be treated as transparent or as an agent of the TIC interest owners?
- Is there a partnership between the TIC interest owners and the master lessee?

Several cases suggest that, if the lessee (or in this case, a master lessee) has a financial interest in the property along with the co-owners, such as a share of the residual interest, the relationship between the co-owners and the lessee may constitute a partnership for federal tax purposes. This line of cases deals with equipment leasing, not real estate, but it is nonetheless illustrative of judicial views on the TIC/partnership debate. Three cases in particular, *Irving J. Bussing* (1987) 88 TC 449, *William G. Alhouse*, TC Memo 1991-652, and *Bergford v Commissioner* (9th Cir 1993) 12 F3d 166, reveal the structural elements that are likely to result in partnership treatment. Thus, these cases are useful in understanding the factors to consider to ensure that a business entity will not be created when a master lease is used.

In *Bussing*, the court held that the taxpayer lessor and the lessee of certain equipment had formed a partnership because the lessee had a stake in the residual value of the property. The lessee contributed services to the transaction and had a significant interest in the rental and residual value of the equipment. On review, the court found that the taxpayer and the lessee were engaged in a joint venture to invest in, lease, and market the equipment and thus were a partnership for federal tax purposes.

In *Alhouse* and *Bergford*, the courts ruled that a business entity existed when participants entered into a subscription agreement with a manager who marketed tenancy-in-common ownership interests in certain computer equipment. This conclusion was reached because the participants and the TIC organizer had a continuing interest in the residual value of the equipment and the intent to join together in a transaction to share profits and losses. The courts found that the interlocking set of agreements, with shared responsibilities, shared profits, and possibly shared losses, formed a partnership.

These cases apply to the master lease format because, if the master lessee is also a co-owner in the underlying property, the master lessee is receiving an income stream from the underlying sublease operations in addition to a share of the rental income under the master lease. This arrangement constitutes a sharing of net income or profits from the property when viewed as a whole, as well as a sharing in the residual value of the property.

NOTE: These cases found that partnerships existed among the parties who expressly joined together through mutual agreements and who shared interests in the equipment's residual value. The courts have not brought ancillary parties to the transaction into the partnerships even though these parties may have been affiliated. Thus, it is reasonable to allow a master lessee to be related to one or more of the TIC interest owners, but not to be a TIC interest owner itself, because if the master lessee is also a material TIC interest owner, the TIC interest owners could be considered as sharing in the profits of the master lessee's real estate business. The ownership of a TIC interest by the master lessee also creates concerns if the master lessee provides services to tenants. If any such service is not "customary" per Rev Rul 75-374, 1975-2 Cum Bull 261 (see §7.25), a prohibited activity may be present that would taint all co-owners.

A second economic sharing issue arises from the different rental structures that can exist in a master lease transaction. Single-tenant, triple-net lease transactions generally have fixed rentals, but master lease transactions often include percentage rent, contingent rent, or other means of participation in the operations. These rental arrangements could indicate participation in the master lessee's business by TIC interest owners. The Internal Revenue Code addresses such arrangements when defining rents for purposes of analyzing the effect on revenue sharing for unrelated business taxable income, *i.e.,* the taint that applies "if the determination of the amount of such rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales)." IRC §512(b)(3)(B)(ii). This concept seems an appropriate analytic tool for TIC purposes, because the objective of determining whether a tax-exempt entity is functioning as a passive property landlord or conducting a business through a partnership with its tenants addresses the same concern that arises in the TIC/partnership inquiry. A full discussion of this concept is beyond the scope of this book. See Weller & Sacon, *Fractional Interests in Real Estate: Legitimate End-run or Illegal Formation?,* 4 J of Passthrough Entities 5 (Sept.-Oct. 2001).

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§7.28 2. Partnership Indicia

In addition to the issues raised in §§7.24-7.27, there are other indicia that a co-ownership arrangement should be classified as a partnership for tax purposes:

- Filing IRS Form 1065;
- Filing as, or doing business under, a fictitious, business, or trade name;
- Holding the group out to third parties as a partnership; or
- Signing contracts as partners.

Each of these will likely result in the conclusion that the co-ownership group is an organization (other than a corporation, trust, or estate) "through or by means of which any business, financial operation, or venture is carried on." IRC §761(a).

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E. IRS Guidance

§7.29 1. Introduction

Although issued as ruling guidance only, Rev Proc 2002-22, 2002-1 Cum Bull 733, contains the most substantive conditions announced by the IRS regarding the characterization of co-ownership arrangements since Rev Rul 75-374, 1975-2 Cum Bull 261. The practical utility of the revenue procedure is that it suggests a framework for tenancy-in-common (TIC) arrangements acceptable to the IRS, and §§7.30-7.43 discuss the substance of this guidance and some of the practical issues that might arise from it.

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2. Framework of TIC Arrangements Under Rev Proc 2002-22

§7.30 a. Definitions

Section 4 of Rev Proc 2002-22, 2002-1 Cum Bull 733, contains important definitions that serve as a foundation for understanding its provisions:

- "Co-owner" means anyone who owns an interest in the property as a tenant in common.
- "Sponsor" means anyone who divides a single interest in the property into multiple co-ownership interests for the purpose of offering those interests for sale.
- "Related person" means anyone bearing a relationship described in IRC §267(b) or §707(b)(1), except that in applying either section the co-ownership will be treated as a partnership and each co-owner will be treated as a partner.
- "Disregarded entity" means an entity that is disregarded as an entity separate from its owner for federal tax purposes. Examples of disregarded entities include qualified real estate investment trust subsidiaries (within the meaning of IRC §856(i)(2)), qualified subchapter S subsidiaries (within the meaning of IRC §1361(b)(3)(B)), and business entities that have only one owner and do not elect to be classified as corporations.
- "Blanket lien" means any mortgage or trust deed that is recorded against the property as a whole.

The revenue procedure contemplates that, although most tenancy-in-common (TIC) arrangements involve a single "property," some arrangements may involve multiple parcels of real estate leased to a single tenant under a single lease agreement, when multiple parcels are pledged as collateral for a single debt. The fact that multiple parcels are involved in the arrangement will not preclude the arrangement from receiving a favorable ruling, but the IRS has imposed particular conditions to these multiple parcel arrangements: (1) each co-owner must have an identical percentage interest in each parcel, (2) the co-owners' interests in each parcel cannot be unbundled or transferred separately, and (3) the multiple parcels "are properly viewed as a single business unit." Rev Proc 2002-22, §4.

The first two requirements in the definition of multiple properties will generally not be a problem, although the "no unbundling" criterion seems somewhat inconsistent with the general requirement, discussed in §7.12, that TIC interest owners be free to transfer their TIC interests. The third requirement is more problematic, because it requires analysis in any multiple property arrangement of what constitutes a "single business unit." Revenue Procedure 2002-22 states that generally this criterion will be satisfied only by contiguous properties or by noncontiguous properties when "there is a close connection between the business use of one parcel and the business use of another parcel." The example given is of an office building and a noncontiguous parking structure, which serves the tenants of the building. Rev Proc 2002-22, §4. Thus, it appears unlikely that separate noncontiguous rental properties leased to different tenants will satisfy the "single business unit" definition.

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§7.31 b. Specific Criteria

Section 6 of Rev Proc 2002-22, 2002-1 Cum Bull 733, describes the conditions that must generally be satisfied for the IRS to consider a ruling request.

NOTE: The revenue procedure as published contains two sections numbered as "6." "Conditions" are described in the first §6. The effect of the procedure on other documents is described in the second §6, which should probably be numbered as §7.

The 15 enumerated conditions can be divided into four broad categories: (1) formation issues, *e.g.,* the legal structure of the arrangement, the scope of the sponsor's activities, and the sponsor's exit strategy; (2) allocation issues regarding revenue, expenses (*i.e.,* profit and loss), and debt; (3) management and control issues (*e.g.,* the scope of the co-owners' activities, property management, and leasing); and (4) co-owner exit strategies (*e.g.,* sale of underlying property, puts, calls, and options). These categories neatly describe the major business terms of most co-ownership agreements, and §6 thus provides some practical advice on where the line between a tenancy-in-common and a partnership/joint venture can be drawn.

It is important to note that the IRS expressly acknowledges the possibility that in certain circumstances failure to satisfy all criteria of §6 will not preclude receipt of a favorable ruling on tenancy-in-common (TIC) status (Rev Proc 2002-22, §6 preamble):

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the conditions described below are satisfied. Nevertheless, where the conditions described below are not satisfied, the Service may consider a request for a ruling under this revenue procedure where the facts and circumstances clearly establish that such a ruling is appropriate.

Further, as discussed in §§7.33-7.35, in the letter rulings issued under Rev Proc 2002-22, 2002-1 Cum Bull 733, the IRS has held that arrangements with limited deviations would nevertheless be treated as eligible property under IRC §1031(a).

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§7.32 c. Formation Issues

Revenue Procedure 2002-22, 2002-1 Cum Bull 733, clarifies the following formation issues:

- **Tenants-in-common under common law.** Co-owners must hold their interests as tenants-in-common under local law. The corollary to this is that title to the property as a whole cannot be held by an entity (such as a partnership) recognized under local law. Rev Proc 2002-22, §6.01. This rule may also apply to trusts or other title holding vehicles, such as IRC §501(c)(2) title holding corporations.

- **No Swaps and Drops.** The IRS will not usually issue a ruling under this revenue procedure if the co-owners held interests in the property through a partnership or corporation immediately before the formation of the co-ownership. Rev Proc 2002-22, §6.03. Thus, taxpayers who obtained their tenancy-in-common interests through a real property distribution from a partnership as part of a plan to allow individual partners to exchange their prorata interests in the property will not be able to obtain rulings relating to these transactions—at least not under this revenue procedure. See §7.31 for further discussion of this issue.

- **Maximum number of owners.** There can be no more than 35 co-owners. Rev Proc 2002-22, §6.02. This number is consistent with prior law maximum numbers for subchapter S corporations (see former IRC §1361(b)(1)(A) before 1997 amendment), and current law maximum numbers for nonaccredited investors in a private placement securities offering. See 17 CFR §§230.505(b)(2)(ii), 230.506(b)(2)(i). For this purpose, a husband and wife are treated as a single person and all persons who acquire interests from a co-owner by inheritance are also treated as a single person.

- **Sponsor fees on purchase of TIC interests.** The amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the property. Rev Proc 2002-22, §6.15.

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§7.33 d. Revenues, Expenses, Debt, and Cash Flow Allocations

Revenue Procedure 2002-22, 2002-1 Cum Bull 733, describes the following allocations:

- **Revenue and expense allocation.** Each co-owner must share in all revenues generated by the property and all costs associated with the property in proportion to that co-owner's undivided interest in the property. Rev Proc 2002-22, §6.08. This rule is consistent with existing law under Reg §1.761-2(a), which requires that all members of an entity eligible to elect out of treatment under Subchapter K be able to separately compute their income without having to compute partnership level taxable income.

- **Debt allocation.** In dealing with debt secured by a blanket lien, the IRS took extremely conservative and, in the authors' opinion, unjustified positions in view of the lack of authority regarding debt associated with co-ownership arrangements. Co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests. Rev Proc 2002-22, §6.09. This is one of the most important restrictions imposed by this revenue procedure and may be the one with the least theoretical support, as discussed in §7.40. (See Note below.) If the property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds distributed to the co-owners. Rev Proc 2002-22, §6.07.

NOTE: In Internal Revenue Service Letter Rulings 200625009 and 200625010, the IRS accepted a slight deviation from the rule that debt must be shared by co-owners (for definition, see §7.30) in proportion to their undivided interests. In these letter rulings, which both involved two-party TIC arrangements, the IRS held that a loan secured by the property from an unrelated lender could be guaranteed by an affiliate of the co-owner and still comport with Rev Proc 2002-22, §6.09. If one co-owner paid more than its share of debt, pursuant to a guaranty or otherwise, that co-owner had the right to be indemnified by the other co-owner for the amount in excess of a 50-percent share of the expense. See also Internal Revenue Service Letter Rulings 200826005, 200829012, and 200829013, which also involved two-party TIC arrangements with a similar indemnity provision but in which the loan was evidently not guaranteed by an affiliate of either co-owner.

- **Creation of blanket liens.** The co-owners must retain the right to approve creation or modification of any blanket lien, and any negotiation or renegotiation of any indebtedness secured by a blanket lien must be with the co-owners' unanimous approval. Rev Proc 2002-22, §6.05. Parties related to the co-owners, the sponsor, the manager, or any lessee of the property may not make loans secured by blanket liens against the property. Rev Proc 2002-22, §6.14.

- **Net revenue distributions.** If the co-owners employ a manager for the purpose of collecting revenue, the manager must disburse to the co-owners their shares of net revenues within 3 months after the date of receipt of those revenues. Rev Proc 2002-22, §6.12.

- **Default remedies.** The other co-owners, the sponsor, and the manager may not advance funds to a co-owner (*i.e.,* a co-owner who fails to fund his or her prorata share of negative cash flow or capital expenses) to meet expenses associated with the co-ownership interest, unless the advance (1) is recourse to the co-owner (and, if the co-owner is a disregarded entity, the owner of the co-owner) and (2) is not for a period exceeding 31 days. Rev Proc 2002-22, §6.08.

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§7.34 e. Property Management, Operations, and Decisions

Revenue Procedure 2002-22, 2002-1 Cum Bull 733, examines the following management and operation issues:

Scope of co-owner activity. The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property ("customary activities"). Rev Proc 2002-22, §6.11. The standards discussed in Rev Rul 75-374, 75-2 Cum Bull 261, are specifically mentioned. Activities will be treated as customary activities for this purpose if they would not prevent an amount received by an organization described in IRC §511(a)(2) from qualifying as rent under IRC §512(b)(3)(A) and regulations under it. In determining the co-owners' activities, all activities of the co-owners, their agents, and anyone related to the co-owners with respect to the property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. See §7.42 for further discussion of this issue.

Sponsor's activities. If the sponsor or a lessee is a co-owner, then all of the activities of that party (or any related person) with respect to the property will be taken into account in determining whether the co-owners' activities are "customary activities" undertaken by owners as tenants-in-common that do not rise to the level of partnership activities, but the activities of a co-owner or a related person with respect to the property (other than in the co-owner's capacity as a co-owner) will *not* be taken into account if the co-owner owns an undivided interest in the property for less than 6 months. Rev Proc 2002-22, §6.11.

Revenue Procedure 2002-22, §6.11, allows continued involvement by the sponsor beyond 6 months as long as the activities of the sponsor and the co-owners are "customary activities" described in IRC §511(a)(2) with respect to the property. It appears that the creation and sale of TIC interests by the sponsor beyond 6 months would not run afoul of this requirement. In Letter Ruling 200327003, the sponsor planned to hold an interest in the property until all of the TIC interests were sold, which the sponsor represented could take up to 18 months. The sponsor would continue to divide and sell (and presumably market) the TIC interests. However, during this time, the property would be subject to a "triple net lease" to a single corporate tenant, thus limiting the sponsor's and co-owners' involvement to "customary activities."

Use of management agents. Co-owners may enter into management or brokerage agreements, which must be renewable no less often than annually, with an agent, who may be the sponsor or a co-owner (or any related person) but who may not be a lessee. Rev Proc 2002-22, §6.12. The co-owners must unanimously approve the agreement. Rev Proc 2002-22, §6.05.

In Letter Ruling 200327003, the IRS ruled that a "negative consent" procedure for renewal of a management agreement complied with the annual renewal requirement contained in Rev Proc 2002-22, §6.12. In Letter Ruling 200327003, the manager was to provide the co-owners notice, no less than annually, of the management agreement's renewal. Any co-owner could then exercise the right to terminate the agreement within 60 days. Co-owners not exercising their right to terminate the management agreement during this period were deemed to consent to renewal.

In Letter Ruling 200513010, the co-owners had a similar "negative consent" procedure for annual renewal of the management agreement. However, an objecting co-owner was required to name a substitute manager and the material terms under which the substitute manager would be engaged. If any other co-owner objected to the substitute manager, then the non-objecting co-owners could acquire the ownership interest of the original objecting co-owner at fair market value. If the non-objecting co-owners did not exercise this option, then the objecting co-owner could hire the substitute manager at its own expense and cease to be a party to the original management agreement.

Compensation to a manager cannot depend on the co-owners' income or net profits and cannot exceed fair market value for the manager's services, a limitation that also applies to brokerage arrangements. The management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the property against any revenues before disbursing each co-owner's share of net revenues. The management agreement may also authorize the manager to prepare statements for the co-owners, showing their shares of revenue and costs from the property, to obtain or modify insurance on the property, and to negotiate modifications of the terms of any lease or any indebtedness encumbering the property, subject to the co-owners' approval. The manager must, however, disburse each co-owner's share of net revenues within 3 months after the date of receipt or apparently no less frequently than quarterly. Rev Proc 2002-22, §6.12.

Leasing. The co-owners must retain the right to approve any leases of a portion or all of the property, and any sale, lease, or re-lease of a portion or all of the property, and several other decisions, must be by unanimous approval of the co-owners. Rev Proc 2002-22, §6.05.

In Letter Ruling 200513010, the IRS ruled that notwithstanding the requirement that co-owners provide unanimous consent for

leases and re-leases of the property, co-owners could grant their management company the ability to lease or re-lease a small percentage of total leasable space. Leases entered into directly by the management company were required to meet lease guidelines preapproved by the co-owners annually.

All leasing arrangements must be bona fide leases for federal tax purposes. Rents paid must reflect the fair market value for the use of the property. The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales), with reference to existing standards under standards applicable to real estate investment trusts under IRC §856(d)(2)(A) serving as the test. Rev Proc 2002-22, §6.13.

In Letter Rulings 200625009, 200625010, 200826005, 200829012, and 200829013, each involving two-party TIC structures, the IRS approved an arrangement by which a portion of the property was leased to an affiliate of a co-owner in order to conduct a business unrelated to the management or leasing of the property. Rents payable were not dependent on the profits of the affiliated (or any other) lessee.

Miscellaneous management decisions. Except when unanimous consent is required in connection with employing a manager or with making sale, lease, and financing decisions, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the property. Rev Proc 2002-22, §6.05. A co-owner who consents to be bound by a majority rule action may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney. Rev Proc 2002-22, §6.05.

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§7.35 f. Co-Owner Exit Strategies

Revenue Procedure 2002-22, 2002-1 Cum Bull 733, discusses the following exit strategies:

- **Sale of underlying property.** Co-owners must retain the right to approve the sale or other disposition of the property, and any sale must be agreed to by 100 percent of the co-owners. Rev Proc 2002-22, §6.05.

- **Restraints on alienation of co-ownership interests.** In general, each co-owner must have the right to transfer, partition, and encumber the co-owner's undivided interest in the property without the agreement or approval of any person. However, restrictions on the right to transfer, partition, or encumber interests in the property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. Rev Proc 2002-22, §6.06.

- **Right to offer.** In addition, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (calculated as of the time the partition right is exercised) before exercising any right to partition. Further, a co-owner may grant the other co-owners, the sponsor, or the lessee a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any potential transfer of the co-ownership interest in the property. Rev Proc 2002-22, §6.06.

In Letter Rulings 200625009, 200625010, 200826005, 200829012, and 200829013, each involving two-party TIC structures, the IRS approved an arrangement by which a specific buy-sell procedure would be followed on a partition of the property or on any sale that would result in a change in control of the property. A change in control is deemed to occur if an outside party becomes the owner of more than 50 percent of the outstanding ownership interests in either co-owner. This buy-sell procedure requires the co-owner seeking the sale or partition to engage in good faith negotiations to sell the property to the other co-owner for a specified period.

In a parallel but slightly different formulation of permissible arrangements, a co-owner may also grant other owners an option to purchase the co-owner's undivided interest (call option) as long as the exercise price for the call option reflects the fair market value of the property calculated as of the time the option is exercised. For this call option purpose, the fair market value of an undivided interest in the property is equal to the co-owner's percentage interest in the property multiplied by the fair market value of the property as a whole. Rev Proc 2002-22, §6.10.

- **Put options.** Absolutely prohibited by the revenue procedure are "put" options in which a co-owner holds a right to sell the co-owner's undivided interest to the sponsor, the lessee, another co-owner, the lender, or any related person. Rev Proc 2002-22, §6.10.

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§7.36 3. Required Information

Section 5 of Rev Proc 2002-22, 2002-1 Cum Bull 733, provides a detailed list of required general information, documents, and supplementary materials that must be submitted with a request for a ruling. These include, among many other things, all co-owners' names and taxpayer identification numbers, title and lease documentation, brokerage agreements, and promotional material.

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4. Practical Issues Arising in Connection With Rev Proc 2002-22 Framework

§7.37 a. Drop and Swap Transactions

A large group of real estate tenancy-in-common (TIC) interest arrangements is created in Drop and Swap transactions. See §§7.7-7.20. The former partners, now tenants in common, then separately sell or exchange their TIC interests.

A key issue in these transactions is whether the IRS will respect the TIC arrangement or recharacterize it as a continuation of the old partnership or the creation of a new one. Apparently the IRS did not want to deal with validating these transactions when other issues are usually present—such as whether the property is held for a qualified use under IRC §1031 or for attribution of the sale back to the original partnership under the *Court Holding* doctrine (which attributes the sale by the distributee of property formerly owned by the distributing corporation back to the distributing corporation; *Commissioner v Court Holding Co.* (1945) 324 US 331, 334, 89 L Ed 981, 985, 65 S Ct 707; see, *e.g.,* IRS Letter Ruling 9545005). The IRS, therefore, expressly excluded TIC transactions from the purview of the rulings that may be sought when a partnership had formerly held the property.

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§7.38 b. Multiple Properties

Although recognition that some tenancy-in-common (TIC) interest arrangements can involve multiple properties appears to be useful, Rev Proc 2002-22, 2002-1 Cum Bull 733, may frustrate certain attempts to structure TIC arrangements when interests in multiple unrelated properties are bundled. These structures do not seem to qualify for favorable ruling reviews because of the "single business unit" concept, which would rule out discrete, unconnected properties. See §7.30. However, one sponsor of such a form of TIC arrangements has obtained a patent that describes a format for creating unit interests in multiple unrelated properties that are the subject of a single master lease. See U.S. Patent Office Patent No. 6,292,788 B1 filed September 18, 2001. The district court has declared this patent to be invalid. *Fort Props. Inc. v American Master Lease* (CD Cal 2009) 609 F Supp 2d 1052.

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§7.39 c. Unanimous Co-Ownership Decisions

The list of decisions in which each co-owner must participate creates problems for many tenancy-in-common (TIC) interest arrangements and requires creative and clever design of these structures. Co-owners must each approve all leases, they must approve any sale of the common property, and they must each approve any financing involving creation of a blanket lien, including refinancing transactions. Rev Proc 2002-22, §6.05, 2002-1 Cum Bull 733. As a practical matter this creates the potential for stalemate of major decisions by any co-owner, regardless of how small an interest that co-owner holds. This possibility of a stalemate will rightfully create anxiety in potential co-owners and in lenders' thinking about financing TIC property.

PRACTICE NOTE: It is probably not practical or sound business practice to allow a 1-percent owner to effectively block a property sale. Planners are likely to explore the possibility of preapproved terms of sale to which all owners consent in advance or other mechanisms providing advance assurance that a business plan that contemplates sale of a common property at a particular time or under particular circumstances can be carried out. The most common solution to date has been to provide that when a majority or supermajority of TIC owners approves a decision, the interests of dissenters can be purchased by those approving the decision or by the TIC sponsor.

Several avenues are available to planners seeking to reconcile a need for orderly management of TIC property and the requirements of Rev Proc 2002-22. One avenue is to assume that partition is the ultimate weapon for a stalemated tenant-in-common arrangement. If the parties cannot unanimously agree on a core decision, the property should be subjected to court-ordered sale and the proceeds divided proportionately. Unfortunately, this avenue places a great deal of power in any minority TIC interest owner willing to exercise the right to dissent from a sale, financing, lease, or management decision desired by all other co-owners.

The IRS will doubtless be asked whether a co-owner can give prior consent to sale, leasing, finance, or management decisions that meet predefined criteria. In other words, can a co-ownership agreement to which all co-owners are party contain provisions stating that the owners agree in advance to a sale at a future date at a price equal to, for example, an independently appraised property value? Can the co-owners agree in advance that they will consent to leases of space within the common property as long as such leases bear minimum rents and contain other predefined terms—such as the amount to be spent on tenant improvements, lease duration, *etc*.? In these cases, all co-owners would be consenting to the actions, but not contemporaneously with the timing of the action. It remains to be seen whether such pre-set criteria will be allowed.

Another approach might be to require each co-owner to invest in a TIC property through a limited liability company in which the sponsor or a related party is the manager but in which the TIC interest owner holds 100 percent of profits, losses, and capital interests.

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§7.40 d. Debt Allocation

The Rev Proc 2002-22, 2002-1 Cum Bull 733, requirement with the least basis in law has to do with debt secured by a "blanket lien." In attempting to prevent partnership-like characteristics from being grafted onto tenancy-in-common (TIC) interest arrangements through their financing structures, Rev Proc 2002-22 appears to have invented a rule without justification in existing law. No published authority addresses a TIC arrangement in which different co-owners wish to use different debt-equity ratios to acquire their prorata share of the common property. It is typical for a lender providing financing to some co-owners to require that such financing be secured by the entire common property rather than an undivided interest; this is because the lender does not want to own an undivided interest if forced to foreclose on its security in the event of loan default. There is nothing strange about nonborrowing co-owners using their TIC interests as collateral for such a loan, as long as they are fully indemnified by the borrowers against loss as a result of any default.

EXAMPLE: Dick and Terry wish to purchase Blueacre for $100,000 with Dick willing to put up $50,000 cash and Terry able to borrow $50,000 from Howard, who requires receipt of a deed of trust to all of Blueacre. Terry's share of net cash flow from Blueacre is sufficient to pay debt service on the $50,000 loan. Dick is willing to cooperate as long as Terry indemnifies Dick against any loss by reason of Dick's pledging his interest in Blueacre to secure the loan from Howard. Terry should be able to service Howard's loan and retire it on sale of the property (or of Terry's interest). If proceeds from the sale of Terry's 50 percent interest are insufficient to pay Howard, Terry must make up the difference. This system does not require any partnership level computation of income nor any allocation of debt. It should not affect characterization of Dick and Terry's relationship as co-owners.

Similarly, the Rev Proc 2002-22, §6.07 requirement that debts secured by blanket liens be retired on the sale of commonly owned property seems unnecessary. Consider the sale of property by tenants in common in which most or all of the co-owners want to engage in a like-kind exchange and become co-owners of the replacement property. The holder of a loan secured by a blanket lien is willing to continue to extend credit to the group and to shift the lender's security to the replacement property. Why should this scenario be prohibited? Further, in a world of securitized mortgaged debt and collateralized mortgage backed securities (CMBS), it is not uncommon to find absolute bars to debt prepayment for fairly lengthy periods after a CMBS loan is initiated. The solution when a mortgage lien must be removed is "defeasance," a procedure in which cash or cash equivalent collateral is substituted for real estate collateral. It is not at all clear that defeasance is allowable under the mandate of §6.07. The IRS's rationale for the requirement of blanket lien debt payoff on a property sale simply does not appear persuasive. For more on CMBS and defeasance, see California Real Estate Finance Practice: Strategies and Forms, chap 1 (Cal CEB 2000).

The absolute limitation on related party loans in Rev Proc 2002-22, §6.14 will require careful vetting of the identity of co-owners and lessees. This requirement will place TIC sponsors in the same position as group investment sponsors subject to the related party debt at-risk limitation of IRC §465(b)(3).

WARNING: In the context of a like-kind exchange, this requirement will make it difficult to create TIC arrangements capable of responding to the separate debt/equity ratio requirements of different co-owners.

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§7.41 e. Capital Calls

A rather peculiar element of tenancy-in-common (TIC) arrangements required by Rev Proc 2002-22, §6, 2002-1 Cum Bull 733, is the limitation on remedies available to co-owners on any owner's failure to contribute required capital. Revenue Procedure 2002-22, §6.08 allows co-owners, sponsors, or managers to advance funds to meet co-owner capital calls, but only if the advance is recourse to the "defaulting" co-owner and "is not for a period exceeding 31 days." It is unclear what happens if the advance is not repaid within that short period. If the only remedy of the advancing co-owners is to purchase the defaulting partner's interest, then the requirement of fair market value payment appears to provide an advantage to the defaulting party. This result is inconsistent with the currently common practice of subjecting a defaulting party to a penalty on mandatory sale of its interest after a default in making a required capital contribution.

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§7.42 f. Scope of Co-Owner Activity

Revenue Procedure 2002-22, §6.11, 2002-1 Cum Bull 733, attempts to limit co-owner business activities to those "customarily performed in connection with the maintenance and repair of rental real property." According to the revenue procedure, the activities of the co-owners, their agents, and related parties will be taken into account. However, it is unclear how this rule will correlate to the principle that for attribution purposes the rule of IRC §707(b)(1)-(2) will apply, *i.e.,* whether noncustomary activities by a 1-percent co-owner will be attributed to the entire TIC interest group. If so, business arrangements involving a 1-percent co-owner directly could be fatal, but business arrangements involving a party related to 49 percent of the co-owners will not. This may elevate form over substance.

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§7.43 g. Sponsor Exit Strategies

In an effort to recognize the sales cycle of tenancy-in-common (TIC) arrangements, the IRS created a 6-month safe harbor during which business activities, *e.g.,* those that rise above the "customary activities" of Rev Rul 75-374, 1975-2 Cum Bull 261, engaged in by co-owners will not taint a TIC arrangement. Rev Proc 2002-22, §6.11, 2002-1 Cum Bull 733. This safe harbor appears to be primarily directed at TIC sponsors who hold TIC interests because they are being sold to unrelated co-owners. Because these rules are not intended as substantive principles, it appears that such limitations may apply only to TIC arrangements seeking rulings.

Adoption of "fair market value" requirements for such things as management fees (Rev Proc 2002-22, §6.12), sponsor compensation (Rev Proc 2002-22, §6.15), co-owner buy-out options (Rev Proc 2002-22, §6.06), lease rates (Rev Proc 2002-22, §6.13), and brokerage fees (Rev Proc 2002-22, §6.12) puts a premium on the methods used to calculate such value. This result could be particularly troublesome for lease rates because the requirement is not limited to related party lessees but is apparently global in an attempt to screen out the possibility of "partnership" arrangements between co-owners and lessees. However, Rev Proc 2002-22 is silent on the standards that may be used to establish the fair market value of lease terms.

An interesting question related to valuation arises from the §6.15 requirement that payments to a sponsor for a TIC interest be equal to the fair market value of that interest "and may not depend, in whole or in part, on the income or profits derived by any person from the Property." This statement seems innocuous, but it is common in valuing commercial real estate, particularly net leased real estate, to establish fair market value by reference to capitalized income from the property. If the revenue procedure admonition is taken literally, use of an income capitalization rate system for establishing TIC interest unit value may not be permissible: a strange result when this is exactly the system typically used by the market to calculate the value.

Another potential problem with this requirement is its effect on variable pricing for co-ownership interests. In any TIC arrangement, the possibility exists that individual TIC interests might be offered by sponsor/sellers at different prices at different times. This possibility could arise from changing property characteristics, *e.g.,* execution of a favorable lease that raises property value or termination of an above-market-rate lease that lowers value. It remains to be seen whether Rev Proc 2002-22, §6.15 will allow for such variations, even though they should have no effect whatever on a determination that the eventual co-owners of a property are or are not partners.

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§7.43A 5. Delaware Statutory Trusts: Rev Rul 2004-86

Some tenancy-in-common (TIC) sponsors have used a form of entity known as a Delaware Statutory Trust (DST) as a means to place title to TIC property into a single name and give certain forms of control to an independent trustee, with TIC owners holding beneficial interests in the trust. These were viewed as grantor trusts, with trust beneficiaries holding direct interests in trust assets for tax purposes, rather than partnership interests (prohibited by IRC §1031(a)(2)(D)) or certificates of trust or beneficial interest (prohibited by IRC §1031(a)(2)(E)). After informally indicating skepticism that this was possible and receiving requests from the public for guidance, in July 2004, the Treasury Department and the IRS released Rev Rul 2004-86, 2004-33 Int Rev Bull 191, which describes a situation when (1) a DST would be classified as a trust rather than a business entity for federal tax purposes, and (2) beneficial interests in such a DST could qualify as replacement property for §1031 purposes.

In the ruling, an individual (A) entered into a 10-year nonrecourse loan with a bank and used the proceeds of the loan to purchase rental real property. After the purchase, A entered into a triple net lease of the property with a tenant for a term of 10 years with fixed rent that could be adjusted based on a fixed rate or objective index (*e.g.,* the Consumer Price Index). On the same day, A formed a DST and contributed the property to it. The DST assumed A's rights and obligations under the loan and the lease.

The interests in the DST, which were of a single class representing undivided beneficial interests in the DST assets, were freely transferable, but they were not publicly traded. The DST would terminate on the earlier of 10 years from the date of its creation or the disposition of the property. It would not, however, terminate on the bankruptcy, death, or incapacity of any owner or on the transfer of any right, title, or interest of the owners. The trustee's activities were limited to the collection and distribution of income. The trustee was authorized to establish reasonable reserves required to operate the property and engage in ministerial activities to the extent required to maintain and operate the DST under local law.

The trustee was prohibited from doing the following:

- Disposing of or exchanging the property and reinvesting the proceeds;
- Purchasing assets other than short-term obligations that matured before the next distribution date (and the trustee was required to hold those obligations until maturity);
- Accepting additional contributions of assets (including money);
- Renegotiating the terms of the property's debt;
- Refinancing the debt;
- Renegotiating the lease or entering into leases with other tenants, except that the trustee was permitted to renegotiate the lease or enter into leases with other tenants in the event of the bankruptcy or insolvency of the tenant under the lease; and
- Making more than minor nonstructural modifications to the property (except as required by law).

After the DST was formed, B and C (through a qualified intermediary) purchased all of A's interest in the DST. B and C had previously sold real property held for investment. Neither the DST nor the trustee were agents of A, B, or C, and neither the DST nor the trustee were represented as an agent in dealings with third parties. The IRS ruled that the DST was an investment trust classified as a trust for federal tax purposes rather than a business entity (*i.e.,* a corporation or partnership), and that B and C could exchange their real property for beneficial interests in the DST and qualify for tax deferral under IRC §1031. The IRS warned that if the trustee had any of the "prohibited powers" described in the bullet list above, the DST would be treated as a business entity, not a trust. If treated as a business entity, the DST would have been treated as a partnership and B and C would not have been able to exchange real property for interests in the DST under IRC §1031.

NOTE: Due to the IRS position that availability of any of the listed powers would change its conclusion that the DST was not a business entity, the prohibited trustee powers listed in Rev Rul 2004-86 have become known as the "Seven Deadly Sins."

As a result of the need to restrict the trustee of a DST from committing any of the Seven Deadly Sins, the DST structure is not well suited to operation of properties when there will be leasing, refinancing, or any material construction. The current solution to this is for DSTs to be created with a provision that permits conversion of the trust to a partnership or limited liability company if active management is required. This conversion would turn the co-ownership arrangement into a partnership for income tax purposes.

PRACTICE TIP: When available, the DST structure may offer advantages over the use of "tenants in common on title" structures, primarily because use of a trustee may avoid need for unanimous owner consent to sell a commonly owned property. Additional benefits of the DST structure may be lenders' preference for this structure's unity of property ownership, which may enable taxpayers to obtain superior financing terms. The use of a DST should also reduce the TIC group's expense and cost of organizing separate LLCs to hold title to each co-owner interest in the common property. Initially, however, it appears that the use of the DST structure is most applicable to single-tenant net-leased and master-leased transactions because the trustee cannot be granted any power to actively manage the property or effectively respond to finance or lease problems. Application in multitenant properties and in other contexts remains uncertain.

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IV. ISSUES UNIQUE TO CORPORATIONS

§7.44 A. Consolidated Groups

Corporations that are part of an affiliated group as defined in IRC §1504(a) (also commonly referred to as a consolidated group) may not undertake like-kind exchanges among each other, because the intercompany transaction rules affecting consolidated returns are the exclusive regime under which such transactions are to be reported. Reg §1.1502-80(f). Nonetheless, a member of a consolidated group may avoid triggering recognition of formerly unreported intercompany gain on disposition of a property subject to the deferred intercompany gain rules to a third party outside the group if the disposition is structured as a like-kind exchange under IRC §1031. Reg §1.1502-13(c)(7)(ii), Example 1(h). If it is, only the net boot received by the exchanging entity will result in intercompany gain.

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§7.45 B. Reorganizations

The IRS has ruled that valid like-kind exchanges may be completed by corporations different from those that disposed of relinquished property when the corporation completing the exchange succeeds to the attributes of the corporation that started the exchange under IRC §382.

In IRS Letter Ruling 9850001, a corporate group obtained a favorable ruling allowing a series of corporate merger transactions to occur "midstream" during a like-kind exchange when the corporation that acquired replacement property succeeded by merger to the corporation that disposed of the relinquished property. This ruling implies a general continuity-of-use principle that has no analogue in the partnership context, because IRC §382 has no parallel under Subchapter K. For similar results, see IRS Letter Rulings 9252001, 9152010.

In IRS Letter Ruling 200151017, the IRS permitted an exchange by a group of corporate subsidiaries. The relinquished property was owned by three first-tier and one second-tier subsidiaries, all owned directly and indirectly (through multiple tiers) by a common parent. After the subsidiaries disposed of their relinquished property, one of the first-tier subsidiaries merged with one of the other first-tier subsidiaries. The IRS ruled that this statutory merger, under IRC §368(a)(1)(A), did not disqualify the exchange by either the disappearing or surviving subsidiaries, because the survivor succeeded to the tax attributes of the disappearing corporation under IRC §381(a) principles.

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§7.45A C. Pre- and Postexchange Asset Movement Between Members of Consolidated Group

The qualified use requirement of IRC §1031 generally creates issues when a taxpayer receives relinquished property immediately before it is exchanged or when a taxpayer transfers replacement property immediately after receiving it in an exchange. Despite favorable authority relating to exchanges of relinquished property acquired with the intent to exchange (see §2.25) and to transfers of property into and out of entities in nonrecognition transactions (see §§2.32-2.33), the tax consequences of these transactions remain uncertain.

Another form of pre- or postexchange transfer can occur when one member of an affiliated corporate group, as defined in IRC §1504(a), receives property from another member in a tax-free, intercompany transfer immediately before an exchange or makes a tax-free intercompany transfer immediately after receiving property in an exchange. No published authority addresses the consequences of such transactions under IRC §1031. However, it is the authors' opinion that the special rules of Treas Reg §1.1502-13 support the conclusion that these intercompany transfers do not prejudice an otherwise valid like-kind exchange, at least insofar as the qualified use requirement is concerned. This is because the fundamental premise of this regulation is that members of an affiliated group are generally treated as divisions of a single corporation rather than as separate taxpayers with respect to timing, character, source, and other attributes of intercompany transactions. Thus, a pre- or postexchange property transfer is regarded as being within a single taxpayer. See Treas Reg §1.1502-13(a)(2). Although there is no explicit reference to the qualified use standard of IRC §1031, the definition of "attributes" that are treated as common to members of a group in intercompany transactions does include the attribute of whether property is held for sale in the ordinary course of business, *i.e.*, is "dealer" property. Treas Reg §1.1502-13(c)(1)(i). This suggests that the question of whether property is held for trade or business or investment purposes should also be an attribute that applies to a transferee of property in an intercompany transaction preceding or following a §1031 exchange.

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§7.46 D. Real Estate Investment Trusts

A corporation or trust that has elected to be taxed as a Real Estate Investment Trust (REIT) is subject to a 100-percent penalty tax on the REIT's net income from "prohibited transactions." IRC §857(b)(6)(A). Section 857(b)(6)(B)(iii) defines the term "prohibited transaction" as the sale or other disposition of property described in §1221(a)(1) that is not foreclosure property. Section 1221(a)(1) describes "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business," sometimes referred to as "dealer property."

Internal Revenue Code §857(b)(6)(C) provides a safe harbor under which the term "prohibited transaction" does not include the sale of property that is a real estate asset if certain requirements are met. The safe harbor requirements in IRC §857(b)(6)(C) are met if

(i) the trust has held the property for not less than 2 years;

(ii) aggregate expenditures made by the trust, or any partner of the trust, during the 2-year period preceding the date of sale which are includible in the basis of the property do not exceed 30 percent of the net selling price of the property; [and]

(iii) (I) during the taxable year the trust does not make more than 7 sales of property (other than sales of foreclosure property or sales to which section 1033… applies), or (II) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property (other than sales of foreclosure property or sales to which section 1033… applies) sold during the taxable year does not exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the trust as of the beginning of the taxable year.

In Letter Ruling 200824018, the IRS held that the holding period of replacement property acquired in a §1031 like-kind exchange includes the holding period of the relinquished property for purposes of IRC §857(b)(6)(C)(i). In Letter Ruling 200824018, a REIT operating partnership sought to dispose of property in a taxable sale that had been acquired in a like-kind exchange. The operating partnership had not held the replacement property itself for 4 years (the Housing Assistance Tax Act of 2008 (Pub L 110-289, 122 Stat 2654) revised the holding period in IRC §857(b)(6)(C)(i) from 4 to 2 years). However, the operating partnership had held the relinquished and replacement properties together for more than 4 years. The IRS held that the holding period of the replacement property included the prior holding period of the relinquished property in order to meet the IRC §857(b)(6)(C)(i) threshold.

For many years, the question of whether a disposition of property by a REIT engaging in a like-kind exchange was to be considered a "sale" for purposes of determining the availability of this safe harbor had gone unanswered.

In Letter Rulings 200701008 and 200728037, the IRS held that the disposition of relinquished property by a like-kind exchange by the operating partnership of a publicly traded REIT is not a "sale" for purposes of computing the limitation on sale dispositions by the REIT under IRC §857(b)(6)(C)(iii) when the operating partnership recognizes no gain or loss in the like-kind exchange. Further, in Letter Ruling 200702021, the IRS concluded that when an operating partnership recognizes some gain as a result of boot received in an otherwise valid like-kind exchange, only the fraction of the relinquished property's basis equal to the fraction whose numerator is the value of the boot received and whose denominator is the value of total consideration received will be considered in applying the "10 percent of basis test" under IRC §857(b)(6)(C)(iii)(II).

PRACTICE NOTE: Although there is no indication in the text of Letter Ruling 200702021 as to the relative amount of boot associated with the fact pattern addressed, representatives of the IRS have informally indicated that only a small amount of boot was involved in the submission that resulted in the ruling and that taxpayers should be wary of relying on the ruling when the ratio of boot to total consideration is significant.

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Directory

§2.49:

The product classes listed in the North American Industrial Classification System are available at http://www.census.gov/eos/www/naics.

§3.89:

The Franchise Tax Board provides a publication on "Real Estate Withholding Guidelines," available at http://www.ftb.ca.gov/forms/ misc/1016.pdf.

§§3.89-3.90:

Franchise Tax Board: See http://www.ftb.ca.gov or call (888) 792-4900 for the most current information on Real Estate Withholding Services and Compliance.

§5.18:

Federation of Exchange Accommodators

100 N. 20th St., 4th Floor

Philadelphia, PA 19103-1443

Telephone: (215) 564-3484

FAX: (215) 963-9785

Website: http://www.1031.org

§5.39A:

ABA Comments Regarding Rev. Proc. 2000-37 Safe-Harbor Build-to-Suit Exchanges Involving Leasehold Improvements, 2004 TNT 90-85 (May 5, 2004) is available at http://www.abanet.org/tax/ pubpolicy/2004/040505seb.pdf.

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Source: Real Property/Real Property Exchanges/Glossary

Glossary

Accommodator. See *Exchange accommodation titleholder*; *Intermediary*

Adjusted basis.

The taxpayer's adjusted basis in property is generally the initial cost increased by expenditures for capital improvements and decreased by allowable depreciation or cost recovery deductions. IRC §§1011-1012, 1016. See §3.2.

Amount realized. See *also Money received*; *Other property*; *Realized gain*; *Realized loss*

The amount realized in an exchange is the sum of any money received plus the fair market value of any other property received. IRC §1001(b). Money paid by the taxpayer to another party to the exchange reduces the taxpayer's amount realized. If the taxpayer pays cash, executes a promissory note, or assumes a liability of another party to the exchange (or acquires property subject to a liability), the taxpayer is treated as having paid money, and the amount realized is reduced accordingly. Reg §1.1031(d)-2, Example 2. See §3.2.

At-risk limitations.

The at-risk limitations are provisions of IRC §465 that limit a taxpayer's deductible loss for income tax purposes to the amount that the taxpayer has at risk in the activity generating the loss. Because the at-risk limitations apply to real property, a taxpayer can deduct losses from a real property investment only to the extent of the amounts personally invested or for which the taxpayer is personally liable (recourse debt). See §1.31.

Boot. See *also Cash boot*; *Constructive receipt*; *Like-kind property*; *Money received*; *Mortgage boot*; *Other property*; *Tax-deferred exchange*

In a tax-deferred exchange under IRC §1031, anything given or received by the taxpayer other than like-kind property that is not excluded by IRC §1031(a)(2) and is either held for investment or used in a trade or business is commonly called boot. Boot can include property expressly excluded from qualification for tax-deferral under §1031, non-like-kind property, money, or other property received. See §3.12.

Boot-netting rules. See *Boot-offset rules*

Boot-offset rules. See *also Boot*

A taxpayer who both gives and receives boot may be able to offset the boot given against the boot received to reduce the amount of gain that must be recognized. The complex rules governing that offset are called the boot-offset or boot-netting rules. See §§3.12, 3.22-3.29.

Buyer. See *also Relinquished property*

In this book, buyer refers to the party that ultimately acquires the relinquished property on completion of the exchange transaction. See §1.20.

Build-to-suit exchange. See *also Qualified intermediary safe harbor*; *Reverse exchange*; *Safe harbor reverse exchange*

A build-to-suit or construction exchange is a transaction by which an accommodating party acquires land or a leasehold interest in land and constructs or causes to be constructed improvements on behalf of an exchanger to serve as replacement property in a like-kind exchange. See §§5.35-5.39A.

Buyer cooperating three-party exchange.

A buyer cooperating three-party exchange is one in which the buyer of the relinquished property acts as the intermediary in the exchange by acquiring the replacement property from the seller and conveying it to the taxpayer in exchange for the relinquished property. See §1.40.

Cash boot. See *also Boot*; *Like-kind property*; *Tax-deferred exchange*

Cash boot is boot that consists of cash or other property that is (a) not like kind, (b) excluded by IRC §1031(a)(2), or (c) not held by the taxpayer for investment or use in its trade or business See §3.13.

Chief Counsel advice. See *also General counsel memorandum*; *Field service advice*

Chief Counsel advice refers to written guidance issued by the National Office of the Chief Counsel of the Internal Revenue Service to the IRS and Treasury (IRC §6110(i)). This guidance takes a variety of forms including Chief Counsel memoranda (CCM), general counsel memoranda (GCM), field attorney advice (FAA), and field service advice (FSA). The purpose of Chief Counsel advice is to advise IRS personnel on legal matters at varying stages of development. Chief Counsel advice cannot be cited as precedent (see IRC §6110(k)(3)), although it may influence an agent or appellate conferee's evaluation of a matter. See §1.13.

Chief Counsel memorandum. See *Chief Counsel advice*

Construction exchange. See *Build-to-suit exchange*

Constructive receipt. See *also Boot*; *Like-kind property*; *Other property*; *Relinquished property*; *Deferred exchange safe harbors*

Money or property is considered to have been constructively received when it is credited to the taxpayer's account, used for the taxpayer's benefit, set apart for the taxpayer, or otherwise made available so that the taxpayer may use it at any time. Money or property is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. IRC §451; Reg §§1.451-2, 1.1031(k)-1(f)-(g). An exchange will not qualify under IRC §1031 if the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the date on which the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives property that has a fair market value equal to a portion (but less than all) of the consideration paid for the relinquished property, the exchange may still satisfy §1031, but the cash and fair market value of the other property received are taxed as boot under IRC §1031(b). See §§4.36-4.37.

Contract price. See *also Excess basis*; *Installment sale*; *Gross profit ratio*; *Net qualifying indebtedness*; *Tax-deferred exchange*

When the installment sale rules are applied, the contract price must be determined in order to calculate the gross profit ratio. When the installment sale occurs in connection with a tax-deferred exchange, the contract price is the fair market value of the relinquished property, reduced by the fair market value of the replacement property, and further reduced by the net qualifying indebtedness that does not exceed excess basis. See §3.44.

Dealer property.

Real property held for sale to customers in the ordinary course of a trade or business is known as dealer property. Dealer property does not meet the IRC §1031 test of property "held for investment or used in a trade or business," and gain from the disposition of dealer property is generally taxed as ordinary income. IRC §§1221(a)(1)-(2); *Margolis v Commissioner* (9th Cir 1964) 337 F2d 1001. See §2.7.

Deferred exchange.

The regulations define a deferred exchange as an exchange in which, under a written agreement, the taxpayer transfers property held for productive use in a trade or business or for investment and subsequently receives property to be held either for productive use in a trade or business or for investment. See Reg §1.1031(k)-1(a). The key definitional element is that receipt of replacement property occurs after a transfer of relinquished property. Deferred exchanges are also known as delayed, or *Starker* exchanges. The term delayed exchange was coined before the adoption of Reg §1.1031(k)-1 and is becoming less common. The term *Starker* exchange associates these transactions with the seminal case of *Starker v U.S.* (9th Cir 1979) 602 F2d 1341, which established the validity of deferred exchanges and ultimately led to the adoption of IRC §1031(a)(3). See §4.7. To be consistent with the definition in the regulations, this book generally uses deferred exchange to refer to a nonsimultaneous exchange that is not a reverse exchange.

Deferred exchange safe harbors. See *also Interest and growth factor safe harbor*; *Qualified escrow accounts and qualified trusts safe harbor*; *Qualified intermediary safe harbor*; *Qualified trust*; *Safe harbor*; *Security and guaranty arrangements safe harbor*

Deferred exchange safe harbors are procedures approved by the Internal Revenue Service that may be used to structure an exchange. See §4.37. They consist of certain prescribed security devices, including qualified trusts, qualified escrows, and qualified intermediaries. Reg §1.1031(k)-1(g). Use of a deferred exchange safe harbor may shield the taxpayer from a determination that the taxpayer is in constructive or actual receipt of money or other property for purposes of IRC §1031 (which could invalidate the exchange). Reg §1.1031(k)-1(g)(1). See §§4.36-4.69, 5.16-5.26, chap 6.

Delaware Statutory Trust.

A Delaware Statutory Trust (DST) is an unincorporated association that (1) is created by a governing (trust) instrument under which (a) property is held, managed, and/or operated or (b) business or professional activities for profit are carried on by a

trustee for the benefit of beneficial owners and (2) files a certificate of trust. 12 Del C §§3801-3824. For tax purposes, an interest in a DST can be considered a direct interest in trust property.

Delayed exchange. See *Deferred exchange*

Direct deeding.

Direct deeding refers to (a) the deeding of replacement property from the seller directly to the taxpayer, rather than indirectly through an intermediary who then deeds it to the taxpayer, or (b) the deeding of relinquished property by the taxpayer directly to the buyer, rather than indirectly to an intermediary who then deeds it to the buyer. See §§2.62-2.64.

Disassociation. See *also Related party*

As used in this book, "disassociation" refers to an event that causes parties related under IRC §267(b) or §707(b)(1) to no longer be considered related to one another. This could include resignation of a trustee, divorce of married couples, or ownership changes in a corporation or partnership. It is unclear whether a planned disassociation or a disassociation that occurred immediately before a like-kind exchange would fall under the purview of IRC §1031(f). See §2.73.

Disqualified person. See *also Constructive receipt*; *Qualified escrow accounts and qualified trusts safe harbor*; *Qualified intermediary safe harbor*; *Safe harbor reverse exchanges*

Certain parties under the control of or related to the taxpayer are restricted from serving as qualified escrow agents, qualified trustees, qualified intermediaries, or qualified exchange accommodation titleholders for purposes of the deferred and reverse exchange safe harbors. The regulations refer to those parties as disqualified persons. See Reg §1.1031(k)-1(k). See §§4.65-4.67, 5.18.

Disregarded entity. See *also Real estate investment trust*

An entity that is ignored as separate from its owner for income tax purposes. Single-member domestic limited liability companies and certain wholly owned S corporations and real estate investment trust subsidiaries are automatically treated as disregarded entities unless an election is made to treat them as associations taxable as corporations. See §2.32.

Drop and Swap. See *also Swap and Drop*; *Separation without divorce*; *Partnership division*

An exchange transaction in which title to a property owned by a corporation or a partnership is distributed to shareholders or partners, respectively, and the shareholders or partners separately undertake like-kind exchanges of the distributed property. See §7.7.

Dwelling unit. See *also Real estate investment trust*

Pursuant to Rev Proc 2008-16, 2008-10 Int Rev Bull 1, which provides a safe harbor for exchanging vacation homes, a dwelling unit is real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including sleeping space, bathroom, and cooking facilities. See §2.39B.

EAT. See *Exchange accommodation titleholder*

Escrow agents or officers.

In real property transactions, the escrow agent or officer is the entity or person that receives documents and funds from the principals in the transaction (*e.g.,* the buyer, seller, and exchanger), holds the documents and funds, and delivers them on the occurrence of specified conditions in accordance with instructions from the principals. In some regions, escrow agents are employed to structure the exchange itself. See §1.54.

Excess basis. See *also Boot*; *Installment sale*; *Like-kind property*; *Exchanged basis*

The term "excess basis" is used in two contexts. First, Former Prop Reg §1.453-1(f)(1)(iii) uses the term to refer to relinquished property basis in excess of fair market value of replacement property. See §3.44. Second, the term also refers to newly created replacement property basis (as calculated under IRC §1031(d)) over exchanged basis. Reg §1.168(i)-6(b)(8). Excess basis, under this definition, can be created when a taxpayer acquires replacement property with a fair market value in excess of fair market value of relinquished property either through additional cash or debt. See §§3.67, 3.76, 3.76F.

Exchange accommodation titleholder. See *also Qualified exchange accommodation arrangement*; *Qualified indicia of ownership*

In a safe harbor reverse exchange, this is the party that holds either replacement property or relinquished property for the benefit of the exchanger. See §5.18.

Exchange counterparty. See *also Buyer*; *Seller*; *Deferred exchange*

In all exchange transactions, the taxpayer actually does or is deemed to swap properties with another party referred to as the exchange counterparty. In a deferred exchange, when the buyer of relinquished property and the seller of replacement property are different parties, an intermediary generally serves as the exchange counterparty. See §§1.39, 4.40, 4.53.

Exchange equity credit. See *also Exchanger*; *Deferred exchange*

Exchange equity credit is the amount held by the intermediary in a deferred exchange, for the benefit of the exchanger, after selling the relinquished property. The intermediary applies the exchange equity credit to one or more items of replacement property. See §§1.6, 3.58, 4.60.

Exchange escrow.

An exchange escrow is the escrow through which properties are exchanged between two parties. In a seller-cooperating three-party exchange, the taxpayer and the seller are the parties to the exchange escrow. See §1.40. In a buyer-cooperating three-party exchange, the buyer and the taxpayer are the parties to the exchange escrow. See §1.40. In a four-party exchange, there is typically no exchange escrow; rather, the deeds for transferring the properties between the taxpayer and the intermediary are recorded as an accommodation in the sale escrows. See §1.39.

Exchange first. See *also Exchange last*

A form of reverse exchange using an exchange accommodation titleholder to acquire and hold an exchanger's relinquished property in a like-kind exchange undertaken at the time of purchase of the replacement property in the exchange. The exchange accommodation titleholder will ultimately sell the property it holds and remit the proceeds to or for the account of the exchanger. See §5.9.

Exchange group. See *also Like-kind property*; *Multiple property exchange*

The first step in determining recognized gain and new basis in a multiple property exchange is to separate the properties into exchange groups. An exchange group consists of all properties relinquished and all properties acquired in the exchange that are of a like kind or a like class. Reg §1.1031(j)-1(b)(2)(i). Each exchange group must contain at least one property transferred by the taxpayer and one property received by the taxpayer. See §3.38.

Exchange group deficiency. See *also Multiple property exchange*

In a multiple property exchange, an exchange group deficiency is the excess of the aggregate fair market value of the relinquished property in an exchange group over the aggregate fair market value of the replacement property in that exchange group (less excess liabilities assumed by the taxpayer that are allocated to the exchange group). Reg §1.1031(j)-1(b)(2)(iv). Gain is recognized in the exchange group to the extent of any exchange group deficiency, but the recognized gain may not exceed the gain realized for that group. See §3.41.

Exchange group surplus. See *also Multiple property exchange*

In a multiple property exchange, an exchange group surplus is the amount by which the aggregate fair market value of the replacement property in an exchange group (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that group) exceeds the aggregate fair market value of the relinquished property in the group. Reg §1.1031(j)-1(b)(2)(iv). An exchange group surplus increases the basis of property received in the exchange. Reg §1.1031(j)-1(c). See §3.41.

Exchange last. See *also Exchange first*

A form of reverse exchange using an exchange accommodation titleholder to acquire and hold what will become the exchanger's replacement property in a subsequent like-kind exchange undertaken at or after the sale of the exchanger's relinquished property in the exchange. See §5.8.

Exchange period. See *also Deferred exchange*

In a deferred exchange, the exchange period is the period within which the taxpayer must receive the replacement property. The exchange period begins on the date on which the taxpayer transfers the relinquished property and ends on the earlier of the 180th day after that date or the due date (including extensions) of the taxpayer's income tax return for the taxable year in which the

relinquished property is transferred. Reg §1.1031(k)-1(b)(2)(ii), (3). See §4.16.

Exchange requirement. See *also Constructive receipt*; *Deferred exchange safe harbors*

The exchange requirement is one of five basic requirements that an exchange must satisfy to qualify for tax deferral under IRC §1031. The transaction must qualify as an exchange of properties—not a sale followed by a reinvestment or purchase. The primary focus in determining whether the exchange requirement has been met is whether the taxpayer actually or constructively received the cash proceeds (or any other consideration) from the disposition of the relinquished property before receiving the replacement property. See §§2.51-2.69, 4.36-4.73.

Exchanged basis.

When calculating carryover basis in replacement property acquired in an IRC §1031 exchange in order to determine depreciation deductions, taxpayers must distinguish between exchanged and excess basis. Exchanged basis is the lesser of (1) the adjusted basis of the relinquished property or (2) the basis in the replacement property. Reg §1.168(i)-6(b)(7). Exchanged basis is the element of basis that carries over from relinquished to replacement property under IRC §1031(d). It is calculated after the depreciation deductions for the relinquished property in the year of disposition are ascertained. See §§3.67, 3.76, 3.76B.

Exchanger. See *also Taxpayer*

Exchanger is a term often used in exchange agreements to describe the taxpayer, *i.e.,* the party intending to complete an exchange to obtain nonrecognition treatment under IRC §1031. See §1.20.

Excluded property. See *also Nonqualifying property*; *Type-of-property requirement*

In this book, excluded property refers to property that is expressly excluded from tax-deferred exchange treatment by IRC §1031(a)(2), such as stock in trade, interests in partnerships, stocks, or bonds. See §§2.6-2.18.

Facilitator. See *Intermediary*

Federally declared disaster.

Federally declared disaster (formerly presidentially declared disaster) is any disaster subsequently determined by the President of the United States to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. See IRC §165(h)(3)(C). The Secretary of Treasury is authorized to extend the time periods required to successfully complete a deferred or safe harbor reverse exchange after the announcement of a federally declared disaster. IRC §7508A. See §§4.18A-4.18D.

Field attorney advice. See *Chief Counsel advice*

Field service advice. See *also Chief Counsel advice*; *Letter rulings*; *Technical advice memorandum*

A field service advice is a memorandum prepared by the National Office of the Chief Counsel of the Internal Revenue Service, analyzing issues presented by an agent relating to an ongoing audit. Unlike letter rulings and technical advice memorandums, a field service advice is not binding, although it generally influences an agent or appellate conferee's evaluation of a case. Field service advice may not be cited as authority or precedent in any tax controversy. See §1.13.

Foreign person. See *also United States real property interest*

For purposes of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) (IRC §§861, 882, 897, 6039C in pertinent part) and IRC §1445, a foreign person is a nonresident alien individual, foreign corporation, foreign partnership, foreign trust, or foreign estate. Reg §1.1445-2(b)(2). When a foreign person disposes of a United States real property interest, FIRPTA imposes special reporting and withholding requirements on the transferee, subject to some exceptions. See §§3.82-3.85.

Forgone interest. See *also Qualified intermediary safe harbor*

Forgone interest means (with respect to any period during which a loan is outstanding) the excess of the interest payable on the loan for the period if it was (1) accrued at the applicable federal rate and (2) payable annually on the last day of the year over any interest payable on the loan allocable to such period. IRC §7872(e)(2). In deferred exchanges using the qualified intermediary safe harbor, if the intermediary is allowed to retain interest earned on exchange proceeds as a fee, the taxpayer may be required to determine whether there is forgone interest. See §4.57C.

Four-party exchange. See *also Deferred exchange*

A four-party exchange involves the taxpayer, the buyer, the seller, and an independent intermediary to facilitate the exchange. The taxpayer transfers the relinquished property to the intermediary, who sells it to the buyer, uses the proceeds to purchase the replacement property from the seller, and then transfers the replacement property to the taxpayer. A four-party exchange can be simultaneous or nonsimultaneous. See §1.39.

GAAP. See *Generally accepted accounting principles*

Generally accepted accounting principles.

Generally accepted accounting principles (often abbreviated as "GAAP" or "US GAAP") are accounting rules used to process, prepare, and present public accounting information. GAAP is the current basis of financial accounting in the United States.

General counsel memoranda. See *also Chief Counsel advice*; *Letter rulings, Technical advice memorandum*

General counsel memoranda (GCM) are legal memoranda prepared by the National Office of the Chief Counsel to provide legal advice to branches of the Internal Revenue Service. GCMs cannot be cited as precedent. IRC §6110(k)(3). See §1.13.

Gross profit. See *also Installment sale*; *Gross-profit ratio*

For purposes of the installment sale rules, gross profit is the selling price less the adjusted basis of the property (which, for this purpose, is increased by commissions and other selling expenses). Temp Reg §15A.453-1(b)(2)(v). In most installment sales, the gross profit is the same as realized gain. When an installment sale is combined with a tax-deferred exchange, the gross profit is reduced by the realized gain that is not recognized because of the exchange (*i.e.,* the deferred gain). IRC §453(f)(6)(B). See §3.44.

Gross-profit ratio. See *also Contract price*; *Gross profit*; *Installment sale*

In an installment sale, the gross-profit ratio is the ratio of the gross profit to the contract price. Temp Reg §15A.453-1(b)(2)(i). In installment sale reporting, the gross-profit ratio is applied to the payments received by the taxpayer in a particular year to determine the amount that will be recognized gain. See §3.44.

Growth factor. See *also Interest and growth factor safe harbor*; *Deferred exchange*

The term "growth factor" arose from *Starker v U.S.* (9th Cir 1979) 602 F2d 1341, discussed in §§4.7 and 4.49. In that case, the taxpayer had agreed to convey to Crown Zellerbach Corporation (CZ) his interest in timberland. CZ agreed to acquire and deed to the taxpayer real property to be designated by the taxpayer within a specified time period. Because the relinquished property was timberland, the agreement provided that CZ would add to the taxpayer's credit an annual growth factor equal to 6 percent of the outstanding balance. The taxpayer contended that this amount was compensation for the growth of the timber on the property during the time period that CZ was obligated to purchase the replacement properties. The court disregarded this label and characterized the growth factor as interest, which was taxable to the taxpayer. 602 F2d at 1356. See §4.7.

Held for productive use in trade or business or for investment. See *also Qualified use*

Only property that is considered to be held for productive use in a trade or business or for investment qualifies for tax-deferred exchange treatment under IRC §1031. No clear definition of these terms is stated by the Internal Revenue Code or the Treasury Regulations. For further discussion of the parameters of such property, see §2.4. The taxpayer's purpose in holding the relinquished property and the replacement property is determined as of the time of the exchange. See §2.8.

Identification period. See *also Deferred exchange*; *Exchange last*; *Relinquished property*; *Replacement property*; *Reverse exchange*

In a deferred exchange, the taxpayer must identify the replacement property within a 45-day period that begins on the date on which the taxpayer transfers the relinquished property. This period is referred to as the identification period. Reg §1.1031(k)-1(b). See §4.16.

In an Exchange Last reverse exchange conducted in accordance with Rev Proc 2000-37, 2002-2 Cum Bull 308, a parallel rule applies, except that the taxpayer must identify the relinquished property within a 45-day period that begins on the date on which the EAT acquires the replacement property. Rev Proc 2000-37. See §5.20.

Incidental property rule. See *also Identification period*; *Deferred exchange*; *Three-property rule*

Incidental property generally refers to property transferred together with a larger item of property in standard commercial transactions and having an aggregate fair market value not exceeding 15 percent of the value of the larger property to which it relates (*e.g.*, washing machines transferred with an apartment building). Reg §1.1031(k)-1(c)(5). The concept is relevant only in

determining whether replacement property has been adequately identified before the end of the identification period in a deferred exchange. For this purpose, the Internal Revenue Service disregards the incidental property, *i.e.,* does not treat it as property separate from the larger property. Thus, if the larger piece of property is adequately identified, the incidental property is considered to be adequately identified, even if no reference is made to the incidental property. In addition, for purposes of the three-property rule, the incidental property and the larger property are treated as one property. Reg §1.1031(k)-1(c)(5)(ii), Example 1. See §4.27.

Installment sale. See *also Dealer property*

An installment sale is a disposition of property in which at least one payment is to be received after the close of the taxable year in which the disposition occurs. Dispositions by dealers and dispositions of personal property inventory do not qualify as installment sales. IRC §453(b). On combining an installment sale with a tax-deferred exchange, see §§3.43-3.45.

Integrated plan test. See *also Step-transaction doctrine*

Courts sometimes use the integrated plan test to measure whether a series of transactions, as a whole, constitute an exchange. The importance of the test has diminished since the promulgation of regulations governing deferred (nonsimultaneous) exchanges. The test is still useful, however, in evaluating exchanges that do not qualify for the regulatory safe harbors. See §2.55.

Interest and growth factor safe harbor. See *also Growth factor*; *Other property*; *Deferred exchange safe harbors*

The interest and growth factor safe harbor is one of four safe harbors in the deferred-exchange regulations. Regulation §1.1031(k)-1(g)(5) provides that the determination of whether the taxpayer is in actual or constructive receipt of money or other property will be made regardless of whether the taxpayer is, or may be, entitled to receive any interest or growth factor as part of the deferred exchange. The safe harbor applies, however, only if the taxpayer's rights to receive interest or a growth factor are expressly limited as stated in Reg §1.1031(k)-1(g)(6). See §§4.44, 4.58-4.62.

Interest credit. See *also Exchange equity credit*; *Exchange period*; *Four-party exchange*; *Independent intermediary*

Interest credit is the term used in a four-party exchange agreement to refer to the interest earned on the exchanger's equity credit, which increases the amount due from the intermediary to the exchanger. See §4.57.

Intermediary. See *also Four-party exchange*; *Deferred exchange*

A party who receives and transfers a taxpayer's relinquished property to a buyer and receives and transfers a taxpayer's replacement property from a seller, thus facilitating an exchange transaction by eliminating the need for buyer or seller cooperation in the exchange. See §1.20.

Irrigation company. See *Mutual ditch company*

Joint signature account. See *also Constructive receipt*; *Independent intermediary*; *Relinquished property*; *Replacement property*

A joint signature account is a bank account in which the signatures of two or more parties are required for withdrawals. Pending acquisition of the replacement property in a deferred real property exchange, the taxpayer may require the intermediary to deposit exchange proceeds in an account in which the taxpayer (or the taxpayer's designee) and the intermediary or the transferee of the relinquished property are joint signatories and for which both parties' signatures are required for withdrawals. See §4.68.

Letter rulings. See *also Revenue ruling*; *Technical advice memorandum*

Letter rulings are written advice issued by the Internal Revenue Service, on written request from taxpayers, regarding the tax treatment of their specific proposed transactions. Letter rulings may be relied on by the taxpayers involved but may not be used or cited as precedent by anyone else, unless the IRS establishes otherwise by regulation. IRC §6110(j)(3). Letter rulings are also called private letter rulings and private rulings. See §1.13.

Like-class. See *also Multiple property exchange*

A safe harbor provided by Treasury Regulations in connection with application of the like-kind standard to depreciable tangible personal property. Depreciable tangible personal properties are considered to be like-class if they are either within the same general asset class (consisting of property described in one of asset classes 00.11-00.28 of Rev Proc 87-56, 1987-2 Cum Bull 674) or within the same product class (consisting of the six-digit product classes within Sectors 31-33 of the North American Industrial Classification System but not including product classes with the last digit 9). Treas Reg §1.1031(a)-2(b). Depreciable tangible personal property that is considered like-class is also considered like-kind. However, properties can be like-kind without being like-class. Treas Reg §1.1031(a)-2(a). See §2.49.

Like-kind exchange.

Exchanges under IRC §1031 are alternatively referred to as "like-kind," "tax-deferred," "tax-free," and "nontaxable" exchanges. "Like-kind exchange" is the most accurate term used to refer to transactions that are the subject of IRC §1031.

Like-kind property. See *also Like-kind requirement*

An exchange of properties will not qualify for tax deferral under IRC §1031 unless the properties exchanged are considered to be of "like kind." That term refers to the nature or character of the property, not to its grade or quality. Reg §1.1031(a)-1(b). See §2.40. With few exceptions, an interest in real property is considered to be like in kind to any other interest in real property, regardless of the presence or absence of improvements or the type of improvements. See §§2.41-2.46. Personal property is not like in kind to real property. Whether property is real property or personal property is established by state law. Personal property is generally like in kind to other personal property if it is put to a similar use. See §§2.47-2.49.

Like-kind requirement. See *also Like-kind property*

The like-kind requirement is one of five basic requirements that an exchange must meet to qualify under IRC §1031. The relinquished and replacement properties must be of like kind. See §§2.40-2.50.

LKE Program.

An ongoing personal property like-kind exchange program involving multiple exchange of 100 or more assets that meets specific criteria outlined in Rev Proc 2003-39. Exchange programs or program exchanges that are not considered LKE Programs may not qualify for the safe harbor prescribed by Rev Proc 2003-39. See §4.73C.

Money received.

Gain is recognized by the taxpayer on any money received as part of the exchange. IRC §1031(b); Reg §1.1031(b)-1(a). For this purpose, money received includes cash, cash equivalents such as bank certificates of deposit or treasury notes, and any secured or unsecured liabilities of the taxpayer that another party assumes or subject to which another party takes property in the exchange. Reg §1.1031(b)-1(b)-(c), (d)-2, (j)-1(b)(2)(ii). See §§3.8-3.9, 3.11.

Mortgage boot. See *also Boot*; *Net mortgage boot*; *Relinquished property*; *Replacement property*

Mortgage boot consists of liabilities that a party assumes or subject to which a party acquires property in the exchange. If another party to the exchange assumes the taxpayer's liabilities or acquires the taxpayer's relinquished property subject to liabilities, the taxpayer is considered to have received mortgage boot. If the taxpayer assumes another party's liabilities or acquires replacement property subject to those liabilities in the exchange, the taxpayer is considered to have paid or given mortgage boot. See §3.14. Mortgage boot received (*i.e.*, debt relief) may be offset by mortgage boot given. See §3.23.

Multiple property exchange. See *also Like-kind property*; *Qualifying property*

A multiple property exchange is an exchange that qualifies under Reg §1.1031(j)-1(a) and is subject to special rules on the determination of recognized gain and the calculation of basis. Reg §1.1031(j)-1. An exchange is a multiple property exchange if (1) more than one type of qualifying property is exchanged for properties of like kind or like class, or (2) two or more properties of the same kind or class are relinquished or acquired in exchange for property of like kind or class. Reg §1.1031(j)-1(a). See §§3.36-3.42.

Mutual ditch company.

A mutual ditch, reservoir, or irrigation company is an entity organized to hold water rights for its shareholders. Stock of a mutual ditch, reservoir, or irrigation company can be considered real property under state law. The definition of "stock" contained in IRC §1031(a)(2)(B) does not include shares of certain mutual ditch, reservoir, or irrigation companies. IRC §1031(i). See §2.11.

Net mortgage boot. See *also Cash boot*; *Mortgage boot*

When the mortgage boot given by the taxpayer as part of the exchange is offset against the mortgage boot received by the taxpayer, the result is the net mortgage boot. If the taxpayer has given more than received, that amount is referred to as net mortgage boot given. If the taxpayer has received more than given, that amount is referred to as net mortgage boot received. See §3.23. Net mortgage boot received may be offset by cash boot given (see §3.24), but cash boot received may not be offset by mortgage boot given (see §3.29).

Net qualifying indebtedness. See *also Cash boot*; *Excess basis*; *Installment sale*; *Mortgage boot*

The net debt relief, consisting of mortgage boot received (total debt relief from disposition of the relinquished property) reduced by net cash boot given and mortgage boot given, is known as net qualifying indebtedness. Former Prop Reg §1.453-1(f)(1)(iii). This concept is relevant in determining whether gain must be recognized in the year of the transaction when an installment sale is combined with a like-kind exchange. If the taxpayer's net qualifying indebtedness does not exceed the excess basis, the excess basis is allocated to the installment obligation and no gain is recognized until payments of principal are received on the installment obligation. If the net qualifying indebtedness exceeds the excess basis (which means that the replacement property has already been allocated basis to the extent of its fair market value and therefore gain was deferred), the excess will constitute a payment in the year of sale. See §3.44.

95-percent rule. See *also Exchange period*; *Deferred exchange*; *Replacement property*; *Three-property rule*; *200-percent rule*

In deferred exchanges, the 95-percent rule permits the taxpayer to make valid identification of as many properties as it desires, and with any values, as long as the taxpayer receives as many of such identified properties, before the end of the exchange period, as have at least 95 percent of the value of all the identified replacement properties. Reg §1.1031(k)-1(c)(4)(ii)(B). See §4.25.

Nonqualifying property. See *also Excluded property*; *Like-kind property*; *Purpose requirement*

As used in this book, nonqualifying property is any property that is excluded property (see §§2.6-2.18), property not held for the required business or investment purpose, or non-like-kind property (see §§2.40-2.50). See generally §§1.17-1.18.

Nonrecourse financing. See *also Qualified nonrecourse financing*

If a loan is secured by specified collateral and, under the terms of the loan or the antideficiency laws, the lender's only recourse in the event of default is to foreclose against the security, that financing is called nonrecourse financing. See §1.31.

Non-safe-harbor reverse exchange. See *also Parking*; *Reverse exchange*; *Safe harbor reverse exchange*

This is a reverse exchange that uses a parking arrangement that does not meet the requirements of the safe harbor provided in Rev Proc 2000-37, 2000-2 Cum Bull 308. See §§4.36-4.43.

Other property. See *also Nonqualifying property*

Other property consists of nonqualifying property received by the taxpayer in the exchange. See IRC §§1031(b)-(c), discussed in §1.21.

Parking.

Parking refers to ownership of property by an accommodator in a reverse exchange. In an Exchange First transaction, the exchanger's relinquished property will be parked. In an Exchange Last transaction, the exchanger's intended replacement property will be parked. The term is sometimes also used to refer to a form of property banking or warehousing in which the taxpayer acquires replacement property in order to complete a deferred exchange within the exchange period provided in IRC §1031(a)(3) but continues to look for different replacement property. Essentially, the taxpayer "parks" the exchange equity in the replacement property for an interim period. This transaction may not qualify under IRC §1031(a)(1), because that subsection requires that the taxpayer intend to hold the replacement property for productive use in a trade or business or for investment and not for the purpose of exchanging again. See §§5.7-5.15.

Partnership division. See *also Drop and Swap*; *Swap and Drop*

This refers to a technique that may allow partners in a partnership (or an entity treated as a partnership for federal tax purposes) to separately acquire individual replacement properties. In a partnership division, a partnership divides into multiple resulting partnerships that are treated as continuations for tax purposes. See §7.7. Each resulting partnership may have the ability to complete an IRC §1031 exchange initiated by the former partnership. See §7.20A.

Passive loss rules.

Losses from a passive activity generally may be offset only against gains from passive activities—not gains from other types of activities. The rules governing these offsets are known as the passive loss rules. Passive activity includes the conduct of a trade or business in which the taxpayer does not materially participate, or engaging in rental activity above a certain dollar threshold regardless of the taxpayer's participation. IRC §469. See §§1.27, 1.29, 1.30, 1.33.

Private letter rulings. See *Letter rulings*

Private rulings. See *Letter rulings*

Production services.

Production services are services received by the taxpayer relating to production of replacement property when production of that property is not complete at the time it is received by the taxpayer. Reg §1.1031(k)-1(e)(4). See §4.32.

Purchase escrow. See *also Replacement property*

Purchase escrow refers to the escrow in which the intermediary purchases the replacement property. See, *e.g.,* forms 4.111-1, 5.64-1.

QIO. See *Qualified indicia of ownership*

Qualified escrow account. See *also Disqualified person*; *Qualified escrow accounts and qualified trusts safe harbor*

A qualified escrow account, for purposes of the qualified escrow accounts and qualified trusts safe harbors from constructive receipt, is an escrow account in which (1) the escrow holder is not the taxpayer or a disqualified person; and (2) the escrow agreement expressly limits that taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account, except as provided in Reg §1.1031(k)-1(g)(6). Reg §1.1031(k)-1(g)(3)(ii). See §4.50.

Qualified escrow accounts and qualified trusts safe harbor. See *also Constructive receipt*; *Qualified escrow account*; *Qualified trusts*

The qualified escrow accounts and qualified trusts safe harbor is one of four safe harbors from constructive receipt described in Reg §1.1031(k)-1(g). The intermediary's obligation to transfer replacement property to the taxpayer may be secured by cash or cash equivalents held in qualified escrow accounts and trusts without the taxpayer's being deemed in constructive receipt of funds. Reg §1.1031(k)-1(g)(3). See §§4.49-4.52.

Qualified exchange accommodation arrangement. See *also Exchange accommodation titleholder*; *Qualified indicia of ownership*; *Safe harbor reverse exchange*

In a safe harbor reverse exchange, the agreement entered into between the taxpayer, as the ultimate owner of the parked property, and the EAT, which describes the terms and conditions for the EAT's acquisition and ownership of property in connection with the taxpayer's proposed like-kind exchange. See §§5.16-5.26.

Qualified indicia of ownership. See *also Exchange accommodation titleholder*; *Qualified exchange accommodation arrangement*; *Safe harbor reverse exchange*

In a safe harbor reverse exchange, the test that the exchange accommodation titleholder must pass relating to ownership of property in order to comply with Rev Proc 2000-37, 2000-2 Cum Bull 308. The exchange accommodation titleholder must either acquire and hold legal title to the parked property or be treated as the beneficial owner of the property under applicable principles of commercial law, at all times during the accommodation arrangement. See §5.19.

Qualified intermediary. See *also Disqualified person*; *Qualified intermediary safe harbor*

A party who transfers the relinquished property after receiving it from the taxpayer *and* transfers the replacement property to the taxpayer after receiving it from the seller and otherwise satisfies Reg §1.1031(k)-1(g)(4). To be a qualified intermediary, the intermediary must be someone other than the taxpayer or a disqualified person. The buyer and the seller are also ineligible to serve as qualified intermediaries. See §§2.66, 4.53-4.57.

Qualified intermediary safe harbor. See *also Constructive receipt*; *Deferred exchange safe harbor*

The qualified intermediary safe harbor is one of four safe harbors provided in Reg §1.1031(k)-1(g). If a taxpayer structures an exchange to use a qualified intermediary, that intermediary will not be considered the taxpayer's agent when receiving money or other property, for purposes of the constructive receipt rules. The protection of this safe harbor ends, however, if the taxpayer has an unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. Reg §1.1031(k)-1(g)(4). See §§4.53-4.57.

Qualified nonrecourse financing. See *also At-risk limitations*; *Nonrecourse financing*

Qualified nonrecourse financing is financing on real property that is (1) borrowed from a qualified person (generally someone actively and regularly engaged in the business of lending money, but not the seller of the property), (2) borrowed from a government entity, or (3) guaranteed by a government entity, which the taxpayer is not personally liable to repay and which is

not convertible debt. IRC §465(b)(6). As an exception to the at-risk limitations, a borrower who receives qualified nonrecourse financing is still considered at risk in terms of qualified nonrecourse financing. IRC §465(b)(6)(A). See §1.31.

Qualified trust. See *also Disqualified person*; *Qualified escrow accounts and qualified trusts safe harbor*

A qualified trust, for purposes of the qualified escrow accounts and qualified trusts safe harbor, is a trust in which (1) the trustee is not the taxpayer or a disqualified person (disregarding the relationship between the taxpayer and the trustee created by the qualified trust); and (2) the trust agreement expressly limits that taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held by the trustee, except as provided in Reg §1.1031(k)-1(g)(6). Reg §1.1031(k)-1(g)(3)(iii). See §§4.49-4.52.

Qualified use.

Only property that is considered to be held for productive use in a trade or business or for investment qualifies for tax-deferred exchange treatment under IRC §1031. No clear definition of these terms is stated by the Internal Revenue Code or the Treasury regulations. For further discussion of the parameters of such property, see §§2.20-2.39. The taxpayer's purpose in holding the relinquished property and the replacement property is determined as of the time of the exchange.

Real estate investment trust.

A real estate investment trust (or REIT) is a corporation, trust, or association that, pursuant to an election under IRC §856(c)(2), can reduce or avoid entity level taxation on income earned from real estate by meeting a number of organizational, asset, income, and distribution requirements. See IRC §§856-859. See also §7.46.

Realized. See *Amount realized*

Realized gain.

The realized gain from a sale or other disposition of property (including disposition through a tax-deferred exchange) is the excess of the amount realized over the adjusted basis of the property transferred. It is generally the amount of gain that would be recognized as taxable income if the disposition were structured as a taxable sale of the property. IRC §1001(a); Reg §1.1031(d)-2. See §§3.2-3.5.

Realized loss.

The realized loss from a disposition of property is the excess of the adjusted basis of the property transferred. IRC §1001(a); Reg §1.1031(d)-2. See §§3.2-3.5.

Recognize. See *also Other property*; *Realized gain*; *Realized loss*

In tax parlance, to recognize an item of gain or loss means to include it in the computation of gross income. Gains and losses are usually recognized in the tax year in which they are realized to the extent of the entire amount of the realized gain or loss, unless another provision of the Internal Revenue Code provides otherwise. IRC §1001(c). In an exchange that qualifies under IRC §1031, the taxpayer's realized gain is recognized only to the extent of the amount of money and the fair market value of other property received by the taxpayer. IRC §1031(b). Losses cannot be recognized in tax-deferred exchanges. IRC §1031(a), (c). See §§2.4, 3.6-3.53. Recognition of realized gain may be spread over several years if the disposition qualifies for installment sale reporting under IRC §453. See §§3.43-3.45. The taxpayer may exclude from gross income a portion of gain realized on the sale or exchange of property owned and used as a principal residence if certain criteria are met. IRC §121. See §2.38.

REIT. See *Real estate investment trust*

Related person.

For purposes of IRC §1031(f), "related person" is defined by reference to IRC §§267(b) and 707(b)(1). IRC §1031(f)(3). Related persons include the taxpayer's spouse, ancestors, descendants, brothers, and sisters. IRC §267(c)(4). Corporations or partnerships are related to the taxpayer if they are owned more than 50 percent by the taxpayer, including indirect ownership. Two corporations or partnerships are related if they are owned more than 50 percent by the same persons. "Related persons" also includes certain relationships between grantors, beneficiaries, and fiduciaries of trusts. See §2.71.

In addition, IRC §1239(a) requires that any gain recognized in an exchange of depreciable property between related persons must be treated as ordinary income. For this purpose, "related persons" generally means (1) the taxpayer and a trust in which the taxpayer or the taxpayer's spouse is a beneficiary (IRC §1239(b)(2)), (2) the taxpayer and a partnership or corporation more than 50 percent of which is owned by or for the taxpayer (IRC §1239(b)(1), (c)(1)(A)-(B)), (3) two entities of which the same

person owns more than 50 percent (IRC §1239(b), (c)(1)(C)), or (4) an executor of an estate and a beneficiary of such estate, except when the sale or exchange occurs to satisfy a pecuniary bequest (IRC §1239(b)(3)). See §3.35.

A third "related person" rule provides that no deduction is allowed for losses from the sale or exchange of property between related persons. IRC §267(a). For this purpose, "related person" means anyone bearing a relationship to the taxpayer described in IRC §267(b). See §§2.70-2.83.

Relinquished property.

Relinquished property is the property given up by the taxpayer in an exchange. See §1.17.

Replacement property.

Replacement property is the property ultimately received by the taxpayer in an exchange. See §1.17.

Reservoir company. See *Mutual ditch company*

Residual group. See *also Multiple property exchange*; *Other property*; *Recognize*

Residual group is a concept used in determining recognized gain or loss in multiple property exchanges. After allocating property to exchange groups, the taxpayer must create a residual group if the aggregate fair market value of the relinquished property in all exchange groups does not equal the aggregate fair market value of the replacement property in all exchange groups. The residual group consists of money or other property (*i.e.,* property that would not qualify for the exchange) having an aggregate fair market value equal to the difference. Reg §1.1031(j)-1(b)(2)(iii). See §3.39.

Revenue procedure.

A revenue procedure is a statement of procedure issued by the National Office of the Internal Revenue Service that affects the rights or duties of taxpayers or other members of the public under the Internal Revenue Code and related statutes, or information that, although not necessarily affecting the rights and duties of the public, should be a matter of public knowledge. 26 CFR §601.601(d)(2)(i)(b). See §1.12.

Revenue ruling.

A revenue ruling is a statement of the Internal Revenue Service's conclusion on the application of the law to a specific set of facts. Taxpayers and IRS personnel are expected to rely on these published rulings as precedent. Rev Proc 89-14, 1989-1 Cum Bull 814. Courts generally do not regard revenue rulings as binding on them. See §1.11.

Reverse exchange. See *also Identification period*; *Safe harbor reverse exchange*

A reverse exchange is a form of nonsimultaneous exchange in which the taxpayer receives the replacement property before transferring the relinquished property. See chap 5.

Round-robin exchange.

A round-robin exchange is a type of three-party exchange in which each party has contractual obligations to transfer his or her relinquished property to a different party than the one from whom the replacement property will be received. See §1.40.

Safe harbor. See *also Deferred exchange safe harbors*; *LKE program*; *Safe harbor reverse exchange*

A safe harbor is a set of requirements promulgated by the Internal Revenue Service or the Department of Treasury that, if followed, will protect a taxpayer from challenge on specific grounds. A number of safe harbors have been issued with respect to §1031 like-kind exchanges, including deferred exchanges (see §§4.36-4.73, 5.16-5.26, chap 6), reverse exchanges (see §§5.16-5.26), LKE Programs (see §4.73C), and vacation homes (see §§2.39B-2.39E).

Safe harbor reverse exchange. See *also Exchange accommodation titleholder*; *Identification period*; *Qualified exchange accommodation arrangement*; *Qualified indicia of ownership*

A reverse exchange that uses an exchange accommodation titleholder and other arrangements involving parking either replacement or relinquished property and that meets the requirements of Rev Proc 2000-37, 2000-2 Cum Bull 308. See §§5.16-5.26.

Sale escrow. See *also Exchange escrow*

Sale escrow refers to the escrow through which property is purchased and sold. In a three-party exchange, the sale escrow is the escrow through which the relinquished property is sold. In a four-party exchange, there are two sale escrows: one for the intermediary's purchase of the replacement property and one for the intermediary's sale of the relinquished property. See forms in §4.108.

Section 1245 property.

Property that is described in IRC §1245 is known as §1245 property. It generally consists of depreciable personal property, although certain types of real property might fall within the §1245 definition. IRC §1245(a)(3). If property is §1245 property, all the depreciation taken is subject to recapture as ordinary income, unlike IRC §1250 property for which the recapture as ordinary income is limited to the excess of the depreciation taken over straight-line depreciation. See §3.51. The nonrecognition provisions of IRC §1031 are overridden to the extent that the depreciation recapture rules of IRC §1245 or §1250 apply. IRC §1250(d)(4).

Section 1250 property.

Property that is described in IRC §1250 is known as §1250 property. It generally consists of depreciable real property. See §3.46. Section 1250 provides for the recapture of excess depreciation and cost-recovery deductions on depreciable real property. See §§3.47-3.50. Although IRC §1031 provides that no gain or loss will be recognized in an exchange solely of qualifying, like-kind property, its nonrecognition provisions are overridden to the extent that the depreciation recapture rules of IRC §1245 or §1250 apply. IRC §1250(d)(4).

Security and guaranty arrangements safe harbor. See *also Constructive receipt*; *Deferred exchange safe harbors*

The security and guaranty arrangements safe harbor is one of four safe harbors in Reg §1.1031(k)-1(g) that taxpayers may use in structuring deferred exchanges. The intermediary's obligation to transfer replacement property to the taxpayer may be secured or guaranteed without the taxpayer's being deemed in constructive receipt of funds. Reg §1.1031(k)-1(g)(2). The safe harbor ceases to apply, however, when the taxpayer has an immediate ability or unrestricted right to receive money or other property under the security or guaranty arrangement. Reg §1.1031(k)-1(g)(2)(ii). See §§4.45-4.48.

Seller.

In this book, the seller is the party that owns the replacement property before the exchange transaction occurs. The seller sells the replacement property to the buyer in a buyer cooperating three-party exchange or to an intermediary in a four-party exchange. In a seller-cooperating three-party exchange, the seller transfers the replacement property to the taxpayer in exchange for the relinquished property and then sells the relinquished property to the buyer. See §1.20.

Seller cooperating three-party exchange.

A three-party exchange in which the taxpayer transfers the relinquished property to the seller of the replacement property in exchange for the replacement property, and the seller of the replacement property then sells the taxpayer's relinquished property to the buyer of the relinquished property. See §1.40.

Step-transaction doctrine.

The step-transaction doctrine is an analysis sometimes applied by the courts and the Internal Revenue Service in determining the tax consequences of a transaction or series of transactions. A series of separate steps is treated as a single transaction if the steps are "in substance integrated, interdependent and focused toward a particular end result." *Robert A. Penrod* (1987) 88 TC 1415, 1428; *Superior Coach of Fla., Inc.* (1983) 80 TC 895, 905. The tax significance of the intermediate steps is ignored, and the focus is on the tax consequences of the transaction when considered as a whole. *Crenshaw v U.S.* (5th Cir 1971) 450 F2d 472, 476, cert denied (1972) 408 US 923, 33 L Ed 2d 333, 92 S Ct 2490. See §3.55.

Substance-over-form doctrine.

Under the substance-over-form doctrine, the courts and the Internal Revenue Service determine tax consequences based on the substance of a transaction rather than its form, if the form chosen by the taxpayer is a legal construct that does not reflect the economic realities of the transaction. *Commissioner v Court Holding Co.* (1945) 324 US 331, 334, 89 L Ed 981, 985, 65 S Ct 707. See §1.9.

Suspended loss. See *also Passive loss rules*

For any taxable year, a taxpayer generally may not deduct the excess of losses from passive activities over income from passive activities sustained or earned during that year. IRC §469(a). The net losses from passive activities that are disallowed are carried over and treated as losses from passive activities in the next taxable year. IRC §469(b). The net passive losses that are carried over

are referred to as suspended losses. When the passive activity that generated suspended losses is disposed of by the taxpayer in an otherwise taxable transaction, the suspended losses are treated as a loss that is not from a passive activity. See §1.33.

Swap and Drop. See *also Drop and Swap*

An exchange transaction in which title to a replacement property is acquired by a corporation or a partnership that disposed of relinquished property, but is thereafter distributed to the corporation's shareholders or the partnership's partners. See §7.17.

Tax-deferred exchange. See *Like-kind exchange*

Taxpayer. See *also Exchanger*; *Relinquished property*

All exchanges and their tax ramifications are analyzed from the point of view of a specific taxpayer. For example, if party A to a two-party exchange owns property 1 and party B to that exchange owns property 2, the relinquished property (*i.e.,* the property given up by the taxpayer) will be property 1 if party A is viewed as the taxpayer but property 2 if party B is viewed as the taxpayer. Attorneys normally think of their client as the "taxpayer" for these purposes, but all parties to an exchange transaction are likely to have tax consequences resulting from the transaction. See §1.20.

Technical advice memorandum.

A technical advice memorandum (TAM) is a written statement issued to a district director of the Internal Revenue Service on a closed and completed transaction in connection with the examination of a taxpayer's return or consideration of a taxpayer's refund claim. A TAM may not be used or cited as precedent by anyone other than the taxpayer involved unless the IRS establishes otherwise by regulation. IRC §§6110(b)(1), (k)(3). See §1.13.

Tenant-in-common interest.

A tenant-in-common (TIC) interest or undivided fractional interest is a direct co-ownership interest in property in which all co-owners have a specified share of ownership of a property but hold an equal right to possess the whole. See §§2.14, 7.22-7.43.

Three-party exchange. See *also Round-robin exchange*; *Buyer cooperating three-party exchange*; *Seller-cooperating three-party exchange*

A three-party exchange is one in which three principal parties are involved. It may be structured as a buyer cooperating, seller cooperating, or round-robin exchange. A three-party exchange does not involve an independent intermediary. See §§1.39-1.40.

Three-property rule. See *also Deferred exchange*

In a deferred exchange, the three-property rule permits the taxpayer to make a valid identification of up to three alternative replacement properties, regardless of the value of the relinquished or replacement properties, even if the taxpayer intends to acquire only one replacement property. Reg §1.1031(k)-1(c)(4)(i)(A), (k)-1(c)(7), Example 4. See §4.23.

200-percent rule. See *also Deferred exchange*

In deferred exchanges, the 200-percent rule permits the taxpayer to make valid identification of more than three replacement properties if the value of all designated replacement properties does not exceed 200 percent of the value of the relinquished property. Reg §1.1031(k)-1(c)(4)(i)(B). See §4.24.

Two-party exchange. See *also Relinquished property*; *Replacement property*

A two-party exchange is a reciprocal transfer of properties in which each party is both a transferor of relinquished property and a recipient of replacement property. See §1.38.

Type-of-property requirement. See *also Excluded property*

The type-of-property requirement is one of five basic requirements that an exchange must meet to qualify for tax deferral under IRC §1031. The property exchanged must not be property statutorily excluded for that purpose, such as inventory or property held primarily for sale, stocks, bonds, notes, other securities, or evidences of indebtedness, interests in a partnership, certificates of trust, or beneficial interest and choses in action. IRC §1031(a)(2). See §§2.6-2.18.

Undivided fractional interest. See *Tenant-in-common interest*

United States real property interest. See *also Foreign person*

A United States real property interest is (1) an interest in real property located in the United States or the Virgin Islands (IRC

§897(c)(1)(A)(i)) or (2) an interest in a domestic corporation as described in IRC §897(c)(1)(A)(ii). The concept is relevant when determining whether a transferee of real property must meet state and federal withholding and reporting requirements. See §§3.84-3.85.

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