CHAPTER 14:

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CHAPTER 14
1031 EXCHANGES

14.1 GENERAL

I.R.C. § 1031(a)(1) states:

> 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.

An exchange qualifying under I.R.C. § 1031 is technically not, as it is often called, a "tax-free" exchange; it is a "deferred" exchange, because recognition of the gain is deferred for tax purposes. The deferral of the gain is accomplished by having a deferred "substituted" adjusted tax basis in the replacement property. *See infra* § 14.4. As the statute states, there must be an "exchange." A sale followed by an immediate investment in like-kind property does not fall within the scope of I.R.C. § 1031. The taxpayer must *not* receive, directly or indirectly, the proceeds from the disposition of the property. It has been said that this is the *only* formality required for an I.R.C. § 1031 exchange.

An exchange can involve *multiple* parties, often referred to as a "three-corner" exchange. For example, X wants to transfer his property to Y in an I.R.C. § 1031 exchange, but Y does not own any property that X desires. Y can acquire property from Z who owns the property that X desires, and arrange for it to be transferred to X. A multi-party exchange does not have to be *simultaneous*. I.R.C. § 1031(a)(3) contains rules for *deferred* exchanges, some times referred to as "*Starker* exchanges" after a 1979 Ninth Circuit case that permitted a nonsimultaneous exchange.

I.R.C. § 1031 is *not* elective. Where an exchange meets the requirements of I.R.C. § 1031, nonrecognition will be afforded, even if the taxpayer desires that the transfer be taxable, or produce a loss. Thus, to have a taxable transaction, the transaction must fall outside I.R.C. § 1031.

Gain is *recognized* to the extent that net cash and other nonqualified property, known as "boot," is received. However, the amount of the gain recognized is limited to the gain *realized*. No *loss* can be recognized in a qualifying exchange. I.R.C. § 1031(c).

An exchange can be with a related party. However, any gain recognized may be ordinary income under I.R.C. § 1239. Also, special rules exist under I.R.C. § 1031(f) for exchanges with *related parties*. These rules generally require that the unrecognized gain be recognized when either of the related parties disposes of the exchanged property within two years. I.R.C. § 1031(f)(2) states that this rule will not apply to the following situations:

- after the earlier of the death of the taxpayer or the related person;
- in a disposition resulting from a compulsory or involuntary conversion; or
- if it is established that neither the original exchange nor the subsequent disposition had as one of its principal purposes the avoidance of tax.

Exchanges must be reported on Form 8824, "Like-Kind Exchanges." This form reports the computation of both the *realized* gain and the *recognized* gain.

A contract for sale can be amended prior to closing of the property to provide that an exchange is desired. *See Alderson v. Comm'r*, 317 F.2d 790 (9th Cir. 1963); *Coupe v. Comm'r*, 52 T.C. 394 (1969); *Borchard v. Comm'r*, 24 T.C.M. 1643 (1965).

14.2 PROPERTY QUALIFYING FOR I.R.C. § 1031 TREATMENT

A. Specific Properties Not Qualifying Under I.R.C. § 1031

These include:

- stock in trade or other property held primarily for sale;
- stocks, bonds, or notes;
- other securities or evidences of indebtedness or interest;
- interests in a partnership;
- certificates of trust or beneficial interests;
- choses in action (a personal right not reduced into possession, but recoverable by a suit at law or other right of action);
- an exchange of real property located in the U.S. for real property located outside the U.S.

I.R.C. § 1031(a)(2) & (h)(1).

B. Partnership Interests

As noted above, I.R.C. § 1031(a)(2)(D) specifically excludes interests in partnerships as property qualifying for exchange treatment under I.R.C. § 1031(a). This restriction applies only to the exchange of interests in *different* partnerships. The exchange of interests in the *same* partnership is permitted. Revenue Ruling 84-52 allowed a partner to convert his general partnership interest into a limited partnership interest. This ruling is cited in the preamble to the I.R.C. § 1031 regulations. T.D. 8346, 1991-1 C.B. 150. Revenue Ruling 84-52 is cited by many of the numerous rulings permitting a partnership to convert to a limited liability company classified as a partnership for federal tax purposes.

The flush language to I.R.C. § 1031(a)(2) states, "an interest in a partnership which has in effect a valid election under [I.R.C. §] 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." Under I.R.C. § 761(a), only those partnerships that are formed under the following circumstances may elect out of I.R.C. subchapter K:

> (1) for investment purposes and not for the active conduct of a business,
>
> (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or
>
> (3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities.

The exchange of membership interests in limited liability companies with two or more members, which are treated as partnerships for tax purposes, also would fall within the exclusion of I.R.C. § 1031(a)(2)(D).

C. Purpose for Holding

To paraphrase I.R.C. § 1031(a)(1), no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment. Property held for productive use can be exchanged for property held for investment. For example, land held for investment can be exchanged for an office building held for rental.

EXAMPLE

Converting non-depreciable property into depreciable property. Jim has some land with a basis of $800,000 and a fair market value of $1,000,000. He trades it and $300,000 in cash for an office building that has a fair market value of $1,300,000. Jim now has an asset with a depreciable base (ignoring the allocation of a portion of the basis to the land underlying the building) of $1,100,000.

There is often a thin line between real property held for sale (which does not qualify) and real property held for investment (which does qualify). *See* J.S. Williford, *Purpose for Which Real Property is Acquired and Held Affects the Tax Consequences of its Sale*, 22 J. REAL EST. TAX'N 56 (1994). Note that I.R.C. § 1031(a)(2)(A) excludes from like-kind property "property held primarily for sale." This phrase omits the phrase "to customers in the ordinary course of his trade or business" contained in I.R.C. §§ 1221 and 1231.

EXAMPLE

Mary has been a real estate developer for many years. She currently owns two farms, one which is being subdivided, improved, and sold as residential property, and the other on which no activity has taken place. Can any of these properties be like-kind exchanged? Among other things, whether Mary's properties will be entitled to exchange treatment will depend on whether she held the properties for investment or use in a trade or business.

The property received in the exchange must also be held for investment or in the taxpayer's trade or business. It is not clear how long such property must be held. The phrase "to be held for" in I.R.C. § 1031(a) implies *a continuity of ownership*. A subsequent disposition of the property received may be evidence that the property was not acquired for investment or use in the taxpayer's business. What if the property has been held a very short time before it is exchanged? For example, if X received a distribution of a building from a partnership and immediately exchanges it, has X met the "held for" requirement?

In *Magneson v. Commissioner*, 81 T.C. 767 (1983), *aff'd*, 753 F.2d 1490 (9th Cir. 1985), the court found that business and investment property qualified under I.R.C. § 1031 even though the property was immediately transferred to a partnership for a general partnership interest. The court found that the contribution to the partnership resulted in a change in form of ownership and not the relinquishment of ownership. The court noted that all of the partnership's assets were predominantly of like kind to the taxpayer's original investment. *Magneson*'s precedential value has been questioned because the exchange at issue occurred before the enactment of I.R.C. § 1031(a)(2)(D).

In *Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir. 1985), *aff'g* 81 T.C. 782 (1983), the court allowed an I.R.C. § 1031 exchange where the real estate transferred had just been received in connection with a liquidating distribution from a corporation. The court found that the requirement that the realty be held for investment was satisfied, as it was not acquired in the liquidation with the intention of liquidating the realty or using it personally.

In *Maloney v. Commissioner*, 93 T.C. 89 (1989), the tax court allowed an I.R.C. § 1031 exchange where a wholly owned corporation distributed property to its stockholders in complete liquidation of the corporation where such property had just been received by corporation in an exchange.

In Revenue Ruling 75-292, the Internal Revenue Service (IRS) held that property received in a purported I.R.C. § 1031 exchange did not qualify, as it was immediately transferred to a controlled corporation under I.R.C. § 351. In Private Letter Ruling 200521002 (May 27, 2005), the IRS ruled that the "held for" requirement was met in an exchange transaction conducted by a testamentary trust where under the trust's terms it was to terminate and the replacement property distributed to its beneficiaries shortly after the exchange. Thus, the replacement property was not acquired with the intent to dispose of it pursuant to a prearranged plan. *See also* Priv. Ltr. Rul. 200651030 (Dec. 22, 2006).

What if the property received is immediately *gifted*? In *Wagensen v. Commissioner*, 74 T.C. 653 (1980), the court approved a like-kind exchange, even though the taxpayer eventually gave the acquired property to his children ten months later, because at the time of the exchange the taxpayer had no concrete plans to give the property away. However, the taxpayer in *Click v. Commissioner*, 78 T.C. 225 (1982) exchanged investment property for two residences and was found to have a prearranged plan to gift the residences to his children seven months after the exchange.

What if the taxpayer wishes to conduct an exchange involving a vacation house? In Revenue Procedure 2008-16, the IRS provides a safe harbor for whether a dwelling unit, including a vacation property, will be considered property held for productive use in a trade or business or for investment. In *Moore v. Commissioner*, 93 T.C.M. 1275 (2007), the court held that vacation homes were not held for investment or use in a trade or business.

If the taxpayer is considered a dealer with respect to property, such property will not qualify for exchange treatment under I.R.C. § 1031 because the property will be considered inventory. Dealer property will be considered property "primarily for sale" in the taxpayer's trade or business. Whether property is held primarily for sale is a factual question. *See, e.g.*, *Baker Enterprises, Inc. v. Comm'r*, 76 T.C.M. 301 (1989).

D. Like-Kind

The term "like-kind" as used in I.R.C. § 1031(a) has reference to the "nature or character of the property and not to its grade or quality." Treas. Reg. § 1.1031(a)-1(b). One kind or class of property may not be exchanged for property of a different kind or class. *Id*. The fact that real estate is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. *Id*.

E. Examples of Properties Qualifying for I.R.C. § 1031 Treatment

- City real estate for a ranch or farm. Treas. Reg. § 1.1031(a)-1(c).
- A leasehold of a fee with 30 years or more to run for real estate. Treas. Reg. § 1.1031(a)-1(c); Priv. Ltr. Rul. 200842019 (Oct. 17, 2008). Optional renewal periods are included.

Rev. Rul. 78-72, 1978-1 C.B. 258. However, where a fee owner merely carves out a 30-year leasehold interest from his fee ownership and exchanges it for real property, the leasehold interest probably will not be treated as property, because it will be more in the nature of an assignment of income. *See Pembroke v. Helvering*, 70 F.2d 850 (D.C. Cir. 1934), *aff'g* 23 B.T.A. 1176; Rev. Rul. 66-209, 1966-2 C.B. 299.

EXAMPLE

Jim sells a piece of vacant land held for investment for $1,000,000 in a deferred exchange. Jim has identified some student housing located on the campus of Good College. Due to the restrictions on private ownership of land, the owner of the student housing only has a leasehold interest in the underlying land with 28 years remaining on the lease. Does this qualify as like-kind property? What if the lease had an optional five-year renewal period? As stated above, a leasehold of 30 years or more, including renewals, is the equivalent of a fee interest in real estate. Thus, it would qualify as like-kind property.

- Improved real estate for unimproved real estate. Treas. Reg. § 1.1031(a)-1(c).
- Investment property and cash for investment property. Treas. Reg. § 1.1031(a)-1(c).
- Timberland for raw land. Rev. Rul. 78-163, 1978-1 C.B. 257.
- Undeveloped ranch land for a commercial building. *Rutland v. Comm'r*, 36 T.C.M. 40 (1977).
- Life estate for a remainder interest. Rev. Rul. 78-4, 1978-1 C.B. 256.
- Timberland for a contract to purchase land. *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979).
- An agricultural conservation easement on a farm in perpetuity for a fee simple interest in real property. Priv. Ltr. Rul. 9232030 (May 12, 1992).
- Interest in an Illinois land trust for real property. Rev. Rul. 92-105, 1992-2 C.B. 204.
- Overriding royalty interest in a mineral estate for a city lot. *Crichton v. Comm'r*, 42 B.T.A. 490 (1940), *aff'd*, 122 F.2d 101 (5th Cir. 1941).
- Apartment building for vacant land on which a golf course was to be built. Priv. Ltr. Rul. 9428007 (Apr. 13, 1994).
- Lot with two sheds for two townhouses to be built on land to be acquired. Priv. Ltr. Rul. 9431025 (May 6, 1994).
- Undivided interest in land as tenants in common for a fee interest. Rev. Rul. 73-476, 1973-2 C.B. 300.
- Water rights for a fee interest. Priv. Ltr. Rul. 200404044 (Jan. 23, 2004).

- Interests in New York cooperatives for improved or unimproved real property. Priv. Ltr. Rul. 200631012 (Aug. 4, 2006).

- Stewardship easements/credits for improved or unimproved real property. Priv. Ltr. Rul. 200651025 (Dec. 12, 2006). *See also* Priv. Ltr. Ruls. 200651018 (Dec. 22, 2006) & 200649028 (Dec. 8, 2006).

- Residential density development rights. Priv. Ltr. Rul. 200901820 (Jan. 2, 2009).

F. Examples of Properties *Not* Qualifying

- General partnership interest in a partnership for a general partnership interest in another partnership; or general interest for limited interest in another partnership, or limited interest for limited interest in another partnership. I.R.C. § 1031(a)(2)(D).

- Timber interest for land and timber. I.R.S. Tech. Adv. Mem. 9525002 (June 23, 1995).

- Unimproved gravesites for improved gravesites to be used to make charitable donations to taxpayer's tax-exempt entities. *Weintrob v. Comm'r*, 60 T.C.M. 895 (1990).

- Orange grove for grazing land where the grazing land was held primarily for sale. *Land Dynamics v. Comm'r*, 37 T.C.M. 1119 (1978).

- Old plant conveyed to a contractor for new building on land already owned by the taxpayer. *Bloomington Coca-Cola Bottling Co. v. Comm'r*, 9 T.C.M. 666, *aff'd*, 189 F.2d 14 (7th Cir. 1951); Priv. Ltr. Rul. 8701015 (Oct. 2, 1986). *But see* Priv. Ltr. Rul. 8847042 (Aug. 26, 1988), which allowed an exchange of land and a structure to a developer who demolished the structure, constructed two town houses, and conveyed one town house to the taxpayer. However, this ruling was revoked by the IRS in Private Letter Ruling 8921058 (February 27, 1989).

G. Mixed-Use Property

A taxpayer may complete a like-kind exchange of real estate where a portion of the property is qualifying property (i.e., held for investment or use in a trade or business) and a portion is non-qualifying property (e.g., personal residence, home office). An important issue is allocation of value between the two types of property. It is not unusual to confront this situation when a taxpayer uses a portion of the real estate for personal use (e.g., lives in one half of a duplex and rents out the other half) or where a taxpayer owns a farm (i.e., personal residence and property used in a trade or business). The portion of the property used as a personal residence is eligible for the exclusion of gain under I.R.C. § 121, and the balance could be available for an exchange transaction. The courts and the IRS have offered various guidelines in determining which portion of the property should be allocated to personal use and business or investment use. *See, e.g.*, *Beckwith v. Comm'r*, 23 T.C.M. 1537 (1964); Rev. Proc. 2005-14, 2005-1 C.B. 528.

PRACTICE TIP

In structuring the transaction for mixed-use property, the portion of the property characterized as non-qualifying property should be structured as a sale, and the business/investment portion should be structured as an exchange. The closing statements should separately reflect the bifurcation of the transaction.

14.3 NON-QUALIFYING PROPERTY GIVEN AND RECEIVED

Money and other non-qualified property *received* in an exchange is called "boot." Other non-qualifying property includes property specifically excluded under I.R.C. § 1031 (e.g., stock), and property that is not like-kind (e.g., land for farm equipment).

The *giving* of boot along with qualified property does not cause the transaction to fall outside I.R.C. § 1031. For example, one can exchange land and farm equipment for land and it will qualify for I.R.C. § 1031 treatment.

Liabilities of the taxpayer assumed by the person receiving the taxpayer's property and liabilities attached to the property transferred (e.g., nonrecourse debt) are treated as boot received by the taxpayer in the exchange. Treas. Reg. §§ 1.1031(b)-1(c) & 1.1031(d)-2. The regulations specifically permit the *netting* of liabilities "given" and "received." Treas. Reg. § 1.1031(b)-1(c). Thus, if a taxpayer transfers property subject to a liability of $1,000,000 and receives property in the exchange subject to a liability of $800,000, he has received boot of $200,000. (The other party to the exchange has given boot of $200,000.)

EXAMPLE

A and B have the following real property that they wish to trade:

	A	B
Fair Market Value	$1,000,000	$1,500,000
Adjusted Basis	$100,000	$500,000
Debt	$500,000	$1,000,000
Net Equity	$500,000	$500,000

A would have a realized gain of $900,000 and a recognized gain of $0, as the liabilities assumed exceed liabilities given up. B would have a realized gain of $1,000,000 and a recognized gain of $500,000, as the liabilities assumed by A exceed the liabilities assumed by B.

It is important to note that the ability to reduce the amount of boot *received* by netting is limited to situations in which the boot received is in the form of a relief from liabilities. Example 2 in Treasury Regulations section 1.1031(d)-2 makes it clear that cash received cannot be reduced by the net liabilities assumed or taken subject to. *See also* Rev. Rul. 79-44, 1979-1 C.B. 265. This rule is apparently based upon the idea that the taxpayer receiving the cash, or other nonqualifying property, is free to use it for whatever purposes he desires. When the boot is received in other property or money, the taxpayer may not reduce this amount either by transferring cash or non-like-kind property, or by assuming or taking

property subject to a liability. For example, assume that taxpayer transfers property subject to a liability of $800,000, and receives property subject to a liability of $1,000,000 plus $100,000 in cash. Although he has increased his liability after the exchange by $200,000, the increase *cannot* be netted against the $100,000 in cash received. Therefore, the taxpayer has received boot of $100,000.

EXAMPLE

A trades real property plus $100,000 cash for B's property.

	A	B
Fair Market Value	$1,000,000	$800,000
Adjusted Basis	$100,000	$500,000
Debt	$500,000	$200,000
Net Equity	$500,000	$600,000

A has a realized gain of $900,000 and a recognized gain of $200,000. B has a realized gain of $300,000 and a recognized gain of $100,000.

Examples 1 and 2 in Treasury Regulations section 1.1031(d)-2 make it clear that liabilities of the taxpayer that are assumed or taken subject to by the other party may be offset by cash *given* by the taxpayer.

The taxpayer generally may not place debt on the property to be exchanged prior to the exchange in order to "cash out." *See Garcia v. Comm'r*, 80 T.C. 491 (1983) & Priv. Ltr. Rul. 8248039 (Aug. 27, 1982). Under the step transaction doctrine, if a liability is incurred in contemplation of the exchange it may be treated as boot. *See Long v. Comm'r*, 77 T.C. 1045 (1981) & Priv. Ltr. Rul. 8434015 (May 16, 1984).

EXAMPLE

Bill owns a building worth $8,000,000 with a $2,000,000 mortgage on it. Bill has identified a buyer willing to pay $8,000,000 cash. Bill does not want the hassle of trying to offset boot by assuming $2,000,000 of liabilities on replacement properties. Bill uses an intermediary and, at the transfer of the sold property, the mortgage is paid off. Can Bill avoid boot treatment by supplementing the escrow account with $2,000,000 in cash? Would Bill have been in a better position by paying the loan off with separate funds before or at closing? In either case, as discussed *supra* in section 14.2(E), Bill would not have a boot issue when he puts additional cash into the exchange.

The treatment of the assumption of *contingent* liabilities has never been directly addressed in connection with I.R.C. § 1031 exchanges. By analogy, Treasury Regulations section 1.752-2(b)(4), which addresses the allocation of liabilities among partners, specifically disregards contingent liabilities.

In Revenue Ruling 2003-56, the IRS addresses issues arising under I.R.C. § 752 when a partnership enters into a deferred exchange where the relinquished property is subject to a liability and the transaction begins in one taxable year and ends in the subsequent taxable year.

When more than one property is transferred and boot is received causing the recognition of gain, the gain must be *allocated* among the assets transferred. However, neither the Internal Revenue Code nor the regulations indicate how the allocation is to be made. There are at least three possible methods for allocating the boot: (a) relative fair market value; (b) remainder; and (c) relative gain realized.

Any gain recognized as a result of the receipt of boot can be recognized on the installment method. I.R.C. § 453(f)(6)(C). The taxpayer's tax basis will first be allocated to qualifying property received to the extent of its fair market value, with any excess applied against the installment payments. Prop. Treas. Reg. § 1.453-1(f)(1)(iii).

EXAMPLE

Alice sells a property for $6,000,000 using an escrow agreement (i.e., Alice intends to do a deferred exchange). The buyer delivers to the escrow account $5,000,000 in cash and a note payable for $1,000,000. What are the tax consequences of this transaction to Alice? The note delivered by the buyer would be nonqualifying property or boot. See *infra* section 14.11(C), regarding potential ways to deal with seller financing and avoid boot treatment.

14.4 BASIS IN PROPERTY RECEIVED

The tax basis of property received in an exchange qualifying under I.R.C. § 1031 is the tax basis of the property surrendered increased by any additional consideration given, decreased by the amount of any money received, and increased by any gain or decreased by any loss recognized on the exchange. I.R.C. § 1031(d). When *multiple* qualifying properties are received, the aggregate tax basis of the properties received is allocated proportionately to each property received in the exchange in accordance with its fair market value. Treas. Reg. § 1031(j)-1(c).

The basis allocation rules can result in a shifting of basis between depreciable and non-depreciable assets. For example, assume that a taxpayer owns land with a tax basis of $1,000,000 and a value of $2,000,000. He exchanges the land for land and a shopping center with a value of $2,000,000, allocated between land of $200,000 and a building of $1,800,000. The basis of the land and shopping center received is $1,000,000, the basis of the land transferred. The $1,000,000 is allocated between the land and shopping center based on the relative values of the land and center. Thus, ten percent of the $1,000,000 basis, or $100,000, is allocated to the land, and $900,000 is allocated to the center. The taxpayer has converted a non-depreciable asset ($1,000,000) primarily to a depreciable asset ($900,000).

On February 27, 2004, the IRS issued proposed, temporary and final regulations for calculating depreciation under the Modified Accelerated Cost Recovery System (MACRS) for property acquired in a like-kind exchange or an involuntary conversion. Under the general rule, the exchange basis is depreciated over the remaining recovery period of (and using the depreciation and convention of) the relinquished MACRS property. Under certain circumstances, the general rule could adversely affect the taxpayer, and the taxpayer, in such circumstances, is allowed to elect out of the application of the general rule. For example, under the general rule, the taxpayer could be required to depreciate the property over a longer recovery period than if the taxpayer treated it as newly acquired property. In such a case, the taxpayer may elect out of the application of the general rule. Furthermore, the general rule will not apply if the replacement MACRS property has a longer recovery period or less accelerated method than the relinquished property. Under the regulations, any excess basis in the replacement MACRS property over the taxpayer's exchange basis and the relinquished MACRS property is treated as property that is placed in service by the taxpayer in the taxable year in which the replacement MACRS property is placed

in service; or, if later, the taxable year in which the disposition of the relinquished MACRS property is placed in service (e.g., reverse like-kind exchange). For a more in-depth discussion of depreciation, please see chapter 13 of this book.

14.5 MULTI-PARTY EXCHANGES

An exchange implies a transfer of properties between two parties. However, this is often not practical, as the person who desires the property of the taxpayer often does not have property that the taxpayer wants in an exchange. Therefore, the other party will be required to acquire property to be transferred to the taxpayer. Thus, a multi-party exchange is created.

Multi-party exchanges are known as "three-party" exchanges or "four-party exchanges." A typical three-party exchange involves three parties: A, the taxpayer desiring to exchange property for new property; B, a would-be purchaser of A's property; and C, who owns property that A wants, but who only wants to sell and not exchange the property.

EXAMPLE

Three-corner. A has property and wants C's property and no gain. B has money and wants A's property. C has property and wants money.

A "four-party exchange" occurs when B, the party desiring A's property, does not want to get involved in exchanging or in acquiring the property to be exchanged. Thus, a fourth party, D, is used. D is usually a title company, a bank, an exchange company or possibly an attorney for one of the parties, and generally receives a fee for the services of acquiring the exchange property and conveying it to A in exchange for A's property, and selling the property to B.

EXAMPLE

Four-corner. A has property and wants an I.R.C. § 1031 exchange. B has money and wants A's property. C has property and wants to get money. D is a qualified intermediary.

Although not specifically permitted in I.R.C. § 1031, the IRS formally recognized the multi-party exchange in Revenue Ruling 77-297. It is not necessary that a transferee of exchange property (i.e., party D above) hold legal title to the property. *See* Rev. Rul. 90-34, 1990-1 C.B. 154 ("section 1031(a) does not require that [the transferee] hold legal title to [the transferred property], but merely that [the transferor] receive solely property of a like kind to the property transferred").

The IRS has used the familiar tax doctrines of substance over form, step transaction and constructive receipt in attacking multi-party exchanges. Taxpayers must be extremely careful in planning multi-party exchanges, as the following quote from a tax court case indicates:

> Not withstanding those deviations from the standard multi-party exchanges which have received judicial approval, at some point the influence of some sufficient number of deviations will bring about a *taxable* result. Whether the cause be economic and business related or *poor tax planning*, prior case law make clear that taxpayers who stray too far run the risk of having their transactions characterized as a sale and investment.

Barker v. Comm'r, 74 T.C. 555, 563-564 (1980) (emphasis added).

On the other hand, a number of cases have held that, except in extreme cases, the details of the transaction may be insignificant as long as an exchange was *intended*. *See Alderson v. Comm'r*, 317 F.2d 790 (9th Cir. 1963), *rev'g* 38 T.C. 215 (1962); *J. H. Baird Publishing Co. v. Comm'r*, 39 T.C. 608 (1962); *Coupe v. Comm'r*, 52 T.C. 394 (1969); *Rutland v. Comm'r*, 36 T.C.M. 40 (1977); *Biggs v. Comm'r*, 632 F.2d 1171 (5th Cir. 1980), *aff'g* 69 T.C. 905 (1978); *Garcia v. Comm'r*, 80 T.C. 491 (1983), *acq*.

14.6 DEFERRED EXCHANGES

A. Background

The concept of a deferred or non-simultaneous exchange was recognized in *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979). Because of the administrative problems caused by the lapse of time allowed in the *Starker* decision, Congress, in the Tax Reform Act of 1984, enacted I.R.C. § 1031(a)(3) to restrict the time in which a deferred exchange may be accomplished. The regulations provide that a "deferred exchange" is an exchange in which, "pursuant to an agreement," the taxpayer transfers and receives qualifying property. Treas. Reg. § 1.1031(k)-1(a). With respect to the property to be received in the transaction, the taxpayer must meet the identification and receipt requirements. *Id*. Furthermore, the transaction must constitute an exchange of properties, as opposed to a transfer of property for money. *Id*.

B. Identification and Receipt Requirements

1. I.R.C. § 1031(a)(3)

I.R.C. § 1031(a)(3) provides that property received by the taxpayer shall not be treated as like-kind unless (a) the property is identified on or before midnight of the 45th day after the date on which the taxpayer transferred the property relinquished in the exchange; and (b) the taxpayer receives the replacement property prior to the earlier of (i) midnight of the 180th day after the date on which the taxpayer transferred the property relinquished in the exchange, or (ii) the due date (including extensions) for the taxpayer-transferor's return for the year in which the transfer of the property relinquished in the exchange occurs. In determining when to begin the counting of the 45- and 180-day periods, the regulations provide that one starts with the day following the date the relinquished property is transferred. Treas. Reg. § 1.1031(k)-1(b)(3).

2. Regulations

With respect to the identification period and exchange period, the regulations provide that if the taxpayer transfers more than one piece of property as part of the same deferred exchange and the relinquished properties are transferred on different dates, the identification period and exchange period are determined by reference to the earliest date on which any of the properties are transferred. Treas. Reg. § 1.1031(k)-1(b)(2).

The proposed regulations provided that, for purposes of determining when the identification period or exchange period ends, I.R.C. § 7503 (relating to the time for performance of acts where the last day for performance falls on a Saturday, Sunday, or legal holiday) will *not* apply. *Id*. In drafting the final regulations, the IRS determined that a specific reference to I.R.C. § 7503 was unnecessary because of the IRS's published position on that section. *See* Rev. Rul. 83-116, 1983-2 C.B. 264 (I.R.C. § 7503 is limited to procedural acts to be performed in connection with the determination, collection or refund of taxes). *But see Snyder v. Comm'r*, 41 T.C.M. 1416 (1981) (where I.R.C. § 7503 applied to timing of an I.R.C. § 337 distribution, and it was not interpreted as being limited as argued by the IRS).

a. Identification of Replacement Property

In the case of any deferred exchange, any replacement property received by the taxpayer before the end of the identification period will in "all events" be treated as identified before the end of the identification period. Treas. Reg. § 1.1031(k)-1(c). In all other cases, replacement property is identified *only* if it is designated as replacement property in a written document signed by the taxpayer and either hand-delivered, mailed, faxed, or otherwise *sent* before the end of the identification period to (a) a person involved in the exchange other than the taxpayer or a "disqualified person" (as defined below); or (b) the person obligated to transfer the replacement property to the taxpayer (regardless of whether that person is a disqualified person). *Id*. A written exchange document, identifying the replacement property, signed by all the parties to the exchange before the end of the identification period, will be treated as satisfying the identification requirement. *Id*.

b. Description of Replacement Property

Replacement property is identified *only* if it is "unambiguously described in the written document or agreement." Treas. Reg. § 1.1031(k)-1(c)(3). Real property is generally unambiguously described if its legal description or street address is provided. *Id*. Personal property generally is unambiguously described by particular type of property. *Id*.

c. Alternative and Multiple Properties

The regulations provide that a taxpayer may identify more than one property as replacement property. Treas. Reg. § 1.1031(k)-1(c)(4). Regardless of the number of properties relinquished as part of the "same" deferred exchange, the *maximum* number of replacement properties that may be identified is (a) three properties without regard to fair market value; or (b) any number of properties, as long as the aggregate fair market value of the properties identified at the end of the identification period does not exceed 200 percent of the aggregate fair market value of all relinquished properties, determined on the date that the relinquished properties were transferred by the taxpayer. *Id*. In a case where, at the end of the identification period, the taxpayer has identified more replacement properties than permitted, none of the replacement properties are treated as having been identified. *Id*. However, this rule will not apply and the identification requirements will be deemed satisfied with respect to (a) replacement property received before the end of the identification period; and (b) replacement property identified before the end of the identification period and received before the end of the exchange period, but only if the taxpayer receives before the end of the exchange period identified replacement property constituting at least 95 percent of the aggregate fair market value of all identified replacement properties. *Id*. For this rule, fair market value of identified replacement property is determined as of the earlier of the date the property is received by the taxpayer or the last day of the exchange period. *Id*.

d. Incidental Property

Solely for purposes of the identification requirement, property that is merely incidental to the transfer of a larger item of property is not treated separately, but rather is treated as a part of the larger item. Treas. Reg. § 1.1031(k)-1(c)(5). Incidental property means property (a) typically transferred with a larger item in standard commercial transactions; and (b) the total fair market value of which does not exceed 15 percent of the aggregate fair market value of the larger item. *Id*.

e. Special Rules for Identification of Replacement Property to Be Produced

The regulations recognize that a transfer of relinquished property will not fail to qualify under I.R.C. § 1031 merely because the replacement property is not in existence or being produced at

the time the property is identified as replacement property. Treas. Reg. § 1.1031(k)-1(e). Replacement property that is being produced must satisfy the identification requirements of the regulations. For example, if the replacement property consists of real property and improvements where the improvements are being constructed, the description satisfies the identification requirement if a legal description is provided for the underlying land and as much detail as is practicable, at the time the identification is made, is provided for the construction of the improvement. *Id*. For purposes of the 200-percent rule and the incidental property rule, the fair market value of any property that is being produced is its estimated fair market value as of the date it is expected to be received by the taxpayer. *Id*.

f. Revocation of Identification

The identification of replacement property may be revoked at any time before the end of the identification period. Treas. Reg. § 1.1031(k)-1(c)(6). However, the identification of replacement property will only be treated as revoked if made in a written document signed by the taxpayer and hand-delivered, mailed, faxed, or otherwise sent before the end of the identification period to the person to whom the original identification of replacement was sent. *Id*. In the case where the identification was made in a written exchange agreement, the identification can be revoked only if made in a written amendment to the agreement, or in a written document signed by the taxpayer and hand-delivered, mailed, faxed, or otherwise sent before the end of the identification period to all parties to the agreement. *Id*.

g. Receipt of Identified Replacement Property

Identified replacement property is considered as received before the end of the exchange period only if (a) the taxpayer receives replacement property before the end of the exchange period, and (b) the replacement property received is "substantially the same property" as identified. Treas. Reg. § 1.1031(k)-1(d). *See also* Treas. Reg. § 1.1031(k)-1(d)(2), example 4 (property equal to 75 percent of fair market value of identified property is treated as substantially the same property). These rules are applied separately to each of the replacement properties received by the taxpayer.

h. Special Rules for Receipt of Replacement Property to Be Produced

For purposes of determining whether the taxpayer has received the replacement property before the end of the exchange period, and whether the replacement property is substantially the same property as identified with respect to property to be produced, the regulations provide that variations due to usual or typical production changes will not be taken into account. Treas. Reg. § 1.1031(k)-1(e)(3). However, substantial changes to such property will cause the property not to be considered substantially the same property as identified. *Id*. With respect to personal property to be produced, such property will not be considered substantially the same property identified unless production is completed on or before the date the property is received by the taxpayer. *Id*. With respect to real property to be produced and where production is not completed on or before the date the taxpayer receives such property, property will be considered substantially the same property as identified only if (a) the property constitutes real property (i.e., real property under state law); and (b) the property received, had production been completed on or before the date the taxpayer received the property, would have been considered to be substantially the same property as identified. *Id*. In addition, the regulations provide that a transfer of property in exchange for services (including production services) will not qualify under I.R.C. § 1031(a), but could otherwise qualify as an exchange involving the receipt of non-qualifying property or boot. Treas. Reg. § 1.1031(k)-1(e)(4).

C. Receipt of Money or Other Property/Constructive Receipt and Agency

1. Common Law

As discussed below, the regulations provide safe harbors which, if met, generally will avoid the IRS challenging the transaction on a constructive receipt or agency theory. Those taxpayers who cannot qualify for, or do not want to structure the transaction to fall within the safe harbors, must rely on common law for determining whether the exchange will qualify under I.R.C. § 1031. It should be noted that transactions that do not fall within the safe harbors of the regulations will be carefully scrutinized.

a. Intermediary (Common Law)

In a deferred exchange, the party ultimately acquiring the taxpayer's property may not desire to have a continuing role in completing the exchange for the taxpayer. In such cases, an intermediary is used to complete the transaction. In relying on common law, as opposed to the safe harbor provided for in the regulations, the taxpayer seeking exchange treatment must use extreme caution to make certain that the intermediary is not the agent of the taxpayer or the proceeds held by the intermediary are not considered as constructively received by the taxpayer. In a case where the intermediary is truly independent, I.R.C. § 1031 treatment can be obtained. *See, e.g.*, *J. H. Baird Publishing Co. v. Comm'r*, 39 T.C. 608 (1962); *Brauer v. Comm'r*, 74 T.C. 1134 (1980).

b. Escrows and Trusts (Common Law)

Absent meeting the safe harbor in the regulations, the taxpayer is subject to a high risk that the proceeds held in the escrow or trust have been constructively received by the taxpayer. In order to avoid the constructive receipt issue, the parties must enter into a "bullet-proof" escrow agreement. *See generally Carlton v. United States*, 385 F.2d 238 (5th Cir. 1967), *aff'g* 255 F.Supp. 812 (S.D. Fla. 1966); *Maxwell v. United States*, 1988 WL 142153 (S.D. Fla. July 29, 1988) (unpublished opinion). In structuring a cash escrow or trust, it is important that the taxpayer not have access to the funds, and that the escrow agent or trustee is not designated as an agent of the taxpayer. To further limit the exposure of treating the funds in escrow or trust as constructively received, it is advisable (but not always practical) that the taxpayer not be entitled to the earnings generated by the funds held by the escrow agent or trustee. *See generally Reed v. Comm'r*, 723 F.2d 138 (1st Cir. 1983) (seller deemed not to have constructively received funds held in escrow where seller received no present beneficial interest from the fund). However, in such an arrangement, it may be possible to structure the transaction similar to the "growth factor" analysis found in *Starker*. *See* Priv. Ltr. Rul. 8915032 (Jan. 13, 1989).

2. Regulations

The regulations contain four safe harbors for deferred exchanges. (Note that the "qualified intermediary" safe harbor has been extended to simultaneous exchanges.) Transactions that fall within the safe harbors generally will avoid an argument by the IRS that the taxpayer was in actual or constructive receipt of any funds used to acquire replacement property.

a. Security or Guarantee Arrangements

The first safe harbor provided for in the regulations states that the obligation of the taxpayer's transferee to transfer replacement property may be secured or guaranteed by (a) a mortgage, deed of trust, or other security interest in the property (other than cash or cash equivalent); (b) a standby letter of credit that satisfies the requirements of Temporary Treasury Regulations section 15A.453-1(b)(3)(iii) and which does not allow the taxpayer to draw on the standby letter of credit except upon a

default of the transferee's obligation to transfer like-kind replacement property to the taxpayer; and (c) a guarantee of a third party. Treas. Reg. § 1.1031(k)-1(g)(2).

b. Qualified Escrow Accounts and Trusts

The second safe harbor provides that the determination of whether the taxpayer is in actual or constructive receipt of money or other property shall be made without regard to the fact that the obligation of the taxpayer's transferee may be secured by cash or cash equivalent in a qualified escrow account or qualified trust. Treas. Reg. § 1.1031(k)-1(g)(3). In order to constitute a "qualified escrow account," (a) the escrow holder must not be the taxpayer or a disqualified person (as discussed below); and (b) the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of the cash or cash equivalent in the escrow account must be expressly limited as provided in the regulations (see *infra* subparagraph (e)). *Id*. In order to constitute a "qualified trust," (a) the trustee must not be the taxpayer or a disqualified person (except that the relationship between the taxpayer and the trustee will not be considered a relationship under I.R.C. § 267(b) for this purpose); and (b) the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of the cash or cash equivalent must be expressly limited as provided in the regulations (see *infra* subparagraph (e)). *Id*. Rights under state law to terminate or dismiss the escrow holder or trustee are disregarded for purposes of determining whether the taxpayer has the immediate ability or unrestricted right to receive, pledge, borrow or otherwise obtain the benefits of the cash or cash equivalent. *Id*. Furthermore, the regulations explicitly state that the taxpayer may receive money or other property directly from a party to the exchange, but not from the qualified escrow account or qualified trust, without affecting the availability of the safe harbor. *Id*.

c. Qualified Intermediaries

The third safe harbor, which is the most commonly used, provides that deferred exchanges may be facilitated by the use of a qualified intermediary if the taxpayer's rights to receive money or other property are limited as provided in the regulations (see *infra* subparagraph (e)). Treas. Reg. § 1.1031(k)-1(g)(4). A transaction structured under this provision of the regulations qualifies regardless of the fact that the intermediary is or may be the taxpayer's agent. A "qualified intermediary" is any person who (a) is not the taxpayer or a disqualified person (as discussed below), and (b) enters into a written agreement with the taxpayer for the exchange of properties pursuant to which such person acquires the relinquished property from the taxpayer, acquires the replacement property, and transfers the replacement property to the taxpayer. *Id*.

The regulations provide guidance with respect to what must be done by the intermediary in order for it to be considered to have acquired and transferred the relinquished and replacement properties. The regulations provide that: (a) an intermediary acquires and transfers property if the intermediary acquires and transfers legal title to that property; (b) an intermediary acquires and transfers the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is so transferred; and (c) an intermediary acquires and transfers replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement for the transfer of that property and, pursuant to that agreement, replacement property is so transferred. Treas. Reg. § 1.1031(k)-(g)(4)(iv). Items (b) and (c) allow the relinquished and replacement properties to be directly deeded by the current owners without the intermediary coming into title. For purposes of determining whether the intermediary has entered into a written agreement, the regulations provide that the intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary, and all parties to that agreement are notified in

writing of the assignment by the date of the relevant transfer of property. In addition, rights under state law to terminate or dismiss the intermediary are disregarded for purposes of determining whether the taxpayer has the immediate ability or unrestricted right to receive, pledge, borrow or otherwise obtain the benefits of the cash or cash equivalent.

d. Interest and Growth Factors

The fourth safe harbor provides that in determining whether the taxpayer is in actual or constructive receipt of money or other property, the fact that the taxpayer is or may be entitled to receive any interest or a growth factor with respect to the deferred exchange shall be disregarded if the right to receive the interest or growth factor are limited as provided in the regulations (see *infra* subparagraph (e)). Treas. Reg. § 1.1031(k)-1(g)(5). The regulations provide that the taxpayer is treated as receiving interest or a growth factor if the amount of money or property the taxpayer is entitled to receive depends upon the length of time that has elapsed between the transfer of the relinquished property and the receipt of replacement property. Treas. Reg. § 1.1031(k)-1(h). If the taxpayer receives interest or a growth factor, such amount will be treated as interest regardless of whether it is paid to the taxpayer in cash or in property. *Id*.

e. Additional Limitations for Qualified Escrow Accounts and Trusts, Qualified Intermediaries, and Interest and Growth Factors

As noted above with respect to the use of qualified escrow accounts and trusts, qualified intermediaries, and interest and growth factors, additional limitations are provided with respect to the taxpayer's rights to the funds held in an escrow or trust, by an intermediary, or received in the form of interest or a growth factor. The taxpayer's rights will be considered as limited under the regulations if the taxpayer does not have the right to receive money or other property until (a) in the case where taxpayer does not identify replacement property before the end of the identification period, after the end of the identification period; (b) in the case where the taxpayer has identified replacement property, after the taxpayer has received all of the identified replacement property which the taxpayer is entitled; (c) in the case where taxpayer identifies replacement property, after the later of the identification period and the occurrence of a substantial contingency that (i) relates to the deferred exchange; (ii) is provided for in writing; (iii) is beyond the control of the taxpayer or any disqualified person; or (iv) otherwise, after the end of the exchange period. Treas. Reg. § 1.1031(k)-1(g)(6).

f. Closing Costs and Similar Items

The regulations provide that certain items related to the transfer of the exchange properties are disregarded for purposes of determining whether the taxpayer has the right to receive, pledge, borrow or otherwise obtain the benefits of the money or property in the exchange transaction. Treas. Reg. § 1.1031(k)-1(g)(7). Specifically, the taxpayer's right to receive, or the receipt of, the following will be disregarded:

> (i) Items that a seller may receive as a consequence of the disposition of property that are not included in the amount realized from the disposition of property (e.g., prorated rents), and
>
> (ii) Transactional items that relate to the disposition of the relinquished property or the acquisition of the replacement property and appear under local standards in the typical closing statement as the responsibility of a

> buyer or a seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees).

Id.

g. Disqualified Person

Under the regulations, a person is a "disqualified person" if (a) the person is an agent of the taxpayer at the time of the transaction (i.e., the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two-year period ending on the date of the transfer of the first of the relinquished properties); (b) the person bears a relationship to the taxpayer described in either I.R.C. § 267(b) or I.R.C. § 707(b) (determined by submitting ten percent for 50 percent each place it appears); or (c) the person and a person described in (a) above bear a relationship described in either I.R.C. § 267(b) or I.R.C. § 707(b) (determined by submitting ten percent for 50 percent each place it appears). Treas. Reg. § 1.1031(k)-1(k). The regulations were amended to except from the "disqualified person" definition certain banks or bank affiliates that are members of a controlled group in which certain other members provided investment banking or brokerage services. Treas. Reg. § 1.1031(k)-1(k)(4)(ii). Solely for purposes for determining whether a person is an agent of the taxpayer as described in (a) above, the following services will not be taken into account: (a) services with respect to exchanges of property intended to qualify under I.R.C. § 1031; and (b) routing financial, title insurance, escrow or trust services for the taxpayer by a financial institution, title insurance company or escrow company. *Id*. *See* Priv. Ltr. Rul. 200630005 (July 28, 2006).

D. Other Open Issues

1. Receipt and Payment of Earnest-Money Deposits

Often the taxpayer has received an earnest money deposit or earnest money from the potential purchaser of his property. Does the *receipt* of the deposit jeopardize the exchange?

Some conservative tax advisors recommend returning the deposit to the purchaser of the relinquished property. The purchaser would then transfer the funds to the qualified intermediary. Other tax advisors insist that the taxpayer can continue to hold the purchaser's deposit after closing the transfer of the relinquished property. The deposit would be transferred to the qualified intermediary at a date close to the date for closing the acquisition of the replacement property. *See* Terence F. Cuff, *What the Deferred Exchange Regulations Forgot to Tell You: How to Handle Deposits in the Deferred Exchange*, 21 J. REAL EST. TAX'N 282 (1994).

PRACTICE TIP

The taxpayer may *pay* an earnest money deposit for the acquisition of replacement property, or the taxpayer may seek the return of his deposit from the qualified intermediary after the sale of the relinquishment property. Neither of these alternatives should jeopardize the exchange.

The earnest money deposit may qualify as a transactional item that is allowed to be paid out of the exchange balance under Treasury Regulations section 1.1031(k)-1(g)(7)(ii). Examples of transactional items listed in the regulations are commissions, prorated taxes, recording or transfer taxes and title company fees. The proration of utility deposits is probably acceptable.

2. Replacement of Qualified Intermediary

The regulations do not address the replacement of a qualified intermediary. However, Treasury Regulations section 1.1031(k)-1(g)(4)(v) permits a qualified intermediary to receive an assignment of the rights of a party to an agreement. The preamble to the final regulation provides that actual or constructive receipt occurs when the taxpayer dismisses an escrow holder, trustee or qualified intermediary.

In Private Letter Ruling 200908005 (February 20, 2009), the IRS ruled that an unrelated party's acquisition of stock of a corporation that made a qualified subchapter S election ("QSub") did not create a new corporation, even though the stock acquisition caused the QSub election to terminate.

3. Deferred Exchange by a Partnership of Property Subject to Debt

Often, a partnership in which the partners have deficit tax basis capital accounts will enter into a deferred exchange where property is transferred subject to liabilities. Because, in connection with a deferred exchange, there is a gap between the transfer of the relinquished property and the receipt of the replacement property, has a deemed distribution of cash occurred under I.R.C. § 752 to the extent of the liabilities on the property transferred, so that the partners would recognize gain under I.R.C. § 731(a) to the extent that money distributed in the form of the relief of the liabilities exceeds their basis in the partnership, especially where the transaction spans the end of the year?

It appears that a sound argument can be made that no relief of liabilities occur as the result of such a deferred exchange. *See* Terence F. Cuff, *What the Deferred Exchange Regulations Forgot To Tell You: Does a Deferred Exchange Result in Liability Relief Income Under Section 752*, 21 J. REAL EST. TAX'N 353 (1994). Treasury Regulations section 1.752-1(f) states, "If, as a result of a *single transaction,* a partner incurs both an increase … and a decrease in the partner's share of the partnership liabilities … only the net decrease is treated as a distribution from the partnership…." (emphasis added). A deferred exchange should be viewed as a "single transaction."

However, in Revenue Ruling 81-242, the IRS held that, in connection with an I.R.C. § 1033 exchange involving a reinvestment of proceeds from an involuntary conversion, the partners recognized gain as a result of a paydown of the mortgage on the condemned building with the condemnation proceeds. The ruling held that the partners recognized gain under I.R.C. § 731(a)(1) to the extent that the deemed distribution, because of the liability relief, exceeded the basis of the partners' interest in the partnership immediately before the distribution, even though the partnership elected to replace the condemned property. In Revenue Ruling 94-4, the IRS addressed the question of when the deemed distribution of money because of relief of partnership liabilities is taken into account. The ruling concluded that the deemed distribution is treated as an advance or drawing of money to the extent of the partnership income. Advances and drawings are taken into account on the last day of the year. Treas. Reg. § 1.731-1(a)(1)(ii). Because this ruling is limited to liabilities to the extent of the income of the partnership, it would seem to not apply to deferred exchanges. In addition, Revenue Ruling 92-97 states that a deemed distribution resulting from a cancellation of partnership liabilities is treated as an advance or drawing which is deemed to occur on the last day of the year. Again, this ruling limits the deemed advance or draw to the cancellation of income.

4. Options

EXAMPLE

A and B entered into an option. B paid A $5,000 per the option, and this amount is to be credited against the purchase price if the option is exercised. Under the terms of the option, A has the right to purchase X's property for a payment of $500,000.

Typically, a taxpayer is not taxed on option payments received by the taxpayer until the option expires unexercised or the option is exercised, at which time the option payment becomes taxable. Under regulations, the taxpayer can receive money from a third party to the transaction without jeopardizing the application of the qualified intermediary safe harbor. Treas. Reg. § 1.1031(k)-1(g)(4)(vii).

14.7 REVERSE EXCHANGES

EXAMPLE

E owns Blackacre, which she intends to sell. E wants to acquire Whiteacre from S, and use Whiteacre as the replacement property for the exchange of Blackacre. S requires that E acquire Whiteacre before she is able to sell Blackacre.

In a reverse exchange, the taxpayer desires to acquire the replacement property before the taxpayer transfers the relinquished property. Typically, this occurs when the seller of the replacement property requires that the sales transaction close before the taxpayer can close on the relinquished property and, in many cases, the taxpayer has not yet found a buyer for the relinquished property. Not surprisingly, the IRS has been quite selective in the fact-patterns of the court cases that have addressed the issue of reverse exchanges. In a number of cases, taxpayers have been unsuccessful in treating the acquisition of replacement property followed by the sale of the relinquished property as an exchange, with the typical reason given by the courts for the failure to meet the exchange standard being the "lack of interdependence" between the purchase and sale transactions. *See, e.g., Bezdjian v. Comm'r*, 845 F.2d 217 (9th Cir. 1988), *aff'g* 53 T.C.M. 368; *Lincoln v. Comm'r*, 76 T.C.M. 926 (1998). Despite the apparent lack of judicial support of the taxpayers in these cases, it appears that the cases do offer a guide for a transaction which, if properly structured, could achieve exchange treatment. *See also DeCleene v. Comm'r*, 115 T.C. 457 (2000) (transaction failed to qualify as exchange where taxpayer "parked" property and accommodator had no economic risk of loss). *But see* Priv. Ltr. Ruls. 200329021 (July 18, 2003) & 200251008 (Dec. 19, 2002) (IRS rules favorably on build-to-suit transactions involving related parties under certain reverse exchange/lease arrangements).

A. Revenue Procedure 2000-37 – "Safe Harbor"

Effective for transactions occurring on or after September 15, 2000, the IRS has issued a revenue procedure providing a safe harbor for reverse exchange transactions. Rev. Proc. 2000-37, 2000-2 C.B. 308. The revenue procedure states that the IRS will not challenge the qualification of property as either relinquished property or replacement property, or the treatment of an "exchange accommodation titleholder" (EAT) as the beneficial owner of either form of property, if the property is held pursuant to a "qualified exchange accommodation agreement" (QEAA).

Revenue Procedure 2000-37 was modified by Revenue Procedure 2004-51. A limitation was added to section 4.05 of Revenue Procedure 2000-37 providing that the revenue procedure does not

apply to replacement property held in a QEAA if the property was owned by the taxpayer within 180 days of the date the property is transferred to the EAT. This modification is effective for transfers after July 19, 2004.

Under Revenue Procedure 2000-37, property is held in a QEAA if *all* of the following requirements are met:

- Qualified indicia of ownership of the property must be held by EAT. EAT shall not be the taxpayer or a "disqualified person" under Treasury Regulations section 1.1031(k)-1(k) and either EAT is subject to federal income tax or, if it is treated as a partnership or S corporation for federal income tax purposes, more than 90 percent of its interests or stock are owned by partners or shareholders who are subject to federal income tax. "Qualified indicia of ownership" means legal title to the property, or other indicia of ownership of the property that are treated as beneficial ownership under applicable principles of commercial law, such as a contract for deed, or interest in an entity that is disregarded as an entity separate from its owner for federal income tax purposes and that entity either holds legal title to the property or such other indicia of ownership.

- At the time the qualified indicia of ownership is transferred to EAT, the taxpayer must have a bona fide intent that the property held by EAT represents either the relinquished property or the replacement property in an exchange intended to qualify under I.R.C. § 1031.

- No later than five business days after the transfer of the qualified indicia of ownership in the property to EAT, the taxpayer and EAT must enter into a QEAA that provides that the EAT is holding the property for the benefit of the taxpayer in order to facilitate an exchange under I.R.C. § 1031 and Revenue Procedure 2000-37, and that the taxpayer and EAT agree to report the acquisition, holding and disposition of the property as provided in Revenue Procedure 2000-37. Furthermore, both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with the QEAA.

- No later than 45 days after the transfer of the qualified indicia of ownership of the replacement property to EAT, the relinquished property must be identified in a manner consistent with the principles of Treasury Regulations section 1.1031(k)-1(c) (i.e., the identification rules for deferred exchanges).

- No later than 180 days after the transfer of the qualified indicia of ownership in the property to EAT, (a) the property is transferred to the taxpayer's replacement property; or (b) the property is transferred to a person who is not the taxpayer or a "disqualified person" as relinquished property.

- The combined time period that the relinquished property and the replacement property are held pursuant to a QEAA does not exceed 180 days.

The IRS recognizes that there are certain practical realities involved in reverse exchange transactions, such as the management, operation and financing of the property held by EAT pending the completion of the exchange. Thus, Revenue Procedure 2000-37 provides that the following legal or contractual arrangements, whether or not undertaken on an arm's length basis, will be disregarded in determining whether property will be treated as being held in a QEAA:

- EAT also may enter into an exchange agreement with the taxpayer if EAT otherwise satisfies the requirements as a qualified intermediary under the regulations.

- The taxpayer or a disqualified person guarantees some or all of the obligations of EAT, such as secured or unsecured debt incurred to acquire the property, or otherwise indemnifies EAT against costs and expenses.

- The taxpayer or a disqualified person loans or advances funds to EAT or guarantees a loan or advance made to EAT.

- The property held by EAT is leased to the taxpayer or a disqualified person.

- The taxpayer or a disqualified person manages the property, supervises improvements to the property, acts as a contractor or otherwise provides services to EAT with respect to the property.

- The taxpayer and EAT enter into agreements or arrangements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices effective for a period not in excess of 185 days from the date the property is acquired by EAT.

- The taxpayer and EAT enter into agreements or arrangements providing that any variation in the value of the relinquished property from the estimated value on the date of EAT's receipt of such property is taken into account upon EAT's disposition of the relinquished property through the taxpayer's advance of funds to, or receipt of funds from, EAT.

Revenue Procedure 2000-37 does not address issues such as whether EAT is allowed, required, or prevented from claiming depreciation deductions for the relinquished or replacement property during the period that it holds such property. In addition, due to the time constraints in the revenue procedure (i.e., the 180-day rule), it may be difficult to complete all transactions contemplated by taxpayers, such as the construction of improvements intending to qualify as suitable replacement property. The American Bar Association's Section of Taxation had proposed a revenue procedure seeking a two-year period for the transfer of property in reverse exchange situations. However, the IRS rejected this proposal and believed the "target audience" for the safe harbor was the "smaller, less sophisticated" taxpayers, and that the 180-day limit was "sufficient" for such taxpayers. *See* DAILY TAX REPORT (Bureau of National Affairs), Oct. 16, 2000, at G-4.

B. "Parking" Transactions Outside of Revenue Procedure 2000-37; IRS Technical Advice Memorandum 200039005 and Private Letter Ruling 200111025

The IRS stated in section 3.02 of Revenue Procedure 2000-37 that it "recognizes" that "parking" transactions can be accomplished outside of the safe harbor in this revenue procedure. Accordingly, "no inference is intended with respect to tax treatment of 'parking' transactions that do not satisfy the terms of the safe harbor … whether entered into prior to or after the effective date of this revenue procedure." Rev. Proc. 2000-37, 2000-2 C.B. 308. The obvious inference is that transactions that do not fall within the safe harbor and otherwise constitute a "valid" parking arrangement would be respected by the IRS. Despite this inference, extreme caution must be exercised, particularly in light of the IRS's position in Technical Advice Memorandum 200039005 (October 2, 2000).

1. Alternative Reverse Exchange Structures

a. Exchange First

Under the "exchange first" scenario, an accommodator acquires the replacement property and immediately exchanges it for the relinquished property held by the taxpayer. The accommodator would then hold the relinquished property until it is sold.

b. Exchange Last

Under the "exchange last" scenario, an accommodator acquires the replacement property and holds it until the relinquished property is sold, at which time the replacement property is transferred to the taxpayer. The exchange last scenario provides the taxpayer with more flexibility in cases where the taxpayer is uncertain which parcel of property ultimately will be the relinquished property and where improvements intending to qualify for exchange treatment will be made to the replacement property. However, arrangements must be made for the management, operation and financing of the replacement property while such property is held by the accommodator, all of which can be dealt with if documented properly.

2. Technical Advice Memorandum 200039005

At the same time that the IRS was crafting Revenue Procedure 2000-37, it issued Technical Advice Memorandum 200039005. In it, the IRS ruled that a transaction that was a reverse exchange did not qualify for like-kind exchange treatment. In the technical advice memorandum, the taxpayer intended to engage in a "straightforward" exchange through an accommodator. However, the sale of the relinquished property fell through and the seller of the replacement property demanded that the closing be completed on the replacement property. Prior to entering into a subsequent sales agreement for the relinquished property, the accommodator acquired the replacement property pursuant to a purchase agreement negotiated by the taxpayer with the seller of the replacement property. The taxpayer provided the funds for the accommodator to acquire the property, and the taxpayer was personally liable on the mortgage. Finally, the property was titled in the name of the accommodator who would hold the property until the sale of the relinquished property.

The IRS stated that the "threshold question … is whether a taxpayer engaging in a reverse deferred exchange … can take advantage of the safe harbors available in Section 1.1031(k)-1 …." I.R.S. Tech. Adv. Mem. 200039005 (May 31, 2000). In other words, the IRS was questioning whether, in a reverse exchange, the taxpayer can take advantage of the qualified intermediary safe harbor which provides, among other things, that the qualified intermediary is not considered the agent of the taxpayer for purposes of I.R.C. § 1031. The IRS, citing the preamble to the final regulations promulgated in 1991, concluded that the safe harbors (particularly the qualified intermediary safe harbor) "do not apply to reverse-*Starker* transactions." *Id*.

Among other things, the taxpayer argued that the accommodator should be viewed as a qualified intermediary and, therefore, the accommodator should not be viewed as the agent of the taxpayer. However, the IRS noted that there was no "written exchange agreement" between the taxpayer and the accommodator at the time that the accommodator acquired the replacement property. "Therefore, [the accommodator] cannot satisfy the requirements of the qualified intermediary safe harbor because [the accommodator] did not acquire Replacement Property, as required by written agreement with Taxpayer …" as required by the regulations. *Id*.

The IRS also concluded that there was not interdependence between the purchase of the replacement property and the sale of the relinquished property. The IRS distinguished two lines of case law concerning whether there was the appropriate interdependence to qualify a reverse exchange as qualifying under I.R.C. § 1031 (cited above). The apparent distinction raised in the cases and recognized by the IRS is the awareness by each party to the transaction of the interdependent nature of the sale and purchase. Thus, in the case of a two-party transaction, such interdependence generally will exist compared to those instances where, for example, the buyer of the relinquished property is unknown at the time that the replacement property is acquired (i.e., multiple-party transactions).

3. Private Letter Ruling 200111025

In Private Letter Ruling 200111025 (March 19, 2001), the IRS issued a favorable ruling in a reverse exchange transaction which fell outside of the safe harbor of Revenue Procedure 2000-37. The taxpayer entered into an option agreement to sell its relinquished property. Prior to the disposition of the relinquished property, an accommodation party acquired the replacement property with financing guaranteed by the taxpayer. The accommodation party leased the replacement property to the taxpayer and gave the taxpayer an option to acquire the replacement property. The IRS ruled that the series of transactions qualified as an exchange because:

- the taxpayer demonstrated an intent to achieve an exchange;
- the steps of the transaction were part of an integrated plan to exchange the relinquished property for the replacement property; and
- the accommodation party was not the taxpayer's agent, citing the six factors of *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949).

In Chief Counsel Advice 200836024 (September 5, 2008), the IRS confirmed what practitioners assumed to be the case: that a taxpayer may combine a reverse and deferred/forward exchange. However, the advice raises an issue as to the number of properties that can be identified as part of an exchange transaction.

14.8 REPLACEMENT PROPERTY TO BE BUILT

Improvements constructed after the taxpayer has acquired the replacement property do not qualify as like-kind replacement property. *Bloomington Coca-Cola Bottling Co.*, 189 F.2d 14 (7th Cir. 1951); Treas. Reg. § 1.1031(k)-1(e)(4). Thus, the improvements must be completed by a third party (e.g., qualified intermediary) prior to the date that the taxpayer receives the replacement property. In the "to be built" exchange scenario, the improvements must be identified in the 45-day identification notice, and the improved replacement property must be transferred to the taxpayer within 180 days after the exchange was commenced.

In the "to be built" exchange, it is common that the qualified intermediary, or a special purpose entity (SPE) wholly-owned by the qualified intermediary, take title to the property directly from the seller. The qualified intermediary or SPE would hold the property until the earlier of the date the improvements are completed or the end of the exchange period. This form of transaction should not raise agency concerns, because the regulations provide that "the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is *not* the agent of the taxpayer." Treas. Reg. § 1.1031(k)-1(g)(4)(i) (emphasis added).

In Private Letter Ruling 9428007 (April 13, 1994), the taxpayer proposed to sell an apartment building and use the exchange proceeds to acquire and improve vacant land. The qualified intermediary would acquire the vacant land and make improvements during the exchange period. At the end of the exchange period, the land and improvements would then be transferred to the taxpayer. The IRS ruled that the transaction qualified for exchange treatment.

14.9 EXCHANGES INVOLVING PARTNERS AND PARTNERSHIPS

EXAMPLE

A, B, C and D are equal partners in ABCD partnership. ABCD's only asset is Blackacre, which is a commercial office building. Buyer has offered to purchase Blackacre from ABCD. A and B want to receive cash from the sale, while C and D want to invest in other real estate.

A. Purchase of Partnership Interest

It is possible for the partner(s) seeking exchange treatment to acquire the partnership interest of the partner(s) wishing to be "cashed out." However, there are certain practical and legal impediments which must be dealt with under this scenario. First, the practical aspect is that in many cases the partner wishing to remain in the partnership and achieve exchange treatment does not have sufficient cash to acquire the partnership interest of those wishing to be cashed out. (Alternatively, the partnership interest could be acquired with a note and paid over time.) Second, if 50 percent or more of the partnership interests are sold as part of this transaction, a tax termination of the partnership could result under I.R.C. § 708(b)(1)(B). In such a case, the reconstituted partnership may not meet the "held for" requirement. While there would be a literal "tax termination" of the partnership, there is no policy reason why this should affect an exchange at the entity level. The reconstituted partnership should be viewed as a continuing entity investing in real estate. *See Long v. Comm'r*, 77 T.C. 1045 (1981).

B. Special Allocation

A second approach to cashing out partners would be to have the partnership use a portion of the cash received from the sale of the partnership's relinquished property to redeem the interests of the partners wishing to be cashed out. In such a case, the cash would be treated as boot, and taxable. The partnership then could make a special allocation of the gain to the partners receiving the cash. However, it is unclear whether such a special allocation will have "substantial economic effect" as required under I.R.C. § 704(b).

According to Terence Cuff, there is considerable doubt that this can be accomplished. The problem is that the I.R.C. § 704(b) regulations generally require a partnership to distribute to the retiring partner the amount in his capital account if allocations are to have "substantial economic effect." Cuff writes:

> As a general rule, cash in the amount of X received by a partnership in an exchange will produce X in taxable gain. Assume that a partnership receives X in cash in an exchange, that this produces X in taxable gain, and that the economic deal is that the retiring partners will receive a cash distribution of X. Assume further that the partner's pre-transaction capital account is some nonzero number Y. The partner's capital account will be X + Y after the gain allocation. The distribution of X in cash will reduce his capital account to a closing value of Y. It is possible to distribute X in cash to the partner and to reduce his closing capital account to zero

> *only* if Y = 0. Since Y was the retiring partner's pre-transaction capital account, it is necessary that the retiring partner's pre-transaction capital account be zero if all of the cash is to be distributed to him, all gain is to be allocated to him and the gain allocation is to have substantial economic effect.

Terence F. Cuff, *Tax-Free Exchanges and Partnerships*, 22 J. REAL EST. TAX'N 363 (1995) (emphasis added).

C. Distribution of Undivided Interests

One of the most commonly used techniques to resolve this problem is the complete or partial liquidation of the partnership and a distribution of undivided interests in the property to the individual partners. Once the partners obtain their undivided interests, they either sell them to the buyer for cash or use the proceeds attributable to their undivided interests to complete an exchange transaction.

The IRS has consistently argued that transfers of property to and from entities immediately prior to or after the completion of an exchange transaction do not meet the "qualified use" or "held for" requirements under I.R.C. § 1031. For example, in Revenue Ruling 77-337, the IRS ruled that the pre-arranged transfer of property in the liquidation of a corporation and the individual shareholder's immediate exchange of the property did not qualify under I.R.C. § 1031 because the relinquished property was not held for the "qualified use."

Assuming there was sufficient time, it would be possible for a partnership to dissolve and have the partners hold the property as tenants in common as long as they do not continue to carry on the activity as though they operated in partnership form (e.g., file partnership tax returns). However, rarely is there a case where partners plan far enough in advance or even contemplate that they wish to operate other than in partnership form.

Typically, the question will arise once the partnership is either negotiating or entering into a purchase and sale agreement for its relinquished property. At that time, certain partners may wish to receive cash and others qualifying replacement property. As part of the transaction, the partnership would distribute the relinquished property to the individual partners as tenants in common, assign the purchase agreement to the individual partners, and the individual partners would either sell their undivided interests for cash or complete an exchange. Under this scenario, the IRS has a series of arguments that could be made to state that those seeking exchange treatment are not entitled to the benefits of I.R.C. § 1031. Those arguments include that the transfer of the property to the individual partners did not change their relationship and they are actually continuing to operate in partnership form, and thus the receipt of replacement property by the individual partners does not satisfy the exchange requirement of I.R.C. § 1031; or that the transaction will violate the "qualified use" test or "held for" requirements as noted in Revenue Ruling 77-337.

The tax court, in *Chase v. Commissioner*, 92 T.C. 874 (1989), held that no exchange occurred where the parties attempted to have a partnership distribute properties to a partner and have the partner enter into a like-kind exchange. Because the distribution of the properties was not recognized by the court, the receipt of exchange properties by the partner did not constitute an exchange, because the partnership was still deemed to have owned the property for which exchange treatment was sought.

For the most part, the IRS has been unsuccessful in litigating cases involving transfers immediately before or after an exchange transaction. However, caution should be exercised in reviewing the cases because a number of them were decided prior to the amendment to I.R.C. § 1031 disallowing exchanges

of partnership interests, or failed to address some of the critical issues facing taxpayers in these transactions.

Courts generally have decided in favor of taxpayers seeking exchange treatment where the property was acquired or disposed of pursuant to other Code provisions allowing for tax-free transfers of property (e.g., I.R.C. §§ 333, 351 and 721). A case that has been particularly troublesome to the IRS is *Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir. 1985). In *Bolker*, a corporation distributed real property to its sole shareholder in a liquidation which qualified under the old I.R.C. § 333. After the decision had been made to liquidate the corporation, the shareholder discovered that he could not obtain financing to develop the property. On the day of the liquidation, the shareholder executed a contract to exchange the real estate received in the liquidation for other real estate. In holding that the taxpayer/shareholder was allowed exchange treatment, the tax court stated that the taxpayer was to be treated as having the same purpose for holding the property as the corporation had before the liquidation. The Ninth Circuit, although upholding the tax court decision, took a somewhat narrower view. In distinguishing Revenue Ruling 77-337, the court found that the liquidation was planned before any intention to exchange the property arose, and was not merely to facilitate the exchange. In addition, the Ninth Circuit held that the taxpayer did not intend to liquidate or to use the property for personal pursuits. Further support can be found in *Magneson v. Commissioner,* 81 T.C. 767 (1983) (holding a transfer to a partnership under I.R.C. § 721 immediately following an I.R.C. § 1031 exchange does not disqualify the exchange from I.R.C. § 1031 treatment), *Maloney v. Commissioner*, 93 T.C. 89 (1989) (like-kind exchange treatment allowed where a corporation exchanged property and, five days after the exchange, liquidated under I.R.C. § 333), and *Mason v. Commissioner*, 55 T.C.M. 1134 (1988) (although court did not address the "holding" requirement, it upheld like-kind exchange treatment where partnership assets were distributed in liquidation and, subsequent to the liquidation, the partners exchanged the property).

14.10 TENANCY IN COMMON INTERESTS AND DELAWARE STATUTORY TRUSTS

The IRS issued Revenue Procedure 2002-22 to specify the conditions under which it would consider a request for a ruling that a tenancy in common interest in real property is eligible for tax-free exchange under I.R.C. § 1031. A tenant in common owns a fractional interest in land with a right to possess the whole of the property, and has rights to a proportionate share of rents from the property, but is not equivalent to a partner in a partnership for federal tax purposes. A tenancy in common, the IRS stated, is conceptually distinct from a partnership, because a tenancy in common is mere co-ownership of property, whereas a partnership involves a "join[ing] together [of] capital or services with the intent of conducting a business enterprise and of sharing the profits and losses from the venture." Rev. Proc. 2002-22, 2002-1 C.B. 733. The recognition of this distinction is key to obtaining tax deferral under I.R.C. § 1031 for an exchange of tenancy in common interests, because an exchange of partnership interests is not eligible for the provisions of I.R.C. § 1031. I.R.C. § 1031(a)(2)(D).

The IRS set forth 15 conditions that generally must be satisfied for a favorable ruling, but stated that it may nonetheless consider ruling in cases where not all conditions are met, but "the facts and circumstances clearly establish that such a ruling is appropriate." The conditions the IRS listed are:

> (1) The property's title must be held by each co-owner as a tenant in common under local law, not by an entity recognized under local law;
>
> (2) The property may not have more than 35 co-owners;
>
> (3) The co-ownership may not act as an entity by filing a partnership or corporate tax return, conducting business under a common name, or otherwise holding itself out as a partnership or corporation;

(4) The co-owners may enter into a limited co-ownership agreement that runs with the land, specifying obligations to each other such as a right of first refusal;

(5) The co-owners must retain rights to participate in ownership-related decisions such as hiring a manager, approving the sale of the property, or approving the creation or modification of a lien. Such decisions must require unanimous approval of the co-owners;

(6) No co-owner may be subject to restrictions on alienation other than those required by a lender consistent with customary lending practices;

(7) The co-owners must have the right to share in the proceeds on disposition of the property;

(8) Each co-owner must share proportionately in the profits and losses from the property;

(9) Each co-owner must share proportionately in any blanket lien on the property;

(10) A co-owner may issue a call option only so long as the option reflects the fair market value of the interest; a co-owner may not acquired a put option to sell his interest to the property's sponsor, lessee, another co-owner, the lender, or any related parties;

(11) The co-owners may not engage in any business activities beyond those customary to operation and maintenance of property;

(12) Any management or brokerage agreement entered into by the co-owners must be renewable at least annually, and must provide for the distribution of net revenues no later than three months from the date of the revenues' receipt;

(13) Any leasing agreements for the property must be bona fide leases under federal tax law, and may not base lease payments on the property's profitability;

(14) The property may not be encumbered with any loan from a party related to any co-owner, the sponsor, manager, or lessee of the property; and

(15) Payments to the property's sponsor for the acquisition of a co-ownership interest must reflect fair market value and not be tied in any way to profits derived from the property.

Rev. Proc. 2002-22, 2002-1 C.B. 733. The IRS has issued various private letter rulings under Revenue Procedure 2002-22. *See* Priv. Ltr. Ruls. 200829013 (July 18, 2008); 200829012 (Mar. 17, 2008); 200826005 (June 27, 2008); 200513010 (Apr. 1, 2005) and 200327003 (July 3, 2003). In addition, the IRS has ruled that the form of ownership of real estate by two co-owners constituted an interest in real property. Priv. Ltr. Ruls. 200625009 (June 23, 2006) & 200625010 (June 23, 2006).

14.11 SELECT ISSUES REGARDING DEBT IN EXCHANGE TRANSACTIONS

A. Pre-Exchange Financing

Taxpayers may consider placing mortgages or other liabilities on the property immediately prior to the exchange, or otherwise incurring a liability that will be assumed in the exchange. Proposed regulations provided that a taxpayer seeking exchange treatment will not be entitled to offset liabilities assumed (or where the property is transferred subject to a liability), with respect to liabilities incurred by the taxpayer "in anticipation" of the exchange. Prop. Treas. Reg. § 1.1031(b)-1(c). The final regulations did not adopt the proposed amendment because the rule "could create substantial uncertainty in the tax results of exchange transactions…." T.D. 8343, 1991-1 C.B. 165. Nevertheless, taxpayers are advised to proceed cautiously in this area. *Compare Long v. Comm'r*, 77 T.C. 1045 (1981) (tax court disregarded the placement of liabilities on property immediately prior to exchange solely for the purpose of reducing boot) *with Garcia v. Comm'r*, 80 T.C. 491 (1983) (liabilities placed on replacement property immediately prior to the exchange were respected because the debt had "independent economic significance"). *See also Fredericks v. Comm'r*, 67 T.C. M. 2005 (1994) (reasons for refinancing prior to exchange were separate from exchange transaction); Priv. Ltr. Ruls. 8434015 (May 16, 1984) & 8248039 (Aug. 27, 1982).

B. Post-Exchange Financing

It would seem that the IRS would have an incredibly difficult time arguing that post-exchange financing should be taxable as boot. It is well settled that the receipt of loan proceeds are not subject to income tax. *Comm'r v. Tufts*, 461 U.S. 300, 307 (1983). In one case, *Behrens v. Commissioner*, 49 T.C.M. 1284 (1985), the tax court rejected the taxpayer's argument that net cash received on the transfer of the relinquished property was actually a tax-free receipt of excess purchase money financing for the replacement property. First, the facts before the court did not support the taxpayer's argument. In dicta, the tax court stated that the taxpayer "could have reduced his net equity … before or after the trade-in through a non-taxable loan (and thereby avoid any adverse tax consequences therefrom)…. It simply did not happen."

Post-exchange financing seems to provide an alternative that would solve any number of problems and provide a safer mechanism to obtain fund than pre-exchange financing. Therefore, to the extent possible, the transaction should be structured with post-exchange financing arrangements. If an advisor is concerned that excess loan proceeds taken at the closing of the replacement property will be classified as boot, the financing arrangement could be structured as constituting two separate transactions: (a) financing to acquire the replacement property; and (b) post-closing financing to fund improvements or disbursements to the taxpayer.

C. Buyer Financing of Relinquished Property

EXAMPLE

E desires to sell Blackacre to B. B will only buy Blackacre if he can pay 50 percent in cash and 50 percent on a contract for deed payable over two years. E accepts B's proposal and enters into a purchase and sale agreement with B. Subsequent to entering into the purchase and sale agreement, E decides she would like to exchange Blackacre for Whiteacre.

It is not uncommon on the sale of relinquished property to be confronted with the situation where a buyer desires to fund the acquisition of the relinquished property through an installment note arrangement. The taxpayer cannot net the receipt of the buyer's note by the assumption of liabilities on

the replacement property because the buyer's note is "cash or other property" for purposes of the boot-netting rules. Therefore, the taxpayer must consider other alternatives to effectively account for the note in the exchange transaction or subject itself to tax as the note proceeds are collected.

1. Sell Note on Open Market

The taxpayer could attempt to have the intermediary sell the note on the open market to obtain cash to acquire replacement property. However, because the note will need to be sold at a deep discount (e.g., at least 20 percent), it is not economically feasible to pursue this route.

2. Transfer Buyer's Note to Seller of Replacement Property

As part of the consideration for the purchase of the replacement property, the intermediary may assign the buyer's note to the seller of the replacement property. However, this method is rarely used in exchange transactions. The seller of the replacement property will not be able to report the gain from the buyer's note under the installment sales method, because the note is from a third party to the seller. *See* I.R.C. § 453(f)(3). It is possible to structure a transaction where the note is issued by the intermediary to the seller of the replacement property, and such a note would mirror the buyer's note held by the intermediary. Again, this is not likely to occur because the intermediary will want to close out of the transaction and have no responsibility for the payment of any obligations.

3. Taxpayer Makes Loan to Buyer of Relinquished Property

The taxpayer could loan cash to the buyer of the relinquished property and secured by the relinquished property. The buyer would then use the proceeds of the loan to acquire, for "all cash," the relinquished property from the intermediary. However, it is likely that this transaction will be stepped-together and treated as though the note were issued in acquisition of the relinquished property.

4. Taxpayer Acquires Buyer's Note from Intermediary for Cash

The most common method of dealing with the problem is for the taxpayer to acquire the note from the intermediary for cash equal to the face value of the note. Of course, this assumes that the taxpayer has sufficient cash to acquire the note. To facilitate the transaction, title to the replacement property should be transferred to the intermediary which, in turn, transfers title to the buyer in return for the buyer's note. The taxpayer should acquire the buyer's note from the intermediary at the time the replacement property is acquired in order to avoid any issues of constructive receipt.

14.12 SPECIAL PURPOSE ENTITIES

EXAMPLE

E transfers Blackacre to S and the proceeds are put with a qualified intermediary pursuant to the exchange agreement. E identifies Whiteacre as his replacement property. Because the proceeds held by the qualified intermediary are not sufficient to acquire Whiteacre, E must arrange to finance the difference. In order to obtain the financing, E's lender requires that Whiteacre be held in a single purpose bankruptcy remote entity.

In many transactions, lenders will require that the replacement property be held in a "single-purpose bankruptcy remote entity" (SPBRE). The SPBRE would borrow the funds and hold title to the property, and the governing documents of the entity would restrict the entity's ability to acquire other assets,

impose insurance requirements, restrict the use and transfer of the property and, most importantly, limit the ability of the entity to declare bankruptcy or allow its owners to dissolve, liquidate, merge or sell substantially all of the assets of the entity.

The IRS has recognized the use of single-member limited liability companies as a means of holding replacement property. Priv. Ltr. Ruls. 200732012 (Aug. 10, 2007); 9807013 (Feb. 13, 1998) & 9751012 (Dec. 19, 1997). Under Treasury Regulations section 301.7701-3(b)(1)(ii), a domestic eligible entity that is not a corporation and that has only one owner will be disregarded as an entity apart from its owner unless it elects to be treated as a corporation. Thus, ownership of the replacement property by a single-member limited liability company by the taxpayer seeking exchange treatment will not otherwise disqualify the transaction. *See* Rev. Proc. 2002-69, 2002-2 C.B. 831 (treatment of unincorporated business entities owned solely by a husband and wife in a community property state).

In Private Letter Ruling 199911033 (March 22, 1999), the IRS ruled that a disregarded entity will include a two-member limited liability company in a case where one of the members had no economic interest in the entity. Under the facts of the ruling, a grantor trust entered into an exchange transaction. As part of the transaction, it desired to finance the acquisition of the replacement property. The lender insisted that title to the replacement property be held in a bankruptcy remote entity. In order to satisfy the lender's requirement, the trust formed a limited liability company between the trustees and a corporation wholly owned by the trust. To protect the lender's interest, one of the members of the board of directors of the corporation was a representative of the lender. Under the limited liability company agreement, all decisions relating to the operation of the limited liability company remained with the trust, with the exception of certain lender protections that must be approved by the corporation with the unanimous consent of its board of directors. Those items included a number of the items set forth above, such as limitations on the business of the limited liability company and the ability of the company to file a petition in bankruptcy or otherwise institute insolvency proceedings. With the exception of those particular rights, the corporation had no other rights relating to the management or economic benefits of the limited company. All the profits and losses from the limited liability company would be allocated to the trust. Based on this fact pattern, the IRS ruled that the corporation is a member of the limited liability company for the sole purpose of preventing the trust from placing the limited liability company into bankruptcy, and the corporation had no interest in profits or losses and neither manages the enterprise nor has any management rights other than those specifically enumerated. Therefore, even though the entity had more than one member, it will not be treated as a partnership, but rather as an entity disregarded from its owner, the trust.

The IRS issued Revenue Ruling 2004-86, stating, under the specific facts set forth in the ruling, that a Delaware statutory trust (DST) will be viewed as a disregarded business entity for federal tax purposes. Therefore, an exchange of real property for the beneficial interests in the DST holding real estate will qualify as a like-kind exchange. However, extreme caution must be exercised when relying on this ruling because of its limited factual application.

14.13 RELATED-PARTY EXCHANGES

I.R.C. § 1031(f) restricts exchanges between related persons. In general, if a taxpayer directly or indirectly exchanges property with a related person (as defined in I.R.C. §§ 267(b) and 707(b)(1)), the taxpayer and the related party must hold the respective properties received in the exchange for a period of two years in order for the original exchange to qualify for non-recognition treatment. I.R.C. § 1031(g) provides that the two-year period for holding the property will be suspended for any period during which the holder's risk of loss is substantially diminished by the holding of a put with respect to such property, the holding of another person of a right to acquire such property, a short sale, or any other transaction. Exceptions to the two-year rule include disposition due to death, involuntary conversion of the property

(i.e., I.R.C. § 1033), or where it is established to the satisfaction of the Secretary that neither the exchange nor the disposition had as one of its principal purposes the avoidance of tax. The legislative history provides that the non-tax avoidance standard will apply, but not be limited to, transactions involving the exchange of undivided interests in different properties so that the taxpayer ends up owning the entire interest or a larger undivided interest in the property, dispositions involving nonrecognition transactions, and transactions that do not involve basis shifting techniques.

In *Teruya Bros., Ltd. v. Commissioner*, 124 T.C. 45 (2005), *aff'd*, 104 AFTR 2d (9th Cir. 2009), the tax court held that imposing a qualified intermediary in a related-party exchange was done to circumvent the related-party restrictions of I.R.C. § 1031(f). *See also Ocmulgee Fields, Inc. v. Comm'r,* 132 T.C. No. 6 (2009) & Rev. Rul. 2002-83, 2002 C.B. 927. On the other hand, the IRS ruled in Private Letter Ruling 200440002 (October 1, 2004) that when both of the related parties end up with suitable replacement property, neither party is "cashing out" and I.R.C. § 1031(f) will not deny nonrecognition treatment.

In Private Letter Ruling 200541037 (October 14, 2005), the IRS ruled that the related-party rules did not apply to an exchange of timber property between the taxpayer and a corporation "related" to the taxpayer. The harvesting and sale of timber by the corporation within two years after the exchange was not considered a sale of real estate for purposes of the related-party rules. In addition, in Private Letter Ruling 200919027 (May 8, 2009), the IRS ruled that the related-party rules were not violated when jointly owned farmland was partitioned and a testamentary trust of a decedent/related party sold its property received in the exchange that occurred at the time of the partition. The IRS found the decedent's trust and its trustees were not related to the decedent's surviving siblings.

Also, in Private Letter Ruling 200712013 (March 23, 2007), the IRS ruled that a taxpayer's sale of relinquished property to a related party and reinvestment of the sale proceeds in suitable replacement property qualified as an exchange and did not run afoul of the related-party rules. The IRS was not troubled by the fact that the related party intended to dispose of the property received from the taxpayer within two years. Among other things, the IRS ruled that the related parties neither swapped low-basis property for high-basis property, nor would the related party's sale of the property acquired from the taxpayer within two years result in the related party "cashing out" of its investment. *See* Priv. Ltr. Ruls. 200730002 (July 27, 2007); 200728008 (July 13, 2007); 200712013 (Mar. 23, 2007) & 200709036 (Mar. 2, 2007).

14.14 SPECIAL ISSUES

A. Mixed-Use Properties – Owner-Occupied Duplex, Farms and Home Business

A taxpayer may complete a like-kind exchange of real estate where a portion of the property is qualifying property (i.e., held for investment or use in a trade or business) and a portion is non-qualifying property (e.g., personal residence, home office). An important issue is allocation of value between the two types of property. It is not unusual to confront this situation when a taxpayer uses a portion of the real estate for personal use (e.g., lives in one-half of a duplex and rents out the other half), or where a taxpayer owns a farm (i.e., personal residence and property used in a trade or business). The portion of the property used as a personal residence is eligible for the exclusion of gain under I.R.C. § 121 and the balance could be used in an exchange transaction. The courts and the IRS have offered various guidelines in determining which portion of the property should be allocated to personal use and business or investment use. *See, e.g., Beckwith v. Comm'r*, 23 T.C.M. 1537 (1964); Rev. Ruls. 82-26, 1982-1 C.B. 114 & 76-541, 1976-2 C.B. 246. For sales occurring after the date of enactment, the American Jobs Creation Act of 2004 amended I.R.C. § 121 to provide that the principal residence exclusion does not apply if the residence was acquired in a tax-deferred exchange in the five-year period before the sale.

In structuring the transaction for mixed-use property, the portion of the property characterized as non-qualifying property should be structured as a sale and the business/investment portion should be structured as an exchange.

B. Vacation Homes, Time Shares as Replacement Property

Personal use property is excluded from deferred taxation under I.R.C. § 1031 because it does not meet the requirement that such property be held for productive use or investment. Because vacation homes and "time share" condominiums are typically held for personal use rather than investment, I.R.C. § 1031 tax deferral is usually not available. *See Moore v. Comm'r*, 93 T.C.M. 1275 (2007). However, possible exceptions to this rule may apply.

In Revenue Procedure 2008-16, the IRS provides a safe harbor for whether a dwelling unit, including a vacation property, will be considered property held for productive use in a trade or business or for investment. The revenue procedure provides that the relinquished property will meet the "held for" standard if, among other things, the property is owned by the taxpayer for at least 24 months, the taxpayer rents the dwelling for 14 days in each 12-month period, and the taxpayer's personal use does not exceed the greater of 14 days or 10 percent of the days the dwelling was rented in the 12-month period. Similar rules apply to the replacement property acquired by the taxpayer.

14.15 EXCHANGES AND OTHER INTERNAL REVENUE CODE SECTIONS

A. Involuntary Conversions

Under I.R.C. § 1033, no gain is recognized from an involuntary conversion where the property is converted into property "similar or related in service or use to the property so converted." Although more restrictive regarding replacement property than I.R.C. § 1031, cases and rulings under I.R.C. § 1033 may have a bearing when considering the applicability of I.R.C. § 1031.

B. Passive Activity Losses

Under I.R.C. § 469(g)(1), a suspended passive activity loss is triggered when the taxpayer disposes of his entire interest in a fully taxable transaction. A like-kind exchange under I.R.C. § 1031 does not qualify, as it is not a "fully taxable transaction."

C. Deemed Sale of Property in Connection with Partnerships

Under I.R.C. § 704(c)(1)(B), if property that has been contributed by one partner is distributed to another partner, the contributing partner shall be treated as selling the property to the other partner. However, under I.R.C. § 704(c)(2), if property is contributed by one partner and distributed to another partner, and other property of like kind is distributed by the partnership to the contributing partner not later than the earlier of (a) the 180th day after the distribution; or (b) the due date of the contributing partner's tax return, this provision will not apply.

D. Withholding in Connection with Dispositions of U.S. Real Property by Foreigners

I.R.C. § 897 addresses the treatment of gains and losses by a nonresident alien individual or foreign corporation from the disposition of a U.S. real property interest. I.R.C. § 1445 requires withholding of 10 percent on the amount realized in a transaction subject to I.R.C. § 897. However, Treasury Regulations section 1.1445-2(d)(2) excludes from the withholding provisions nonrecognition transactions, which

include like-kind exchanges under I.R.C. § 1031. However, this exception applies only if *no* gain is recognized under I.R.C. § 1031.

Even though no withholding is required in connection with a totally tax-free exchange, a notice must be provided at the time of the exchange that a non-recognition provision is applicable. In connection with a deferred exchange, this can create a problem, because at the time the purchaser acquires the taxpayer's relinquished property, it is not known if an exchange will occur or if it will be totally without gain. There is no guidance as to how this is to be handled.