The Like Kind Exchange: A Current Review

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I. OVERVIEW

Without Sec. 1031, I.R.C., the income tax consequences of any exchange would be the same as those of a sale. The amount of gain or loss would be determined by calculating the difference between the adjusted basis of the asset relinquished and the fair market value of the property received. Sec. 1001(b), I.R.C.

II. BASICS OF LIKE KIND EXCHANGES

A. General Rules -- Under Sec. 1031(a)(1), I.R.C., gain or loss will not be recognized when property that is held for productive use in a trade or business or investment purposes is exchanged solely for property of like kind to be held either for productive use in trade or businesses or for investment.

1. Exclusions

a. Sec. 1031(a)(2), I.R.C. specifically excludes from like kind treatment the exchange of:

(1) stock in trade or other property held primarily for sale,
(2) stocks, bonds or notes,
(3) other securities or evidences of indebtedness or interest,
(4) interests in a partnership,
(5) certificates of trust or beneficial interests, or
(6) choses in action.

b. Note that, to the extent the underlying assets of a partnership constitute real property, an exchange of a partnership interest for real property does not qualify as like kind for nonrecognition treatment under Sec. 1031, I.R.C. (See MHS Co., Inc. v. Comm'r, 35 TCM 733 (1976), aff'd 575 F.2d 1177 (CA6 1978).) This conclusion is based on the fact that a partnership interest is considered as personalty rather than realty. However, where a partnership has in effect a valid election under Sec. 761(a), I.R.C., the interest in the partnership is treated as an interest in each of the assets of the partnership and not as an interest in the partnership. Sec. 1031(a)(2), I.R.C.

c. Certainly, the exclusion of partnership interests from like kind treatment is not intended to apply to an exchange of interests in the same partnership. See General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, prepared by the Staff of the Joint Committee on Taxation, at 245-247. But see Priv. Ltr. Rul. 9741017 (July 10, 1997), wherein the Service ruled that a proposed exchange between two brothers, each of whom owns one-half of an entity that owns 10 rental properties, will not qualify for Sec. 1031,
I.R.C. nonrecognition treatment because the parties would be exchanging partnership interests. Management differences motivated the brothers to realign the ownership of nine of the properties so that one owned six and the other owned three. The Service ruled that the exchange did not qualify under Sec. 1031, I.R.C., without referencing or taking into account the legislative intent explained in the language of the General Explanation of the 1984 Act.

d. Note that Rev. Proc. 2002-22, 2002-14 I.R.B. 733, superseding Rev. Proc. 2000-46, 2000-2 C.B. 438, sets forth the following conditions under which the Service will consider a request for a ruling that an undivided fractional interest in rental real property (other than mineral property) is not an interest in a business entity, within the meaning of Reg. § 301.7701-2(a):

(1) Nonrecognition treatment under the like-kind exchange rules does not apply to the exchange of an interest in a business entity. Accordingly, Rev. Proc. 2002-22 applies to the co-ownership of rental real property (other than mineral interests) in an arrangement classified under local law as a tenancy-in-common. [The Service is expected to release guidance shortly as to whether a Delaware business trust works under this Revenue Procedure.]

(2) The Service will treat multiple parcels of property as a single property to the extent that (a) the parcels are owned by co-owners, (b) the parcels are leased to a single tenant pursuant to a single lease agreement, and (c) any debt of one or more co-owners is secured by all of the parcels.

(3) The Service will not consider a ruling request in such case unless (a) each co-owner’s percentage interest in each parcel is identical to that co-owner’s percentage interest in every other parcel, (b) each co-owner’s percentage interests in the parcels cannot be separated and traded independently, and (c) the parcels of property are properly viewed as a single business unit. Contiguous parcels will be treated as a single business unit.

(4) Each of the co-owners must hold title to the property (either directly or through a disregarded entity) as a tenant in common under local law. The title to the property as a whole may not be held by an entity recognized under local law.

(5) The number of co-owners must be limited to no more than 35 persons. A husband and wife are treated as a single person.

(6) The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders or members of a business entity, or otherwise hold itself out as a form of business entity.

(7) The co-owners cannot have held interests in the property through a partnership or corporation immediately prior to the formation of the co-ownership.
(8) The co-owners may enter into a limited co-ownership agreement that may run with the land. In addition, the co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of property, any lease(s) of a portion or all of the property, or the creation or modification of a blanket lien.

(9) Each co-owner must have the rights to transfer, partition and encumber such co-owner's undivided interest in the property without the agreement or approval of any person. Restrictions on the right to transfer, partition or encumber interests in the property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited.

(10) If the property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners. The Revenue Procedure also specifies

(11) Conditions concerning the proportionate sharing of profits and losses, proportionate sharing of debt, options, business activities, management and brokerage agreements, leasing agreements and loan agreements are also specified.

e. "Property held primarily for sale" is not eligible for like kind treatment. Note that the statutory language of Sec. 1031, I.R.C., does not include the language of Sec. 1221, I.R.C., "to customers in the ordinary course of his trade or business". Accordingly, property that qualifies for capital gains treatment under Sec. 1221, I.R.C. may not necessarily qualify for like kind treatment.

(1) In Neal T. Baker Enterprises, Inc. v. Comm'r, 76 TCM 301 (1998), the taxpayer ("NTB") engaged in real estate subdivision and development and leased restaurants to a related corporation. In 1978, NTB acquired vacant land in Beaumont, California, initially planning to subdivide and sell the property. Eleven years later, NTB agreed to exchange the remaining undeveloped lots for other property. NTB treated the transaction as a like kind exchange under Sec. 1031(a), I.R.C. The Service disallowed the Sec. 1031, I.R.C. nonrecognition treatment, arguing that the property was held primarily for sale pursuant to Section 1031(a)(2)(A), I.R.C. NTB contended that it held the property for investment. NTB relied on the factors established in Section 1221, I.R.C. cases, which are used to determine whether property was primarily held for sale to customers in the ordinary course of business. The Court noted that these factors "provide guidance" in deciding if the property was held primarily for sale, but specifically disregarded factors that evaluated whether the property was intended to be sold "to customers in the ordinary course of business." The Court further noted that the exception enumerated in Section 1031(a), I.R.C. relating to property held primarily for sale is broader than the exception to capital gain treatment in Section 1221(1), I.R.C. The standards are not one and the same. The Court then turned to an analysis of the taxpayer's intent in holding the property, noting that NTB's intent as of the time of the exchange was controlling. Eline Realty Co. v. Comm'r, 35 T.C. 1, 5 (1960). After an exhaustive analysis of the facts surrounding the holding of the property, the Court concluded that NTB did not meet its "burden of proving that when it was dealing with the Exchange Property it was wearing the hat of an investor", and, therefore, Section 1031, I.R.C. did not apply. NTB did not help its case by listing
on its tax returns "real estate subdivider and developer" as the company's principal business activity, and classifying the property as inventory on its financial statements.

(2) But see Paullus v. Comm'r, 72 TCM 636 (1996), where the Court held that real estate owned by a corporation for four years was not "dealer property", even though the taxpayer obtained residential zoning for the property and maintained an office for purposes of selling individual lots.

f. Where dealer property is exchanged, the Service has stated that the transactions may be taxable as to the dealer in the exchange, but nonetheless tax-free as to the other party. See Rev. Rul. 77-297, 1977-2 C.B. 304.

g. Where dealer property is incidental to real estate, the entire transfer may qualify for Sec. 1031, I.R.C. deferral. See, e.g., Beeler v. Comm'r, 75 TCM 1699 (1998), holding that, entire gain was deferred where primary purpose for holding land was for possible expansion of mobile home park and mining sand was merely an incidental activity. Cf. Watson v. Comm'r, 345 U.S. 544 (1953) (purchase was primarily of orange groves, not real estate).

2. Definition of "Solely" -- The word "solely" does not mean that a taxpayer who receives non-like kind property in the exchange is entirely outside Sec. 1031, I.R.C. The transaction will be taxable to the extent that a taxpayer receives non-like kind property ("boot"). Sec. 1031(d), I.R.C.

3. Held for Use in a Trade or Business or for Investment

a. Property held for productive use in a trade or business may properly be exchanged for investment property under Sec. 1031, I.R.C. Reg. §1.1031(a)-1(a)(1).

b. It is recommended that property be held for productive use in a trade or business or for investment purposes during at least 2 taxable years before a like kind exchange is attempted.

c. Transfer to a Corporation -- The Service has held that the prearranged transfer by an individual of land and buildings used in his trade or business to an unrelated corporation in exchange for land and an office building, followed by the immediate transfer of such property received to the individual's newly formed corporation in a Sec. 351, I.R.C. transaction, does not qualify as an exchange under Sec. 1031(a), I.R.C. Rev. Rul. 75-292, 1975-2 C.B. 333.

(1) The rationale for this conclusion was that the property received was not held for investment or for productive use in a trade or business, but rather for the immediate transfer to a corporation.

(2) The same result was reached in Regals Realty Co. v. Comm'r, 127 F.2d 931 (CA2 1942), where property received in an exchange by a parent
corporation and immediately transferred to its subsidiary was held not to be a Sec. 1031, I.R.C. exchange of like kind property.

d. **Transfer from a Corporation** -- Property received in a corporate liquidation may be viewed as "held" for investment if the taxpayer did not formulate the intent to exchange the property until after the liquidation occurred.

(1) In *Bolker v. Comm'r*, 81 T.C. 782 (1983), aff'd 760 F.2d 1039 (CA9 1985), the Ninth Circuit permitted the taxpayer nonrecognition treatment for the exchange of land received in a former Sec. 333, I.R.C. liquidation for like kind property. The issue was whether the taxpayer actually "held" the property for investment prior to the exchange as required by Sec. 1031(a), I.R.C.

(2) In affirming the Tax Court, the Ninth Circuit distinguished Rev. Ruls. 77-337 and 77-297 by noting that the liquidation was in fact planned before any intention to exchange the property arose and that the taxpayer actually held the property for three months prior to the exchange. The Ninth Circuit found that the "holding" requirement of Sec. 1031(a), I.R.C. was satisfied if the taxpayer owned property and did not intend to liquidate it or use it for personal pursuits.

(3) See also *Maloney v. Comm'r*, 93 T.C. 89 (1989), holding that the acquired property was not liquidated in the sense of being cashed out, but rather that the taxpayers continued to have an economic interest in essentially the same investment, although there was a change in the form of ownership.

(4) See also Priv. Ltr. Rul. 9252001 (September 12, 1992), where the Service ruled that the receipt of like kind real property by a surviving corporation following a merger in exchange for property transferred by a predecessor corporation prior to the merger qualified for nonrecognition of gain treatment, since the taxpayer did not "cash in" on the investment in the relinquished property.

e. **Transfer to a Partnership** -- In *Magneson v. Comm'r*, 81 T.C. 767 (1983), aff'd 753 F.2d 1490 (CA9 1985), the taxpayer traded a fee simple interest in a commercial property for an undivided 10% interest in another commercial property, and on the same day contributed that 10% interest and cash to a partnership for a 10% general partnership interest therein.

(1) Effectively denying viability to Rev. Rul. 75-292, the Court, noting that the receipt of the partnership interest was tax free under Sec. 721, I.R.C., held the like kind exchange to be good because the taxpayers "merely effected a change in the form of the ownership of their investment instead of liquidating their investment".

(2) In affirming the decision of the Tax Court, the Ninth Circuit noted that, in order to qualify under Sec. 1031(a), I.R.C., the taxpayer must intend, at the time the exchange is effectuated, to hold the acquired property for investment. *Magneson v. Comm'r*, 753 F.2d 1490, 1493 (CA9 1985).
(a) The issue was whether contributing property to a partnership in return for a general partnership interest was “holding” the property for investment within the meaning of Sec. 1031(a), I.R.C.

(b) The Ninth Circuit sought to distinguish Rev. Rul. 75-292 by pointing out that (i) a corporation is a distinct entity, while a partnership is an association of its partners/investors, and (ii) at the time of this exchange Sec. 1031(a), I.R.C. expressly excluded exchanges of stock, but had no such prohibition for partnership interests.

f. Transfer from a Partnership --

(1) In Crenshaw v. U.S., 450 F.2d 472 (CA5 1971), cert. denied, 408 U.S. 923 (1972), the taxpayer liquidated her investment in a partnership, receiving an undivided interest in the partnership's primary asset, an apartment building. She then exchanged this interest for a shopping center held in her husband's estate. The estate sold the interest in the apartment building to a corporation owned by her former partners. The Fifth Circuit held that the taxpayer was not entitled to nonrecognition treatment because she engaged in all of the steps to avoid the taxable sale of her partnership interest to her former partners.

(2) See F.S.A. 199951004 (September 3, 1999). The taxpayer was a partnership that owned real property with rights to acquire adjacent property. The taxpayer and an individual formed a joint venture in order to construct, develop and operate two buildings. Subsequently, the two parties decided to dissolve the venture and distribute the assets. The individual had made additional capital contributions and owned a 75 percent interest in the venture at the time of the dissolution. The venture was originally treated as a partnership for Federal income tax purposes until the parties filed an election under Sec. 761, I.R.C. concurrent with the dissolution to treat their percentage interests in the venture as interests in each of the assets. The taxpayer had owned a 25 percent interest in the venture and purported to transfer a 25 percent interest in each of the two buildings to the individual. In exchange for its 25 percent interest in each building, the taxpayer received consideration from the individual in the form of debt relief for the taxpayer's share of liabilities attributable to each building. The taxpayer transferred its 25 percent interest in each of the two buildings to a qualified intermediary and the qualified intermediary transferred the interests in the properties to the individual. The taxpayer entered into two separate exchange agreements in which the taxpayer agreed to identify and acquire replacement property within the statutory time period. The taxpayer attempted to treat the transfer of the interest in the properties as an exchange under Sec. 1031, I.R.C. However, the Service determined that the transaction was in substance a sale by the taxpayer of its 25 percent interest in the joint venture to the individual. Consequently, Sec. 1031, I.R.C. did not apply, and the taxpayer was not entitled to nonrecognition treatment on the sale of the 25 interest in the joint venture.

g. Transfer of Property to an LLC Treated as a Disregarded Entity Prior to Sec. 1031, I.R.C. Exchange -- In two private letter rulings, the Service ruled that the disregarded character of such single-member LLCs will be respected for Sec. 1031, I.R.C.

(1) In these rulings, Sec. 1031, I.R.C. exchange treatment was accorded to a transfer of relinquished property by the sole owner of the single-member disregarded entity LLC in exchange for replacement property received by such disregarded entity. The Service concluded that, because the single-owner LLC is disregarded as an entity, the transactions in question would be viewed as if the taxpayer itself had directly received the replacement property, therefore satisfying the holding requirement of Sec. 1031, I.R.C.

(2) The same result will ensue when an LLC is formed after disposition, but prior to acquisition of replacement property. See Priv. Ltr. Rul. 9911033 (December 18, 1998) (LLC formed at insistence of lender financing acquisition of replacement property); and Priv. Ltr. Rul. 9850001 (August 31, 1998) (transfer of replacement property to LLC formed after disposition).

(3) In Priv. Ltr. Rul. 200131014 (August 6, 2001), the taxpayer transferred two hotel properties into two separate wholly owned LLCs after receiving the hotel properties as replacement properties in a like kind exchange. Because the LLCs would be disregarded and the taxpayer considered the direct owner of the hotel properties, the Service held that the hotel properties would be considered held for productive use in a trade or business or for investment.

(4) See Priv. Ltr. Rul. 200118023 (January 31, 2001), where the taxpayer’s qualified intermediary was a single member LLC with disregarded entity status for Federal income tax purposes. The taxpayer proposed to acquire the single member LLC as replacement property in a like kind exchange transaction. The qualified intermediary acquired real property selected by the taxpayer. The qualified intermediary had constructed improvements on the real property that it acquired. The direct transfer of the real property to the taxpayer would have been subject to a real estate transfer fee under state law. However, the transfer of the interest in the single member LLC would not be subject to the real estate transfer fee. The taxpayer’s receipt of the LLC interest was treated as the direct receipt of the real property owned by the LLC for purposes of Sec. 1031, I.R.C.

(5) See also Priv. Ltr. Rul. 199911033 (December 18, 1998), wherein a grantor trust formed an LLC in order to effectuate a like kind exchange of real property. The trust was treated as the sole owner of the LLC. The Service ruled that the replacement property was acquired directly by the trust for purposes of Sec. 1031(a)(3), I.R.C.

h. Exchange Followed by Liquidation or Reorganization --

(1) Corporation -- In Priv. Ltr. Rul. 9850001 (August 31, 1998), T, a 100%-owned subsidiary of H, held hotel property for productive use in a trade or business (the relinquished property). T transferred the relinquished property to a qualified intermediary, which then transferred the relinquished property to a third party. Within the 45-day identification period, T identified like kind replacement property and directed that the
replacement property be transferred to LLC2, a wholly owned limited liability company and a disregarded entity.

The parties contemplate that, shortly thereafter, T will liquidate into H, under Sec. 332, I.R.C., and that H will merge into S, in an "A" reorganization under Sec. 368(a)(l)(A), I.R.C. S is the sole owner of LLC1, a limited liability company, and a disregarded entity for tax purposes. As a result of the merger, S will be the sole owner of LLC1 and LLC2, which will retain their character as disregarded entities. It is then contemplated that S will transfer its interest in LLC2 to LLC1, with both continuing in existence. The taxpayer requested a ruling that the liquidation of T into H and the merger of H and S would not affect the holding period requirement under Sec. 1031(a)(l), I.R.C. that the replacement property be held for either productive use in a trade or business or investment. In making its determination, the Service considered the legislative history and case law that has developed under Sec. 1031, I.R.C. The Service articulated two major rationales for Sec. 1031, I.R.C.: (1) that nonrecognition treatment should lie where the taxpayer received like kind property because he has not "cashed out" of his investment; and (2) that requiring sale or exchange treatment in this context would create administrative burdens with respect to valuing such replacement property. See Starker v. United States, 602 F.2d 1341, 1352 (CA9 1979).

The Service concluded that these concerns are equally applicable where, as here, as a result of a Sec. 332, I.R.C. liquidation or a Sec. 368(a)(l)(A), I.R.C. reorganization, a successor corporation obtains ownership of like kind property previously received by a liquidated or an acquired corporation in a transaction to which Sec. 1031, I.R.C. would otherwise apply. Thus, a liquidation or reorganization subsequent to a good Sec. 1031 transaction, under these facts, will not operate to preclude nonrecognition treatment.

(2) Partnership / LLC – In Priv. Ltr. Rul. 199935065 (May 28, 1999), two S corporations owned more than 95 percent of the membership interests in two LLCs. The two LLCs each owned and operated one hotel property. The LLCs planned to dispose of the hotel properties and to acquire resort-like hotels in a like kind exchange transaction. Prior to the date when the companies would receive the replacement properties, the LLCs liquidated and transferred all of the assets to the members. The members immediately contributed the assets from the LLC in formation of new limited partnerships. The new limited partnerships were formed to prevent a carryover of liabilities to the replacement properties from the LLCs which transferred the relinquished properties. The lenders required the limited partnerships acquiring the replacement properties to be separate and apart from the owners of the relinquished properties to prevent such transfer of liabilities. The Service ruled that the conversion of the two LLCs into limited partnerships would not result in a termination of the entities under Sec. 708, I.R.C. The limited partnerships were considered as a continuation of the LLCs. The Service also determined that the limited partnerships would be treated as both the transferors of the relinquished properties and as the transferees of the replacement properties for purposes of Sec. 1031(a), I.R.C. The Service did not conclude whether the transaction would definitely qualify for nonrecognition treatment under Sec. 1031, I.R.C.
i. **Gifts** -- The fact that a taxpayer intends eventually to make a gift of the property received in a like kind exchange does not prevent Sec. 1031, I.R.C. from applying based on the theory that the property will not be held for investment.

(1) In *Wagensen v. Comm'r*, 74 T.C. 653 (1980), the taxpayer was found to have acquired like kind property even though, at the time of the exchange, he intended eventually to give the acquired property to his children, and in fact did so 10 months later. In the Court's view, to hold otherwise would have elevated form over substance. The Court noted that, if the taxpayer had given his property to his children, and they made the trade, it would have been a like kind exchange as to them. See also Priv. Ltr. Rul. 8429039 (April 17, 1984) (trade of a beach house for a personal residence to be rented for at least two years after the exchange qualified for tax-free treatment).

(2) Nonetheless, taxpayers should be sure not to make a gift of the property received in a like kind transaction immediately after the exchange, particularly if the recipients intend to use the property for personal purposes, rather than for investment or use in a trade or business. Nonrecognition treatment is not accorded to the extent property is held for personal use. See *Click v. Comm'r*, 78 T.C. 225 (1982), where the taxpayer did not qualify for nonrecognition treatment because her children moved into the acquired residential properties on the date of the exchange and taxpayer gifted the properties to them seven months later.

j. **Decedent as transferor of relinquished property** -- Any proceeds from the like-kind exchange of two properties will not give rise to income in respect of a decedent under Sec. 691, I.R.C.

(1) In Priv. Ltr. Rul. 9829025 (April 17, 1998), a husband and a wife, who lived in a community property jurisdiction, transferred two parcels of real estate to a grantor trust. The husband and wife, as trustees of the trust, entered into a separate like-kind exchange agreement with a bank and separately sold each of the two properties. On the husband's date of death, the trustees had identified and entered into a contract to purchase replacement property for one of the properties, but not the other.

(2) The Service concluded that, inasmuch as the exchange qualified for nonrecognition treatment under Sec. 1031, I.R.C., the proceeds from the exchange attributable to the husband's interest in the properties are not treated as an item of income in respect of a decedent. The surviving spouse was entitled to a step up in basis for the entire interest in both properties under Sec. 1014, I.R.C.

4. **Mandatory Applicability** -- The application of Sec. 1031, I.R.C. is mandatory rather than elective. Thus, if a taxpayer has any favorable reason to recognize gain or loss, the transaction should not be structured to qualify under Sec. 1031, I.R.C.

5. **Definition of Like Kind** -- The term "like kind" refers to the nature or character of property (for example, real property vs. personal property), as opposed to its quality or grade. Reg. §1.1031(a)-1(b). See Priv. Ltr. Rul. 200240049 (October 4, 2002) (concluding that a light duty truck is different in nature or character from an automobile, and, thus, they are
not like kind property); and Priv. Ltr. Rul. 200035005 (May 11, 2000) (exchange of FCC radio station license for FCC television station license qualified as like kind property based on character of property rather than quality or grade).

6. Personal Property -- Treatment as Like Kind

a. Personal property of a particular kind or class may not be exchanged in a nonrecognition transaction with personal property of a different kind or class. See Reg. §1.1031(a)-2(b)(4) (Modifications of Rev. Proc. 87-56 and S.I.C. Manual). For example, a corporation in the messenger service business could not trade its used delivery trucks for passenger automobiles to be used in its business. See Reg. §1.1031(a)-1(b).

b. Depreciable tangible personal property will be of a like kind or class only if the properties are within the same General Asset Class, as determined under certain Sections of Rev. Proc. 87-56, 1987-2 C.B. 674, or the properties are within the four-digit product class of the Standard Industrial Classification Manual put out by the Office of Management and Budget. Reg. §1.1031(a)-2(b).

c. See Tech. Adv. Memo. 200035005 (September 1, 2000). The taxpayer corporation transferred an FCC license to several radio stations in exchange for a license to a television station. The asset exchange agreement also provided for the transfer of tangible personal property including radio and television broadcasting equipment. The Service concluded that the exchange of an FCC radio license for a television license qualified as a like kind exchange within the meaning of Sec. 1031, I.R.C. because the nature and the character of the rights involved in both licenses were comparable under Reg. §1.1031(a)-2(c)(3).

d. In Tech. Adv. Memo. 200224004 (June 14, 2002), the Service found that the assigned frequency of the electromagnetic spectrum referred to in a television license is the sole underlying property to which a television license relates for purposes of the nonrecognition rules under Section 1031. The Service rejected the taxpayer’s assertion that the ability to affiliate with a major television network is part of the underlying property to which the license relates. This technical advice memorandum did not alter the Service’s earlier conclusion in Tech. Adv. Mem. 200035005 that a taxpayer’s exchange of FCC radio licenses for an FCC television license qualified as a like kind exchange.

e. See F.S.A. 199951006 (September 10, 1999). The taxpayer corporation and its subsidiary owned certain property to be relinquished in an asset exchange transaction. The property to be relinquished included land with improvements, computer equipment, patents and patent applications associated with facilities, and tradenames, trademarks and service marks associated with the facilities. The taxpayer and its subsidiary entered into an exchange agreement with another parent corporation and a subsidiary corporation utilizing a qualified intermediary. The taxpayer’s transfer of the relinquished property also included the transfer of goodwill. The taxpayer corporation identified replacement property within the required statutory period.
The Service focused on the coordination between Secs. 1031 and 1060, I.R.C. The Service determined that the exchange of the relinquished property was intended to be a sale of an ongoing business based on the terms of the asset purchase agreement between the parties. The Service concluded that Reg. § 1.1031(a)-2(c)(2) governs for purposes of determining whether goodwill or going concern value constitutes like kind property. Specifically, Reg. § 1.1031(a)-2(c)(2) provides that the goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business.

7. Real Property -- Treatment as Like Kind
   a. Real Property -- Defined

(1) State law is the general determinant of what constitutes real property.

   (a) An illustration of the impact of state law is found in Oregon Lumber Co. v. Comm'r, 20 T.C. 192 (1953), holding that, where the right to cut timber was an interest in personalty under Oregon state law, the exchange of land for the same did not qualify for like kind treatment under Sec. 1031, I.R.C.

   (b) Nevertheless, state law will not always govern, such as where the exchanged interest is considered as real property under state law but is treated as a right to future income for Federal income tax purposes. See, e.g., Comm'r v. P. G. Lake, Inc., 356 U.S. 260 (1958). See also Coupe v. Comm'r, 52 T.C. 394 (1969), holding that the taxpayers' rights under the sales contract were choses in action, and that a subsequent exchange of those rights for real property did not qualify as a like kind exchange under Sec. 1031, I.R.C.

(2) A land lease of 30 years or longer is treated as the equivalent of an interest in land and therefore should qualify in a like kind exchange under Sec. 1031, I.R.C. See Reg. §1.1031(a)-1(c); Rev. Rul. 60-43, 1960-1 C.B. 687; and Rev. Rul. 76-301, 1976-2 C.B. 241. See also Priv. Ltr. Rul. 8304022 (October 22, 1982).

(3) See Priv. Ltr. Rul. 200137032 (June 15, 2001), holding that the exchange of shares and a proprietary lease of a New York cooperative housing corporation for a condominium deed was a good like kind exchange. The Service noted that there was some ambiguity as to whether the cooperative shares were real property under New York, but held that the weight of authority was to such effect.

b. In Rev. Rul. 92-105, 1992-2 C.B. 204, the Service held that a taxpayer's interest in an Illinois land trust (or other similar arrangement) constituted real property and therefore could be exchanged for like kind property. See also Priv. Ltr. Rul. 9851039 (September 15, 1998), holding that an exchange of an agricultural conservation easement, which is considered as an interest in land under state law, for a fee simple interest in land qualified for nonrecognition under Sec. 1031(a), I.R.C.; and Priv. Ltr. Rul. 2002010007 (October 2, 2001), holding likewise.
c. The fact that one property may be developed completely while the other is raw land will not preclude like kind treatment. Reg. §1.1031(a)-1(b).

d. It may be logically thought that real property exchanged for real property will always qualify for "like kind" treatment. As a warning, however, it should be noted that the Service has ruled, in connection with Sec. 1033(g), I.R.C., that, although the term "real estate" is often used to embrace both land and improvements thereon, land and improvements are by nature not alike merely because one term is used to describe both. Rev. Rul. 67-255, 1967-2 C.B. 270; Rev. Rul. 64-237, 1964-2 C.B. 319; Rev. Rul. 76-390, 1976-2 C.B. 243.

(1) The relationship of Secs. 1031, 1033(a) and 1033(g), I.R.C. can be summarized as follows:

(a) Sec. 1031, I.R.C. applies only to property (both real and personal) held for productive use in a trade or business or for investment when such property is exchanged for property of a like kind to be held either for productive use in a trade or business or for investment.

(b) Sec. 1033(a), I.R.C. is dissimilar in its requirement that the properties involved in the conversion be "similar or related in service or use".

(c) A special rule is found in Sec. 1033(g), I.R.C. which applies solely to real property. This provision allows the nonrecognition provisions of Sec. 1033(a), I.R.C. to apply if the proceeds from a conversion of real property held for productive use in a trade or business or for investment are reinvested in property of a like kind to be held either for productive use in a trade or business or for investment.

(2) It is evident that the standards of Secs. 1031 and 1033(g), I.R.C. are, or at the least should be, virtually identical regarding real property. Consequently, interpretations of Secs. 1031 and 1033(g), I.R.C. should be equally illustrative in determining what does or does not qualify as real property of a like kind for purposes of these two Sections. However, in this regard, in the context of Sec. 1033(g), I.R.C., see Rev. Rul. 67-255, 1967-2 C.B. 270; Rev. Rul. 71-41, 1971-1 C.B. 223; and Priv. Ltr. Rul. 9118007 (January 30, 1991). These all reflect the unwillingness of the Service to allow a taxpayer to utilize Sec. 1033(g) where land is involuntarily converted, but the reacquisition does not include land.

(3) Sec. 1033(a), I.R.C. provides that, at the election of the taxpayer, gain is recognized to the extent the amount realized from a conversion exceeds the cost of the replacement property. A partnership rather than the individual partners are required to make the election not to recognize gain under Sec. 1033, I.R.C.

(4) See Priv. Ltr. Rul. 199907029 (September 30, 1998), where four individuals contributed cash and an apartment building in the formation of a residential real estate venture. Subsequently, the individuals entered into a partnership agreement that allocated profits and losses with respect to the venture. The venture, determined
to be a partnership for Federal income tax purposes, obtained financing and constructed a second
apartment building. A natural disaster destroyed the first apartment building and the four
individuals received cash from the filing of their insurance claims. Three of the partners used
their proportionate share of the insurance proceeds to purchase another apartment building
intended to qualify as replacement property under Sec. 1033, I.R.C. The purchase price of the
replacement property exceeded the gain realized by the three individuals from the conversion.
Consequently, the partnership qualified for the deferral of gain from the conversion under Sec.
1033, I.R.C. The Service allowed the election under Sec. 1033, I.R.C. of the first partnership
consisting of all four partners to apply with respect to the continuation of such partnership with
the three remaining partners.

e. Unproductive real estate, held by a non-dealer for future use or for
future realization of the increment in value, is property held for investment and not held
primarily for sale. Reg. §1.1031(a)-1(b).

f. Under Sec. 1031(h), I.R.C., real property located in the United
States and real property located outside the United States are not like kind. Under Sec.
7701(a)(9), I.R.C., the term "United States", when used in the geographic sense, includes only
the states and the District of Columbia. This would mean that the Virgin Islands, Guam and
Puerto Rico are considered to be outside the United States. However, real property located in
the Virgin Islands will be considered as located within the United States for purposes of Sec. 1031,
I.R.C. to the extent that Sec. 932, I.R.C. applies. Section 932, I.R.C. will apply if the taxpayer
involved in the exchange is a citizen or resident of the United States and has income derived
from sources within the Virgin Islands. Section 932, I.R.C. will also apply if the taxpayer has
income effectively connected with the conduct of a trade or business within the Virgin Islands or
if the taxpayer files a joint tax return with an individual who meets the applicable requirements
for the taxable year of the exchange. See Priv. Ltr. Rul. 200040017 (June 30, 2000), holding that
the Virgin Islands is included within the United States; and Priv. Ltr. Rul. 9038030 (June 25,
1990).

B. Exchanges

1. An exchange is a reciprocal transfer of property, as opposed to a sale of
property for consideration and a purchase reinvestment. See Reg. §1.1002-1(d). Substance will
prevail over form.

2. A transaction couched in terms of an exchange may be deemed a sale. In
Carlton v. United States, 385 F.2d 238 (CA5 1967), the taxpayers agreed to sell their ranch under
a contract giving them the option either to receive cash or to find other real property and require
the purchaser to exchange it for their ranch. The purchaser entered into contracts to purchase the
replacement property, but at closing the purchaser assigned the contracts of purchase plus the
cash to the taxpayers, who then paid the sellers of the replacement property. The Court found
that an exchange did not occur because the taxpayers received cash.

3. The purchase of one property and the subsequent sale of another are two
separate transfers that do not constitute an exchange. A sale for cash is not an exchange even if

4. The Service may also recharacterize an exchange transaction as a sale based on the view that a series of steps actually constitutes integrated steps in a single transaction. See Smith v. Comm'r, 537 F.2d 972 (CA8 1976), where the Court found that three "separate" transactions constituted steps in one transaction, thereby holding that a sale took place. But see Biggs v. Comm'r, 69 T.C. 905 (1978), aff'd 632 F.2d 1171 (CA5 1980); and Boise Cascade Corp. v. Comm'r, 33 TCM 1443 (1974).

5. By contrast, the Service may treat what is in form two sales as an exchange, especially to the extent that a loss is disallowed. In Allegheny County Auto Mart, Inc. v. Comm'r, 12 TCM 427 (1953), the taxpayer purchased real property that did not accommodate the taxpayer's used car business. Two weeks later, in what appeared on its face to be a separate transaction, the taxpayer arranged to purchase a larger lot from the owner and sell him the recently acquired property as partial consideration. The Court viewed these transfers as part of a single transaction for tax purposes, an exchange instead of two sales, and disallowed recognition of the loss incurred by the taxpayer.

6. The trade of real property for the construction of a building to the taxpayer's specifications may be treated as either a sale or an exchange, depending on whose land such building is constructed.

a. If the taxpayer owns the land used in the transferee's construction of the building, then the transaction is considered as a sale rather than as an exchange. The transaction constitutes a sale because there is no exchange of like kind property. The transferee provides services (the construction of improvements) in exchange for the real property received from the transferor. See Bloomington Coca-Cola Bottling Co. v. Comm'r, 189 F.2d 14 (CA7 1951). See also Priv. Ltr. Rul. 9031015 (May 4, 1990), ruling that the use of proceeds from the sale of rental houses to construct an apartment building for the seller on land he already owned did not qualify as a like kind exchange. But see Priv. Ltr. Rul. 8847042 (August 26, 1988).

b. However, if the transferee owns the land on which the building is constructed and then transfers the land and the building, there will be a qualifying like kind exchange. See J. H. Baird Publishing Co. v. Comm'r, 39 T.C. 608 (1962).

c. See also Rev. Rul. 75-291, 1975-2 C.B. 332, where X exchanged land and a factory used by X in its manufacturing operations for land acquired and a factory constructed on it by Y solely for the purpose of the exchange with X. The Service ruled that the transaction qualified as a like kind exchange as to X but not as to Y. Nonrecognition treatment was not accorded to Y because it acquired the property transferred to X immediately prior to the exchange, and constructed the factory for purposes of the exchange, so that it did not hold such property for productive use in its trade or business or for investment. See also Priv. Ltr. Rul. 7929091 (April 23, 1979), where it was noted that the building would be constructed by another party according to plans and specifications approved by the taxpayer, solely for purposes of a trade with the taxpayer. See, likewise, Priv. Ltr. Rul. 9149018 (September 4, 1991).
7. A transaction qualifies as a like kind exchange under Sec. 1031, I.R.C. only to the extent the taxpayer who sells the relinquished property also receives replacement property. In the partnership context, this means that, where property being relinquished is held by the partnership, the reciprocal transfer of replacement property must be received by the partnership, not deeded directly to the partners. Priv. Ltr. Rul. 9818003 (December 24, 1997). The Service emphasized that, although the seller of the replacement property need not have title to the replacement property (see Rev. Rul. 90-34, 1990-1 C.B. 154), the seller of the relinquished property must take legal title to the replacement property.

8. Taxpayers seeking to exchange real estate which has been depreciated, in whole or in part, via accelerated depreciation (generally, realty placed in service prior to 1987) must be wary of the recapture provisions of Secs. 1245 and 1250, I.R.C. Typically, the recapture will only be triggered where the taxpayer's real estate is exchanged for unimproved land, which is deemed nondepreciable realty. (Revenue Act of 1964, Pub. L. No. 88-272, H. Rep. No. 88-749, 1964-1 (Part 2) C.B. 123, 230.) Generally, the amount subject to recapture, and taxed as ordinary income, is the lesser of excess depreciation claimed or the amount of gain realized. (See Sec. 1250(a), I.R.C. for special rules.) However, if the taxpayer's real estate is commercial property, the entire amount of depreciation taken may be recaptured. This is because commercial property placed in service after 1980 and before 1987, and depreciated by an accelerated method, may be considered Sec. 1245, I.R.C. property. (Former Sec. 1245(a)(5), I.R.C., prior to repeal by Sec. 201(d)(11) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 99th Cong., 2d Sess., approved October 22, 1986), effective generally for property placed in service after 1986, in tax years ending after 1986.) Under Sec. 1245(a), I.R.C., all depreciation claimed is recaptured as ordinary income upon disposition, up to the gain realized in the transaction. Thus, it is advisable to proceed with extreme caution at any time a taxpayer plans to dispose of realty that has been written off via accelerated depreciation.

9. See Priv. Ltr. Rul. 200137032 (June 15, 2001), wherein the Service ruled that a condominium ownership interest and a shareholders' interest in a cooperative housing corporation qualified as like-kind properties for purposes of Sec. 1031, I.R.C.

C. Designations of Replacement Property -- Generally

1. Generally, a property owner may require a would-be purchaser to acquire other property to exchange for the owner's property solely in order to effectuate a tax-free exchange rather than a sale. See, e.g., Rev. Rul. 77-297, 1977-2 C.B. 304.

2. For example, in Alderson v. Comm'r, 317 F.2d 790 (CA9 1963), the Court held that it was acceptable to allow the taxpayers to amend an executed sales contract to convert the transaction into an exchange for purposes of Sec. 1031, I.R.C. See also Coupe v. Comm'r, 52 T.C. 394 (1969); Borchard v. Comm'r, 24 TCM 1643 (1965); and Rev. Rul. 75-291, 1975-2 C.B. 332. But see Estate of Bowers v. Comm'r, 94 T.C. 582 (1990), where substantial implementation of the sale before restructuring as an exchange cast the transaction as a sale.
3. In Mercantile Trust Company of Baltimore, Executors v. Comm'r, 32 B.T.A. 82 (1935), the purchaser had an option to buy the property for cash or to exchange property, and this was held acceptable as an exchange.

4. As the Tax Court held in another case, "[o]f crucial importance in such an exchange is the requirement that title to the parcel transferred by the taxpayer in fact be transferred in consideration for property received". Coupe v. Comm'r, 52 T.C. 394, at 405 (1969). See also Rutland v. Comm'r, 36 TCM 40 (1977).

5. See Priv. Ltr. Rul. 8852031 (September 29, 1988), where the Service ruled that a good like kind exchange may result notwithstanding the fact that the exchangor does not have title to the property exchanged. The exchanging party proposed to have third parties convey certain properties directly to the taxpayer in order to avoid the possibility of double taxation from the transfer. The IRS relied on W.D. Haden Co. v. Comm'r, 165 F.2d 588 (CA5 1948).

6. An interesting approach was used in 124 Front Street, Inc. v. Comm'r, 65 T.C. 6 (1975), a case in which the taxpayer owned an option to acquire property that the Fireman's Fund Insurance Company wanted to purchase. Fireman's advanced the taxpayer the funds to purchase the property. Subsequently, the taxpayer exchanged such property for other property acquired by Fireman's for purposes of the exchange.

   a. The Tax Court held that the transaction was a valid like kind exchange, and that the loan, which was bona fide, was not boot to the taxpayer. Note, that the Court emphasized the documentation and form, which the Court stated was "consistent with the intent of the parties".

   b. The 124 Front Street case was followed in Biggs v. Comm'r, 69 T.C. 905 (1978), aff'd 632 F.2d 1171 (CA5 1980), which found for the taxpayer in a factual situation in which the taxpayer advanced the funds that ultimately enabled the other party to the exchange to acquire the property needed for the exchange.

III. EXCHANGES WITH "BOOT"

A. Generally

1. "Boot" is cash or other property not falling in the tax-free category.

   a. Generally, the transfer by the taxpayer of qualified property for like kind property plus cash or other property will result in the transaction being only partially tax-free. Sec. 1031(b), I.R.C. provides:

"If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the
recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property."

b. If the fair market value of the like kind property plus the cash or other property ("boot") received is greater than the basis of the property transferred, then gain will be realized. Such gain is recognized to the extent of the cash plus other non-like kind property received, valued at its fair market value. See Leach v. Comm'r, 91 F.2d 551 (CA6 1937) for a simple illustration of Sec. 1031(b), I.R.C. in operation.

2. Where the boot exceeds the gain, such excess reduces the basis of the like kind property acquired in the exchange.

3. If other non-cash property is received in the exchange, the basis is allocated first to the "boot" property to the extent of its fair market value. Reg. §1.1031(d)-1(c).

a. Any remainder is then allocated to the property acquired. This allocating mechanism does not affect the gain computation.

b. EXAMPLE: A transfers real property with a value of $315,000 and a basis of $250,000 to B in exchange for real property worth $300,000, a car worth $5,000 and $10,000 in cash. The gain realized by A is $65,000, which is recognized only to the extent of $15,000. A's basis for the property received is $255,000 ($250,000, less $10,000 cash received, plus the $15,000 gain recognized). This $255,000 is allocated $5,000 to the car and $250,000 to the new real property.

c. In transactions that involve boot, gain recognized will not exceed the amount received as boot, except to the extent depreciation recapture may occur.

4. If the value of the like kind property plus the cash or other property ("boot") received is less than the basis of the property transferred, then no loss is recognized. Sec. 1031(c), I.R.C.

a. Instead, the receipt of boot causes the basis of the like kind property received to be reduced.

b. EXAMPLE: If, in the above example, A's original basis had been $350,000, with a $315,000 value, A would now hold the car and the real property with a total basis of $340,000 ($350,000, less $10,000 cash received, there being no gain recognized). This $340,000 would be allocated $5,000 to the car and $335,000 to the land. See Reg. §1.1031(d)-1(d).

5. Section 1250(d)(4), I.R.C. provides a limitation on the amount of gain recognized under Sec. 1250(a), I.R.C. where gain is not recognized in whole or in part under Sec. 1031, I.R.C. The general rule under Sec. 1250(d)(4), I.R.C., is that ordinary income is not recognized under Sec. 1250, I.R.C. where no boot is received, unless the amount of any Sec.
1250, I.R.C. gain (which would have been recognized if Sec. 1031, I.R.C. did not apply) exceeds the fair market value of Sec. 1250, I.R.C. property acquired. See Sec. 1250, I.R.C.; Reg. §1.1250-3(d).

EXAMPLE: A building held for the production of income is traded for raw land, to be held for investment. There is $20,000 in recapturable depreciation attributable to the building, but raw land does not constitute Sec. 1250 property, because it is not depreciable. Accordingly, there is $20,000 of ordinary income recognized on the exchange. If, on the other hand, there were a building with a fair market value of at least $20,000 on the land, there would be no recognition of ordinary income on the exchange.

6. For depreciable business assets placed in service after September 10, 2001, taxpayers may claim an additional first-year write-off equal to 30% of the cost of such assets. This additional depreciation, however, is limited in the case of a like kind exchange. Only the amount of money the acquirer pays for the replacement property (i.e., boot in the hands of the recipient) is eligible for the additional first-year write off. Consequently, taxpayers contemplating the replacement of a depreciable asset worth less than its tax basis should consider selling the asset outright in a taxable transaction rather entering a like kind exchange to replace the asset. The taxpayer can use the sales proceeds to purchase the replacement asset. Under this scenario, the seller may recognize the loss on the sale and also benefit from the additional depreciation deduction based on the replacement asset’s full cost. The IRS is expected to release guidance explaining this limitation in the coming months.

B. The Impact of Mortgages

1. Where mortgages appear on only one side of the transaction, two general rules govern.

   a. First, if the transferor transfers property subject to a mortgage, whether or not the transferee assumes the debt, the amount of the liability is treated as money received by the transferor for purposes of adjusting the basis under Sec. 1031(d), I.R.C. See Reg. §1.1031(d)-2. The Regulations provide that the amount of the liability is to be treated as money received by the taxpayer in the exchange, regardless of whether the assumption resulted in the recognition of gain or loss to the taxpayer. Section 1031(d), I.R.C. exclusively governs the tax treatment of mortgages assumed or property taken subject to by the exchanging parties. Consequently, the boot provisions of Sec. 1031(b), I.R.C. do not apply. See Rev. Rul. 59-229, 1959-2 C.B. 180; Reg. §1.1031(a)-1.

   b. Second, if the transferor acquires property subject to a mortgage, or assumes the debt, his basis for the new property is increased.

   c. EXAMPLE: A transfers an apartment house with a fair market value of $1,600,000 and a basis of $1,000,000 and subject to a $300,000 mortgage to B for an apartment house worth $1,300,000 and a basis to B of $800,000. The tax consequences to A are
as follows: the realized gain is $600,000 ($1,300,000 value of B's property, plus $300,000 liability to which A's property is subject, less $1,000,000 basis of A's property). A's recognized gain is $300,000, the amount of the mortgage. A's basis is $1,000,000 ($1,000,000 less $300,000 liability plus $300,000 gain recognized). The tax consequences as to B are: a realized gain of $500,000 ($1,600,000 value of A's property, less $300,000 liability to which A's property is subject, less $800,000 basis of B's property). B recognizes no gain and his basis is $1,100,000 ($800,000 plus $300,000).

2. A netting rule applies to the extent that the relinquished property and the replacement property are subject to mortgages or if debt is assumed by the transferee. This netting feature with like kind exchanges is generally favorable in managing distressed property foreclosures and workouts. Reg. §1.1031(d)-2.

a. The transferor of the property encumbered by the larger mortgage is treated as having received cash in an amount equal to the excess of the mortgage on the property transferred over the mortgage on the property received. However, if the taxpayer also transfers cash or other boot, the excess mortgage liability is reduced to the extent of the cash or fair market value of the other boot transferred. Reg. §1.1031(d)-2. See Blatt v. Comm'r, 67 TCM 2125 (1994).

b. The impact of such an exchange potentially may have an adverse impact on the transferee, who still receives boot, because the receipt of cash or other boot (including promissory notes) is not offset by any excess of the mortgage on the property received over the mortgage on the property transferred. See Coleman v. Comm'r, 180 F.2d 758 (CA8 1950).

c. The issue becomes to what extent may the transferor and transferee adjust the level of their mortgages through refinancings prior to the exchange to minimize their boot issues.

(1) The transferee could increase the amount of the mortgage prior to the exchange, if practicable, to receive cash and in that way equalize the mortgages, thus assisting both the transferor and the transferee. See Fredericks v. Comm'r, 67 TCM 2005 (1994).

(a) However, pre-exchange financing will be considered boot when the refinancing is an integral part of the exchange. See Long v. Comm'r, 77 T.C. 1045 (1981); and Simon v. Comm'r, 32 T.C. 935 (1959), aff'd 285 F.2d 422 (CA3 1960).

(b) In Prop. Reg. §1.1031(b)-1(c), it was provided that the netting concept "shall not apply to the extent of any liabilities incurred by the taxpayer in anticipation of an exchange" under Sec. 1031, I.R.C. The problem was that the phrase "in anticipation of" was, at best, ambiguous. Did it mean "as a step in the transaction", or "within a short period before the transaction", or "at any time prior to an exchange if the taxpayer contemplates making an exchange at any time in the future"? Due to a hue and cry from the real estate industry, this Proposed Regulation was dropped.
(2) A more conservative plan would be for the transferor to pay down the mortgage prior to the exchange, again in order to equalize the mortgages on both sides.

(3) EXAMPLE: A transfers property with a fair market value of $200,000, subject to a $100,000 mortgage and with a $100,000 basis to B for like kind property with a $200,000 fair market value, subject to a $150,000 mortgage and $50,000 in cash. B's basis is $100,000. As to B, the gain realized is $100,000 ($200,000 fair market value of property received less $100,000 mortgage less zero basis (arrived at by $100,000 plus $50,000, less $150,000)). B recognizes no gain. As to A, the gain realized equals $100,000 ($200,000 fair market value of the property received plus $100,000 mortgage given up plus $50,000 cash received, less $150,000 mortgage received, less the basis of $100,000). A will recognize gain because he must treat the $50,000 cash received as boot. He should have increased his mortgage or insisted, if possible, that B pay down his mortgage. A could have refinanced post-exchange on a tax-free basis had B paid down the mortgage.

d. In many exchanges, the taxpayer will use proceeds received from the disposition of the transferred property to satisfy the mortgage and then borrow to finance the acquisition of the replacement property. This should constitute mortgage netting even though there is technically no assumption of or transfer subject to debt. See Barker v. Comm'r, 74 T.C. 555 (1980). See Priv. Ltr. Rul. 8003004 (September 19, 1979), where taxpayer allowed to pay off transferee's mortgage and refinance with new debt and have mortgage netting apply. Accord, Priv. Ltr. Rul. 9853028 (September 30, 1998) (mortgage on transferred property may be netted with debt incurred to purchase acquired property).

e. See Rev. Rul. 2003-56, 2003-23 I.R.B. 985, in which the Service addressed the question of whether liabilities are netted for purposes of Sec. 752, I.R.C. when a partnership enters into a deferred like-kind exchange under Sec. 1031, I.R.C. straddling two taxable years. In Situation 1 of the Ruling, a partnership started a deferred like-kind exchange in year 1 by disposing of relinquished property with a value of $300x and subject to a liability of $100x. In year 2, the partnership (within the applicable time requirements) acquired replacement property with a value of $260x and subject to a liability of $60x. In Situation 2 of the Ruling, the same facts applied except that the replacement property had a value of $340x and was subject to a liability of $140x. The Service applied the liability offsetting rule in regulations under Sec. 1031, I.R.C. in determining whether any deemed distributions occurred for Sec. 752, I.R.C. purposes. In both situations, consequently, the partners of the partnership were entitled to net the liability on the replacement property against the liability on the relinquished property in determining their consequences under Sec. 752, I.R.C. As a result, although the partners of the partnership experienced a deemed distribution under Sec. 752, I.R.C. in Situation 1 ($100x liability on relinquished property offset only to the extent of the $60x liability on the replacement property), they received no deemed distribution and, therefore, recognized no income or gain under Situation 2 ($100x liability on relinquished property fully offset by $140x liability on the replacement property). The Service also stated that a similar analysis would apply in determining reductions of partnership minimum gain.

f. See Priv. Ltr. Rul. 200019014 (February 10, 2000), wherein the taxpayers were six state limited partnerships with the same general and limited partners. The
The general partner in the partnerships was a state business corporation. The partnerships owned real properties which included mobile home park improvements. The taxpayers proposed to enter into a tax-free forward deferred exchange transaction with a qualified intermediary. The relinquished properties would be transferred to the qualified intermediary, which would sell such properties and retain the proceeds. The transaction would be structured so that the taxpayers' right to receive the proceeds from the sale of the relinquished properties would be limited to the permissible circumstances described in Reg. § 1.1031(k)-1(g)(6). Subsequently, the intermediary would acquire replacement properties selected by the taxpayers within the required statutory period and transfer such properties to the taxpayers. The taxpayers intended that the replacement properties would consist of apartment complexes in which each partnership owned an undivided interest as tenant in common. The taxpayers had refinanced nonrecourse mortgages to which the relinquished properties were subject. A portion of the proceeds of the refinancing was distributed to the partners. The partners used the distributed proceeds from the refinancing to purchase more properties. The taxpayers represented in the transaction that the aggregate amount of mortgages on the replacement properties would exceed or equal the amount of mortgages on the relinquished properties.

The Service concluded that the transaction qualified as a deferred like kind exchange rather than a sale of the properties. The transfer of the fee simple interests in the real property and the mobile home park improvements in exchange for undivided interests in other real and personal property qualified for nonrecognition treatment under Sec. 1031, I.R.C. The Service determined that the proceeds from the refinancing of the mortgages on the relinquished properties would not be considered as payments of boot in the deferred exchange transaction. The refinancing had economic significance independent from the proposed exchange. The taxpayers received lower interest rates on the loans and the proceeds from the refinancing were used to purchase more properties (a legitimate business reason). The Service concluded that the taxpayers will not recognize any gain or loss in the exchange of the relinquished properties for the replacement properties, except to the extent that the sum of the proceeds from the relinquished properties and the amount of the refinanced debt exceeds the purchase price of the replacement properties.

C. **Installment Sales**

1. The taxpayer may elect the installment method of reporting taxable gain on the exchange if the requirements of Sec. 453, I.R.C. are met. Generally, Sec. 453, I.R.C. allows taxpayers to allocate the gain or loss recognized on the disposition of property over the term of the installment obligation. The amount of tax imposed is paid per installment according to the allocation formula set forth in Sec. 453(b)(2), I.R.C. This general rule is subject to the overriding provisions of Sec. 453(i), I.R.C. which govern the recognition of recapture income under Secs. 1245 and 1250, I.R.C. with respect to an installment obligation. See Rev. Rul. 65-155, 1965-1 C.B. 356, and Priv. Ltr. Rul. 8453034 (September 28, 1984).

   a. According to Sec. 453(f)(6), I.R.C., the gain is generally recognized ratably as the taxpayer is paid during the term of the installment note.
b. Specifically, the Regulations provide that, if the taxpayer's basis exceeds the fair market value of the like kind property received, that excess constitutes "excess basis". Prop. Reg. §1.453-1(f)(1)(iii).

2. The exchange is treated as if the taxpayer had made an installment sale of appreciated property, with a basis equal to the "excess basis", in which the consideration received is comprised of the installment obligation and any other boot. Prop. Reg. §1.453-1(f)(1)(iii).

a. The selling price is the sum of the face value of the installment obligation (reduced in accordance with the original issue discount rules), any net qualifying indebtedness, net cash received and the fair market value of any boot.

b. The total contract price is the selling price less any net qualifying indebtedness that does not exceed the excess basis.

c. Finally, payment in the year of exchange includes any net qualifying indebtedness that exceeds the excess basis.

IV. EXCHANGES BETWEEN RELATED PERSONS -- TRIGGERING DEFERRED GAIN

A. Background

1. Congress was concerned that taxpayers were able to defer taxable gain through the use of certain shifts in basis among related taxpayers. For example, assume that two wholly owned subsidiaries of a holding company own parcels of undeveloped real estate. Parcel 1 (in the hands of Corporation X) has an adjusted basis of $100,000 and Parcel 2 (in the hands of Corporation Y) has an adjusted basis of $800,000. An unrelated party, Corporation T, wishes to buy Parcel 1 for $900,000. If Corporation X sells Parcel 1, it will have a gain of $800,000 ($900,000 less $100,000). However, if Corporation X and Corporation Y first trade their parcels under Sec. 1031, I.R.C., then Corporation Y will own Parcel 1 with an adjusted basis of $800,000, and thus, on sale, will have a gain of only $100,000 ($900,000 less $800,000). However, if Corporation X and Corporation Y first trade their parcels under Sec. 1031, I.R.C., then Corporation Y will own Parcel 1 with an adjusted basis of $800,000, and thus, on sale, will have a gain of only $100,000 ($900,000 less $800,000).

2. The Service could have challenged this trade as beyond the scope of Sec. 1031(a), I.R.C. in all events based on the theory that Corporation Y did not acquire Parcel 1 for holding for productive use in a trade or business or for investment. See, e.g., Regals Realty Co. v. Comm'r, 127 F.2d 931 (CA2 1942); and Rev. Rul. 75-292, 1975-2 C.B. 333.

3. However, in order to solve this problem, Sec. 1031(f), I.R.C. and Sec. 1031(g), I.R.C. were added to the Code.

B. General Rules

1. A special rule under Sec. 1031(f), I.R.C. governs for exchanges between related persons. Specifically, nonrecognition treatment is not available to the extent that (i) the
taxpayer exchanges property with a related person; (ii) nonrecognition treatment would otherwise apply outside the scope of Sec. 1031(f), I.R.C.; and (iii) either the related party or the taxpayer disposes of the property within two years of the date of the exchange. The term "related person" is defined according to Secs. 267(b) or 707(b)(1), I.R.C. for purposes of Sec. 1031, I.R.C. See Priv. Ltr. Rul. 199926045 (April 2, 1999) (taxpayer attributed more than 50 percent ownership in holding company with voting and nonvoting common stock owned by son and through trust). See also F.S.A. 200137003 (May 10, 2001) (related party rule did not preclude nonrecognition treatment where subsequent disposition occurred more than two years after the date of the exchange).

a. Section 1031(f)(1), I.R.C. provides that a taxpayer's gain or loss recognized in a like kind exchange with a related party is taken into account on the date of a subsequent transfer of the exchanged property.

   (1) Note that any amount of loss may be limited by the related party rules of Sec. 267, I.R.C.

   (2) Nonrecognition treatment within the scope of Sec. 1031, I.R.C. does not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the related party limitation provided in Sec. 1031(f), I.R.C. See, e.g., Priv. Ltr. Rul. 9748006 (August 25, 1997), in which the Service concluded that a taxpayer was not entitled to nonrecognition treatment because the taxpayer's mother was involved in the multiparty exchange, in a clear attempt to disguise the related-party nature of the underlying transaction.

   (3) S. Rep. No. 1750, 101st Cong., 1st Sess. 206-207 (1989), points out, as an avoidance technique, the use of the unrelated third party as an intermediary. For example, using Corporations X, Y and T as described above, Corporation Y would first sell Parcel 2 to Corporation T, recognizing the $100,000 profit on sale, and Corporation T would then, within two years, trade Parcel 2 with Corporation X for Parcel 1. See Rev. Rul. 2002-83, 2002-49 I.R.B. 927 (discussed below).

b. In Priv. Ltr. Rul. 9609016 (November 22, 1995), the taxpayer proposed to exchange his undivided interests in 23 separate parcels of farm land (which he owned with five related persons) for a 100% interest in three of the 23 parcels. The taxpayer represented to the Service that the owners of the 23 parcels would not dispose of their interests (other than by reason of death) during the two-year period following the exchange. The Service ruled that the exchange would qualify under Sec. 1031, I.R.C.

c. The two-year period is suspended during any portion thereof that the holder's risk of loss as to the property is substantially diminished by (i) the holding of a put with respect to such property; (ii) the holding by another person of a right to acquire such property; or (iii) a short sale or any other transaction. Sec. 1031(g), I.R.C.
C. **Exceptions (Certain Dispositions Not Taken into Account)**

1. A disposition will not trigger recognition if it occurs:
   a. After the earlier of the death of the taxpayer or the death of the related person (Sec. 1031(f)(2)(A), I.R.C.); or
   b. In a compulsory or involuntary conversion (under Sec. 1033, I.R.C.) if the exchange occurred before the threat or imminence of such conversion. Sec. 1031(f)(2)(B), I.R.C.

2. A disposition also will not trigger recognition if it is established that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax. Sec. 1031(f)(2)(C), I.R.C.
   a. The Senate Finance Committee Report indicates that this exception generally is intended to apply to transactions that do not involve the shifting of basis between properties. See S. Rep. No. 1750, 101st Cong., 1st Sess. 206-207 (1989).
   b. This exception also applies to the following:
      1) Dispositions of property in nonrecognition transactions.
      2) A transaction involving an exchange of undivided interests in different properties that results in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of such properties. See Priv. Ltr. Rul. 199926045 (April 2, 1999).

D. **Treatment of Certain Transactions**

1. Section 1031(f)(4), I.R.C. sets forth a tax avoidance provision so that nonrecognition treatment under Section 1031, I.R.C. does not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the related party limitations under Sec. 1031(f), I.R.C.

2. In Rev. Rul. 2002-83, 2002-49 I.R.B. 927, the Service concluded that a taxpayer who transferred relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party was not entitled to nonrecognition treatment under Sec. 1031(a) because the related parties used the qualified intermediary to circumvent the Sec. 1031(f)(1) limitation.

In this Ruling, two individual taxpayers, who were related persons within the meaning of Sec. 267(b), I.R.C., held separate parcels of investment real property with the same fair market value. Taxpayer #1 owned appreciated real property with a low basis. Taxpayer #2's basis in his property equaled its fair market value. Taxpayer #3, an unrelated taxpayer, sought to purchase the property owned by Taxpayer #1. Seeking to defer the immediate recognition of
gain on the sale of his property, Taxpayer #1 attempted to use a qualified intermediary to structure a like-kind exchange. Pursuant to an agreement, Taxpayer #1 transferred his property to the qualified intermediary, who then sold the property to Taxpayer #3 for fair market value. Following this sale, the qualified intermediary used the sales proceeds from the sale of Taxpayer #1’s property to acquire Taxpayer #2’s property. The qualified intermediary then transferred this property to Taxpayer #1.

Although taxpayers may use a qualified intermediary to facilitate a like-kind exchange, a taxpayer exchanging like-kind property with a related person cannot use the nonrecognition provisions of Sec. 1031, I.R.C. if, within two years of the date of the last transfer, either the related person disposes of the relinquished property or the taxpayer disposes of the replacement property. This limitation is intended to deny nonrecognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. Moreover, nonrecognition is not available for a transaction or series of transactions designed to avoid this limitation. In this scenario, because Taxpayer #1 employed a qualified intermediary to circumvent this limitation, the nonrecognition provisions of Sec. 1031, I.R.C. do not apply to the exchange between Taxpayer #1 and the qualified intermediary. Thus, Taxpayer #1 must recognize gain on this exchange.

3. Several weeks after releasing Rev. Rul. 2002-83, the IRS released Priv. Ltr. Rul. 200251008 (December 20, 2002). In this ruling, the Service held that an S corporation will not recognize gain or loss in a like-kind exchange of real property using the qualified exchange accommodation arrangement (QEAA) with an exchange accommodation titleholder (EAT). This transaction is sometimes referred to as a “parking” transaction. Rev. Rul. 2000-37, 2000-40 I.R.B. 308, set forth a safe harbor for acquiring replacement property through this type of transaction. Even though the proposed parking transaction involved related parties, the Service noted that Sec. 1031(f)(1) is not a concern in this case because the taxpayer and the related parties continue to remain invested in the exchange properties and they are not cashing out their respective interests.

4. See Tech. Adv. Mem. 200126007 (March 22, 2001), in which the taxpayer owned investments in real property and operated several different businesses. The members of two families owned the stock of the taxpayer. The taxpayer and the shareholders of the taxpayer owned the stock in another corporation. The taxpayer and the other corporation were related parties within the meaning of Sec. 267(b), I.R.C. and for purposes of Sec. 1031(f)(3), I.R.C. The related party operated a retail business through various stores.

The taxpayer decided to dispose of its fee simple interest in a high-rise, residential rental property (Property 1). On September 6, 1994, the taxpayer executed a letter of intent with the related party corporation for the acquisition of two properties, Property 2 and Property 3, in the first of two separate like kind exchange transactions. The related party had purchased a parcel of land for development in 1992. The related party subdivided the parcel into a large parcel (Property 2) and two small parcels (Property 5). The small parcels on Property 5 were leased for commercial use. The related party obtained financing to develop a shopping center on Property 2. The owner of Property 2 had the right to restrict the operation of a particular retail business conducted on an adjoining property. The retail business competed with the related party’s
shopping center and store located on Property 2. The taxpayer had an economic interest in acquiring Property 2 to control the level of competition for the related party's store. Property 3 was located adjacent to another property on which the related party's store was located. Property 2 and Property 3 shared a parking lot.

The taxpayer signed a contract to sell Property 1 to a purchaser with the closing scheduled to take place concurrently with the closing of the exchange transaction between March 1, 1995 and July 31, 1995. On August 2, 1995 following the renegotiation of the purchase price, the taxpayer assigned the contract for the sale of Property 1 to an intermediary. On August 22, 1995, the taxpayer guaranteed payment of part of the purchaser's financing. The closing of the sale of Property 1 occurred on August 24, 1995, the same day as the closing of the sale of Property 2 and Property 3 with the intermediary.

The taxpayer also owned a fee simple interest in a parcel of land (Property 4) with a condominium constructed on the land. The taxpayer's fee simple interest was subject to a long-term ground lease and a sublease with the Condominium Association. The taxpayer agreed to the sale of the fee simple interest to the lessee under the long-term ground lease. The sale of Property 4 was conditioned on a like kind exchange cooperation provision. The taxpayer had a low basis in Property 4 and wanted to avoid the recognition of gain through the use of a like kind exchange. The Condominium Association was eventually substituted as the purchaser of Property 4. The sale of Property 4 finally closed on September 1, 1995 when the taxpayer applied the proceeds to purchase Property 5 from the related party in a like kind exchange transaction.

Section 1031(f)(1), I.R.C. disallows nonrecognition treatment where a taxpayer and a related party enter into a like kind exchange transaction and then one of the parties disposes of either the relinquished property or the replacement property within two years of the exchange. Section 1031(f)(4), I.R.C. provides that Sec. 1031, I.R.C. does not apply to any exchange which is part of a transaction or a series of transactions structured to avoid the purposes of Sec. 1031(f), I.R.C. The Service determined that the taxpayer's multi-party exchanges facilitated the shifting of the taxpayer's low basis in its relinquished properties (Properties 1 and 4) to the replacement properties (Properties 2, 3 and 5) owned by the related party prior to the exchanges. The Service determined that the taxpayer and the related party had essentially cashed out certain investments in the real properties because the amounts realized from the sale of the taxpayer's relinquished properties were applied to reduce the related party's bank debt. Consequently, the Service concluded that the taxpayer entered into both exchange transactions with a tax avoidance motive, so that neither of the exchange transactions qualified for nonrecognition treatment under Sec. 1031, I.R.C.

The Service rejected the taxpayer's various arguments, including that (1) the taxpayer and the related party were not the types of parties to which Sec. 1031(f)(4), I.R.C. was intended to apply, and (2) the taxpayer's exchanges were the result of permissible tax planning rather than a tax avoidance motive. The taxpayer also argued, unsuccessfully, that the multi-party exchanges were not subject to Sec. 1031(f), I.R.C. which should apply to a direct or indirect related party exchange rather than related party sales of replacement property in transactions with an intermediary. See also F.S.A. 199931002 (April 12, 1999), stating that Sec. 1031(f)(1),
I.R.C. governs to the extent that an adjustment also could be made under the authority of Sec. 1031(f)(4), I.R.C.

V. SIMULTANEOUS EXCHANGES

A. Description -- The seller/transferor and the buyer/transferee exchange title to like kind properties simultaneously. The seller/transferor transfers the relinquished property and receives the replacement property in an integrated simultaneous transaction with the buyer/transferee. The buyer/transferee acquires the relinquished property and transfers the replacement property in an exchange transaction that occurs simultaneously.

B. Difficulties of Simultaneous Exchange -- The most usual difficulty in accomplishing a simultaneous like kind exchange is the need to find two parties who desire to exchange properties currently owned by each other. However, a simultaneous exchange may be accomplished successfully where the transferee is willing to wait to acquire the transferor's property until the transferor has designated like kind property and the transferor is willing to designate such like kind property within a time frame acceptable to the transferee.

C. Use of an Intermediary -- In the case of simultaneous transfers of like kind properties involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of Sec. 1031(a), I.R.C. Reg. §1.1031(b)-2(a).

D. Like Kind Transaction Agreement -- The transferor and transferee enter into a standard purchase and sale agreement ("Sales Agreement"). It is favorable, but not absolutely required, that the Sales Agreement should include provisions whereby both parties covenant to cooperate so that the transferor may effectuate a like kind exchange. Note the effect of the following provision:

Further Assurances. Buyer hereby covenants and agrees to use its reasonable efforts and diligence to assist and cooperate with Seller in order to effectuate a like kind exchange under Section 1031 of the Internal Revenue Code of 1986, as amended ("Section 1031"), including, without limitation, executing and delivering any and all documents reasonably required in accordance with the agreements of the parties set forth in this Agreement; provided, however, that Buyer shall not incur any additional costs, expenses, liabilities, obligations or other financial risk with respect thereto.

It is important to note that Sec. 1031, I.R.C. provisions can be incorporated by reference and added, by amendment if necessary, at any time prior to the actual closing in order to provide for the like kind exchange.

E. Illustrations

1. See Priv. Ltr. Rul. 199926045 (April 2, 1999), where the taxpayer and her deceased husband owned substantial acreage in old-growth and young timberlands. A holding
company owned by a state held an option to acquire an undivided one-half interest in 39,000 acres of the timberland owned by the taxpayer. The taxpayer was deemed to own more than 50 percent in the holding company through attribution under Secs. 267(b) and 1031(f)(3), I.R.C. The holding company desired to exercise its option to acquire an interest in the old-growth timber for development purposes. The taxpayer transferred her undivided one-half interest in a portion of various parcels of the old-growth timber in exchange for a 100 percent interest in one or more parcels. The taxpayer’s transaction involved an exchange of undivided interests in different properties resulting in the taxpayer’s acquisition of an entire interest in a single property or a larger undivided interest in such properties. Consequently, the Service ruled that the taxpayer’s transaction qualified as a like kind exchange and the planned cutting of timber within two years of such exchange would not trigger the recognition of gain or loss under the related party rule of Sec. 1031(f)(1), I.R.C. See also Rev. Rul. 79-44, 1979-1 C.B. 265 (partitioning of two jointly owned parcels into two individually owned parcels); Rev. Rul. 73-476, 1973-2 C.B. 300 (exchanges by three proportionate owners of three parcels of real estate for separately held 100 percent interests in the same properties); and Rev. Rul. 72-515, 1972-2 C.B. 466 (timberlands of differing quality and quantity exchanged).

2. See also Priv. Ltr. Rul. 199945046 (August 12, 1999), in which the taxpayer was the son of the decedent and the decedent’s husband. The decedent and the decedent’s husband each owned an undivided one-half interest as tenants in common in property used for ranching operations. The decedent’s husband held his undivided one-half interest in the ranch property via a revocable trust, of which the decedent’s husband was the grantor, trustee and beneficiary. The decedent also conveyed her undivided one-half interest in the property to a revocable trust, which became irrevocable on the death of the decedent. The undivided one-half interest in the property owned by the decedent’s trust was included in the gross estate of the decedent and was transferred to the taxpayer, who is the son of the decedent. The executor of the decedent’s estate elected to have the undivided one-half interest valued in the decedent’s estate according to the special use valuation provision of Sec. 2032A, I.R.C. The value of the qualified real property, including ranches, in the estate is the value based on qualified use rather than fair market value.

The taxpayer proposed to enter into a simultaneous exchange of his undivided one-half interest in the ranch property for a 100 percent fee simple interest in one half of the property. The taxpayer and the revocable trust of the decedent’s husband would each convey their undivided one-half interest in the ranch property in exchange for a 100 percent interest in one-half of the property. The transfer of ownership was accomplished by the exchange of quitclaim deeds, and no cash or other property was transferred in the transaction.

Section 2032A(c)(1), I.R.C. provides that additional estate tax is imposed if, within 10 years after a decedent’s death, a qualified heir disposes of an interest in qualified real property (other than by disposition to a family member) or the qualified heir ceases to use the qualified real property for the qualified use. Section 2032A(i)(1)(A), I.R.C. provides that, if an interest in real property is exchanged solely for an interest in qualified exchange property in a transaction which qualifies under Sec. 1031, I.R.C., no additional estate tax is imposed by Sec. 2032A(c), I.R.C. The Service considered whether the exchange of the taxpayer’s interest was a disposition within 10 years of the decedent’s death for purposes of imposing additional estate tax under Sec.
2032A(c)(1), I.R.C. The Service also addressed the issue of whether the exchange qualified under Sec. 1031, I.R.C. so that additional estate tax would not be imposed by Sec. 2032A(c), I.R.C.

The Service treated the decedent’s husband as the owner of the property held by his revocable trust since he was the grantor, trustee, and beneficiary. Consequently, the taxpayer was considered to have transferred his undivided one-half interest in the property to the decedent’s husband, i.e., his father. The Service concluded that no additional estate tax would be imposed under Sec. 2032A(c)(1), I.R.C. following the taxpayer’s exchange occurring within 10 years of the decedent’s death because the taxpayer transferred his interest to a family member.

The Service also concluded that the taxpayer’s transfer of his undivided one-half interest in the ranch property in exchange for a 100 percent fee simple interest in one-half of the property qualified as a like kind exchange under Sec. 1031, I.R.C. The decision was based on the analysis provided in Rev. Rul. 73-476, 1973-2 C.B. 300 (nonrecognition treatment accorded to three taxpayers who exchanged undivided one third interests in three parcels of land for a 100 percent ownership interest in one parcel of land) and Rev. Rul. 79-44, 1979-1 C.B. 265 (nonrecognition treatment accorded to two taxpayers who exchanged undivided one-half interests in two parcels of land for a 100 percent interest in one parcel of land.

VI. DEFERRED LIKE KIND EXCHANGES

A. Overview -- Reg. §1.1031(k)-1(a) currently provides that a deferred exchange is an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the “relinquished property”) and subsequently receives property to be held either for productive use in a trade or business or for investment (the “replacement property”).

1. Because of the timing difficulties in finding suitable replacement property, the deferred like kind exchange has become very popular. It first was widely publicized as a result of Starker v. United States, 602 F.2d 1341 (CA9 1979), rev'g 432 F.Supp. 864 (D. Or. 1977), where the Court held that an exchange qualified for nonrecognition treatment even though under the agreement, the transferor (1) could designate the property to be exchanged for up to five years after the transaction, and (2) could receive cash instead of replacement property.

2. As part of the Tax Reform Act of 1984, Congress adopted, but limited, the application of Starker by adding Sec. 1031(a)(3), I.R.C. to the Code. Sec. 1031(a)(3), I.R.C. provides that any property received by a taxpayer in a deferred exchange is treated as property which is not like kind property if --

   a. Such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or
b. Such property is received after the earlier of—

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

(2) the due date (including extensions) of the taxpayer's tax return for the taxable year in which the transfer of the relinquished property occurs.

3. Sec. 1031(a)(3), I.R.C., was enacted due to concern by Congress that, without the statutory restrictions, the application of Sec. 1031, I.R.C. to deferred exchanges would give rise to unintended results and administrative problems. Particularly from the perspective of the Treasury, the greater the taxpayer's discretion to vary the particular property to be received in exchange for the relinquished property and to vary the date on which such replacement property (or money) is to be received, the more the transaction is appropriately treated as a sale and not as a like kind exchange.

4. As a practical matter, any 180-day exchange period which runs beyond April 15 of the subsequent year will require the individual taxpayer to file an extension of its income tax return for the prior year. The extension essentially allows the taxpayer to take advantage of the exchange period in order to close out the deferred exchange after April 15 of the subsequent year. See Christensen v. Comm'r, 98-1 USTC ¶50,352 (CA9 1998), aff'g 71 TCM 3137 (1996), where the taxpayer argued unsuccessfully that the permissible period for the tax-free exchange should be extended by the automatic four-month extension of time to file. The court did not concur because the extension is not actually automatic since the taxpayer must apply for it using Form 7004.

5. Additionally, there is no good faith exception for the failure to meet the timing requirements. In Knight v. Comm'r, 75 TCM 1992 (1998), the Court disallowed deferred exchange treatment because the taxpayers' receipt of property fell outside the statutory 180-day window, despite the good faith efforts of taxpayers to comply. The fact that the seller cancelled the sale one day before the 180-day period expired did not constitute grounds for exemption from the Sec. 1031(a)(3), I.R.C. time period, even though the circumstances were beyond the taxpayers' control. The Court held that it lacked jurisdiction to provide taxpayers with the equitable relief they sought. An exchange transaction will not qualify for nonrecognition treatment if the taxpayer fails to comply with the 45-day identification requirements. See Dobrich v. Comm'r, 74 TCM 985 (1997) (no deferral where taxpayer failed to identify property within 45 days).

6. In order to constitute a deferred exchange, the transaction must be an exchange (that is, a reciprocal transfer of property for property, as distinguished from a transfer of property for money). Reg. §1.1031(k)-1(a). In C. Bean Lumber Transport, Inc. v. United States, 99-1 USTC ¶50,474 (W.D. Ark. 1999), the taxpayer negotiated the purchase of new trucks and trade-in of used trucks at the same time, but each transaction was documented separately and the used trucks were paid for by the dealership by check, not as a credit against the purchase of new trucks. The court held that the transactions did not qualify as like kind.
7. If the taxpayer actually or constructively receives money or property which does not meet the requirements of Sec. 1031(a), I.R.C. (that is, "other property" or actual or constructive receipt of cash) in the full amount of the consideration for the relinquished property, the transaction will constitute a sale, and not a deferred exchange, even though the taxpayer may ultimately receive like kind replacement property. Reg. §1.1031(k)-1(a). In Big Hong Ng v. Comm’r, 73 TCM 2900 (1997), for example, the taxpayer initially complied with all of the requirements in order to qualify under Sec. 1031, I.R.C., engaging a qualified intermediary to sell a property owned by the taxpayer personally, then purchasing a property from the taxpayer’s wholly owned corporation. After the exchange, however, the taxpayer withdrew the funds from the corporate account and used them to pay personal expenses. The court determined that the transaction was a “sham”, and, therefore, disallowed the deferral of gain.

8. **Forward Deferred Like Kind Exchange** -- In Priv. Ltr. Rul. 200111025 (December 8, 2000), the taxpayer owned a park and was in the business of real estate investment and leasing operations. The taxpayer entered into an option agreement with a tax-exempt conservation organization that desired to acquire the park. The option agreement contained a tax-deferred exchange cooperation provision, which reserved the right to the taxpayer to exchange the park in a Sec. 1031, I.R.C. nonrecognition transaction. The taxpayer’s transfer of the park as the relinquished property in exchange for replacement property acquired from an accommodation party qualified for nonrecognition treatment under Sec. 1031, I.R.C.

   a. **Relinquished Property** -- The conservation organization desired to acquire the taxpayer’s park for public recreational purposes. The taxpayer and the conservation organization entered into a bargain sale option agreement for the sale of the park. The agreement provided an exclusive and irrevocable contingent option for the conservation organization to acquire the park. The option was contingent upon the passage of certain state bond legislation which actually occurred.

   b. **Replacement Property** -- The business operations of the accommodation party involved the acquisition, ownership, leasing, financing and disposition of real property. The accommodation party acquired the taxpayer’s replacement property and financed the acquisition. The financing consisted of a loan obtained by the accommodation party from a bank and the concomitant guaranty of the taxpayer. Subsequently, the taxpayer leased the replacement property from the accommodation party under an agreement with the standard provisions of a triple net lease.

   c. **Forward Deferred Exchange** -- The Service applied a three-part test to determine if the taxpayer was entitled to nonrecognition treatment under Sec. 1031, I.R.C. The exchange of the park qualified as a forward deferred like kind exchange based on the following factors:

      (1) The taxpayer had the requisite intent to enter into a forward deferred like kind exchange according to Sec. 1031(a)(3), I.R.C.
(2) The taxpayer's transaction was part of an integrated plan to exchange the park as the relinquished property for the replacement property; and

(3) The accommodation party was not considered as the taxpayer's agent for the purpose of holding the replacement property.

9. See F.S.A. 200048021 (August 29, 2000), in which the taxpayer sold four properties to his children in a transaction intended to qualify as a like kind exchange. The children financed the acquisition of the taxpayer's relinquished property by executing a note with an escrow agent. Subsequently, the taxpayer acquired the replacement property. The taxpayers were not entitled to nonrecognition treatment under Sec. 1031, I.R.C. because the transaction did not meet the following requirements:

   a. The escrow agent did not meet the definition of a qualified intermediary under the regulations;

   b. The taxpayer failed unambiguously to identify the replacement property; and

   c. The taxpayer constructively received the proceeds from the transfer of the relinquished property prior to receiving the replacement property.

B. Actual and Constructive Receipt of Money or Other Property -- The Safe Harbors

1. The issue of receipt of cash or a cash equivalent arises in the context of a deferred like kind exchange because of the transferor's need for security after the transfer of the exchange property to the transferee, but before the receipt of the replacement property by the transferor. Such security arrangements may be challenged on the grounds that they constitute the actual or constructive receipt of cash or a cash equivalent. Generally, if a taxpayer actually or constructively receives money or other property from the transfer of relinquished property before the taxpayer receives like kind replacement property, then the transaction constitutes a sale rather than a deferred exchange. Reg. §1.1031(k)-1(f)(1).

   a. The taxpayer is in actual receipt of money or property at the time the taxpayer actually receives such money or property or receives the economic benefit thereof. Reg. §1.1031(k)-1(f)(2).

   b. The taxpayer is in constructive receipt of money or property at the time such money or property is credited to the taxpayer's account, or set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it, either immediately or after giving appropriate notice. Reg. §1.1031(k)-1(f)(2).

   c. Where the taxpayer's control of the receipt of money or property is subject to substantial limitations or restrictions, constructive receipt occurs at the time such limitations or restrictions lapse, expire or are waived. Reg. §1.1031(k)-1(f)(2).
d. The general rules governing actual or constructive receipt by the taxpayer (or his or her agent or representative) thus apply, without regard to the taxpayer's method of accounting.

2. There are four safe harbors which, if used correctly by the taxpayer, will not create an actual or constructive receipt of money or other property for purposes of Sec. 1031(a)(3), I.R.C. Nonetheless, the safe harbors apply only until the taxpayer has the ability or unrestricted right to receive money or other property. Reg. §1.1031(k)-1(g)(1).

3. **Safe Harbor No. 1** (Security or Guarantee Arrangements) --

   a. There will not be actual or constructive receipt where the obligation of the taxpayer's transferee (that is, the person to whom the taxpayer transfers the relinquished property) to transfer the replacement property to the taxpayer is or may be secured or guaranteed by one or more of the following:

      (1) A mortgage, deed of trust or other security interest in property (other than cash or a cash equivalent);

      (2) A standby letter of credit which meets the requirements of Temp. Reg. §15A.453-1(b)(3)(iii) and which does not allow the taxpayer to draw on it except on a default of the taxpayer's transferee's obligation to transfer like kind property to the taxpayer; or

      (3) A guarantee of a third party. Reg. §1.1031(k)-1(g)(2).

   b. As to the standby letter of credit, see Temp. Reg. §15A.453-1(b)(5) Exs. (7) and (8).

4. **Safe Harbor No. 2** (Qualified Escrow Accounts and Qualified Trusts) --

   a. The obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer may be secured by cash or a cash equivalent if the cash or cash equivalent is held in a qualified escrow account or in a qualified trust. Reg. §1.1031(k)-1(g)(3).

   b. As set forth in Reg. §1.1031(k)-1(g)(3), a qualified escrow account or trust is an escrow account or trust where --

      (1) The escrow holder or the trustee is not the taxpayer or a disqualified person (as defined in Reg. §1.1031(k)-1(k)); and

      (2) The taxpayer's right to receive, pledge, borrow or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account or by the trustee are limited (the "(g)(6) limitations") so that the taxpayer does not have the right to receive the money
or other property in the qualified escrow account or qualified trust until (as set forth in Reg. §1.1031(k)-1(g)(6)) --

(a) If the taxpayer has not identified replacement property before the end of the identification period, after the end of the identification period; or

(b) After the taxpayer has received all of the identified replacement property to which the taxpayer is entitled; or

(c) If the taxpayer identifies replacement property, after the end of the identification period and the occurrence of a material and substantial contingency that

(i) relates to the deferred exchange,

(ii) is provided for in writing, and

(iii) is beyond the control of the taxpayer and any disqualified person; or

(d) Otherwise, after the end of the exchange period.

(3) See Priv. Ltr. Rul. 200027028 (July 7, 2000), holding that an amended exchange agreement did not meet the requirements of Reg. §1.1031(k)-1(g)(6)(iii). The taxpayer entered into a like kind exchange transaction with the use of a qualified intermediary. The agreement provided that the taxpayer was only entitled to receive the proceeds from the exchange before the end of the exchange period if certain events occurred. The qualified intermediary amended the agreement to provide that the taxpayer could receive the proceeds before the end of the exchange period to the extent that a binding agreement for the replacement properties was not concluded. See, as a distinct contrast to the safe harbor, Greene v. Comm'r, 62 TCM 512 (1991). See also, as to the taxpayer's failure to follow the appropriate guidelines, Klein v. Comm'r, 66 TCM 1115 (1993), and Hillyer v. Comm'r, 71 TCM 2945 (1996).

(4) See Priv. Ltr. Rul. 9448010 (December 2, 1994), where the escrow was non-interest bearing, but the taxpayer instead received fee waivers from the bank where the escrow was located. This was held not to violate the safe harbor because such benefits were not available until the end of the exchange period.

(5) See also Tech. Adv. Mem. 199907029 (February 19, 1999), wherein a partnership with four partners owned real property including an apartment building that was destroyed in a natural disaster. Three of the partners from the original partnership continued to operate their business as a continuation of the first partnership. The second partnership transferred the real property remaining after the natural disaster in a like kind exchange transaction. The partners in the second partnership used the insurance proceeds from the destruction of the apartment building to purchase replacement property within the scope of.
Sec. 1033, I.R.C. The Service determined that the exchange qualified for the deferral of gain as an involuntary conversion but did not meet the requirements of Reg. §1.1031(k)-1(g)(6)(i). The transaction did not qualify for the safe harbor because one of the partners received proceeds from the disposition of the relinquished property prior to the expiration of the exchange period.

c. The rights of the taxpayer under state law to terminate or dismiss the qualified escrow holder or trustee of a qualified trust are disregarded in considering whether the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow or otherwise obtain the benefits of the cash or cash equivalent held in the qualified escrow account or qualified trust. Reg. §1.1031(k)-1(g)(3)(iv).

d. Escrow Agreement -- Detailed escrow provisions may be placed in the Sales Agreement or the parties may elect to enter into a separate Escrow Agreement.

5. Safe Harbor No. 3 (Interest and Growth Factors) --

a. If the (g)(6) limitations likewise apply to any interest or growth factor, then such interest or growth factor will not cause the taxpayer to be in actual or constructive receipt. Reg. §1.1031(k)-1(g)(5).

b. 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 on the length of time elapsed between the transfer of the relinquished property and the receipt of the replacement property. Reg. §1.1031(k)-1(h)(1).

c. The interest or growth factor will be treated as interest, regardless of whether paid to the taxpayer in cash or in property (including like kind property), and must be included in income according to the taxpayer's method of accounting. Reg. §1.1031(k)-1(h)(2).

6. Safe Harbor No. 4 (Qualified Intermediaries) --

a. If the taxpayer's transferee is a "qualified intermediary" and if the (g)(6) limitations apply, then it does not matter whether or not the taxpayer's transferee is the taxpayer's agent. Regs. §§1.1031(k)-1(g)(4)(i) and (ii).

b. A "qualified intermediary" is a person who --

(1) Is not the taxpayer or a disqualified person; and

(2) Acts to facilitate the deferred exchange by entering into a written agreement with the taxpayer for the exchange of properties pursuant to which such person

(a) acquires the relinquished property from the taxpayer,
transfers the relinquished property (either on its own behalf or as the agent of any party to the transaction),

(c) acquires the replacement property (either on its own behalf or as the agent of any party to the transaction), and

(d) transfers the replacement property (either on its own behalf or as the agent of any party to the transaction) to the taxpayer. Reg. §1.1031(k)-1(g)(4)(ii).

(3) The qualified intermediary does not have to take legal title to either the relinquished property or the replacement property so long as the rights of a party to the agreement are assigned to the intermediary and all the parties are notified in writing of the assignment on or before the date of the relevant transfer of property. Reg. §1.1013(k)-1(g)(4)(v).

See Priv. Ltr. Rul. 200242009 (October 18, 2002) (each transfer by the taxpayer of a relinquished vehicle in the taxpayer's leasing business followed by the receipt of an identified replacement vehicle in accordance with the Exchange Agreement constituted separate like-kind exchanges that qualified for nonrecognition treatment); and Tech. Adv. Mem. 200130001 (July 27, 2001) (a series of transactions did not meet the requirements of the qualified intermediary safe harbor and therefore did not qualify as like-kind exchanges under Sec. 1031, I.R.C.). See also Rev. Rul. 90-34, 1990-1 C.B. 154. It is certainly in the best interests of an intermediary to avoid taking legal title to the property because of the possibility of environmental liability in the event the property is contaminated. Additionally, the Service has ruled that an intermediary's disbursement of funds from an account for the purchase of nonreplacement property constitutes acceptable "routine financial trust services" which will not disqualify the intermediary from being a qualified intermediary. Priv. Ltr. Rul. 9812013 (December 12, 1997).

c. Generally, at some time prior to the settlement of the transferor's property (the "Settlement Date"), the transferor and the qualified intermediary enter into an Exchange Agreement. As with the escrow provisions and the form Escrow Agreement, this document sets out in specific detail, and with specific instructions to the respective parties, the procedures for accomplishing the like kind exchange through a qualified intermediary. It is recommended that the transferor accomplish this step prior to entering into a Sales Agreement with the transferee. If accomplished in advance, the qualified intermediary can negotiate directly with the transferee and there is no need for the assignment of the Sales Agreement.

d. Also prior to or at settlement on the transferor's property, if the qualified intermediary has not dealt directly with the transferee, the transferor assigns the Sales Agreement to the qualified intermediary. At settlement, however, the qualified intermediary will instruct the transferor to convey its property directly to the transferee in order to avoid duplicate recordation and transfer taxes as well as potential chain of title liability to the qualified intermediary.

e. Finally, prior to 180 days after the Settlement Date, the qualified intermediary or the transferor enters into a purchase contract for the replacement property or properties. The preferred course of action is to have the qualified intermediary enter into the
contract. However, it is acceptable (although IRS agents examine such transactions more closely) to have the transferor contract and then assign the exchange contract to the qualified intermediary through an Assignment of Purchase Agreement. As a general rule in this regard, however, it is important that the seller of the replacement property either (1) permit (in the exchange agreement or by written consent) an assignment of the exchange agreement to the transferee, or (2) agree in writing to cooperate with the transferor in order to effectuate a like kind exchange.

f. In addition, the qualified intermediary should not enter into a purchase contract unless specified damages are the seller’s sole remedy, and the transferor has held the qualified intermediary harmless from the same.

g. The qualified intermediary may construct, or cause to be constructed, the improvements on the replacement property prior to the transfer to the taxpayer. Priv. Ltr. Rul. 9428007 (April 13, 1994).

h. Where a qualified intermediary is used with respect to a portion of the property exchanged, and the taxpayer constructively receives cash for the sale of the remainder of the property, gain is deferred as to the portion that qualifies. See Tech. Adv. Mem. 199907029 (February 19, 1999) (where partnership exchanged property and departing partner received share of proceeds directly from intermediary, gain recognized to extent of constructive receipt by partnership).

i. Note, however, that the use of a qualified intermediary is merely a safe harbor. An exchange that utilizes a non-qualified intermediary may also qualify for Sec. 1031, I.R.C. treatment. See F.S.A. 1999-485 (settlement “may be appropriate” for like kind exchanges utilizing a non-qualified intermediary).

C. The Disqualified Person

1. A person is a disqualified person (under Reg. §1.1031(k)-1(k)(1)) if --

   a. Such person and the taxpayer bear a relationship described in Sec. 267(b), I.R.C. or 707(b), I.R.C., but substituting 10% for 50% each place it appears; or

   b. Such person is the taxpayer’s agent at the time of the transaction, including persons performing services as the taxpayer’s employee, attorney, accountant, investment banker or broker; or

   c. Such person and the taxpayer’s agent bear a relationship described in Sec. 267(b), I.R.C. or 707(b), I.R.C., but substituting 10% for 50% each place it appears.

2. A person who has acted as the taxpayer's employee, attorney, accountant, or real estate agent or broker, within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the
transaction. However, Reg. §1.1031(k)-1(k)(4) provides that a bank or bank affiliate that is a member of a banking controlled group is not a disqualifying person if --

a. The bank or bank affiliate is a member of a controlled group that includes a member which provides investment banking or brokerage services; and

b. The investment banking or brokerage services member has provided services to the taxpayer in a Sec. 1031, I.R.C., transaction within the two years before the relinquished property is transferred

3. In determining whether a person is the taxpayer's agent, solely for purposes of the disqualifying person concept, the following are not taken into account:

a. The performance of services for the taxpayer with respect to exchanges of property intended to qualify under Sec. 1031, I.R.C.; and

b. The performance by a financial institution, title insurance company or escrow company of routine financial, title insurance, escrow or trust services for the taxpayer. Reg. §1.1031(k)-1(k)(2).

D. Identification and Receipt Requirements

1. Generally, replacement property will not be treated as property which is of a like kind to the relinquished property if --

a. The replacement property is not "identified" before the end of the "identification period", or

b. The identified replacement property is not received before the end of the "exchange period". Reg. §1.1031(k)-1(b)(1). [Note that, in Priv. Ltr. Rul. 200211016 (March 15, 2002), the Service held that Sec. 6503(b) does not authorize the Service to suspend the 180-day replacement period, even under circumstances where a state agency took possession and control of the qualified intermediary, appointed a receiver and froze all of its assets, including the taxpayer's proceeds from the sale of the replacement property.]

2. Definitions --

a. The "identification period" begins on the date the taxpayer transfers the relinquished property and ends at midnight 45 days thereafter. Reg. §1.1031(k)-1(b)(2)(i).

b. The "exchange period" begins on the date the taxpayer transfers the relinquished property and ends at midnight on the earlier of 180 days thereafter or the due date (including extensions) for the taxpayer's income tax return for the taxable year in which the transfer of the relinquished property occurs. Reg. §1.1031(k)-1(b)(2)(ii).
In Priv. Ltr. Rul. 200211016 (March 15, 2002), the taxpayer executed a real estate exchange agreement with an intermediary in a Sec. 1031, I.R.C. transaction. The taxpayer directed the closing agent to pay over the sale proceeds to the intermediary. A state agency took possession and control of the intermediary and appointed a receiver. All of the assets of the intermediary were frozen including the taxpayer’s sale proceeds. The taxpayer submitted a designation form to the receiver to designate replacement property and entered into a contract to purchase the property. The taxpayer was prevented from purchasing the replacement property within the required 180-day exchange period because the sale proceeds continued to be frozen as part of the receivership against the intermediary. The Service concluded that Sec. 6503(b), I.R.C. does not authorize the IRS to suspend the 180-day exchange period. Section 6503(b), I.R.C. generally provides that the period of limitation on collection is suspended for the duration that the assets of the taxpayer are in the control or custody of a state or federal court.

c. If, as part of the same deferred exchange, the taxpayer transfers more than one relinquished property, and these properties are transferred on different dates, both the identification period and the exchange period are determined by reference to the earliest date on which any of such properties are transferred. Reg. §1.1031(k)-1(b)(2)(iii).

3. Identification of the Replacement Property --

a. Generally, any property in fact 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. Reg. §1.1031(k)-1(c)(1).

b. Identification occurs only in one of two ways, as follows:

(1) Identification in a written agreement signed by all parties thereto before the end of the identification period. Reg. §1.1031(k)-1(c)(2).

(2) Identification in a written document signed by the taxpayer and sent (by hand delivery, mail, telecopy or otherwise) before the end of the identification period to either the person obligated to transfer the replacement property to the taxpayer or to a person involved in the exchange other than the taxpayer or a disqualified person. Reg. §1.1031(k)-1(c)(2). Property which is being constructed must be identified with as much detail and specificity as practicable. Note that discussions regarding a given replacement property which took place prior to the expiration of the identification period, supplemented by backdated letters reflecting the identification of the replacement property, were held to be clearly insufficient to comply with the identification period rules of Reg. §1.1031(k)-1(b)(2)(i). Dobrich v. Comm’r, 74 TCM 985 (1997).

c. Replacement property is identified only if it is unambiguously described in the written document or agreement. Reg. §1.1031(k)-1(c)(3).

(1) Real property is so described if described by a legal description, street address or distinguishable name.
(2) Personal property is so described if described by a specific description of the particular type of property.

d. The taxpayer may identify more than one property as replacement property subject to applicable limitations set forth in the Regulations.

(1) Regardless of the number of relinquished properties transferred by the taxpayer as part of the same deferred exchange, the maximum number of replacement properties that may be identified is --

(a) Three properties without regard to their fair market values (the "3-property rule"); or

(b) Any number of properties so long as their aggregate fair market value at the end of the identification period does not exceed 200% of the aggregate fair market value of all the relinquished properties at the date transferred by the taxpayer (the "200% rule"). Reg. §1.1031(k)-1(c)(4)(i).

(2) The "fair market value" of property means the fair market value of the property without regard to any liabilities secured by the property. Reg. §1.1031(k)-1(m).

(3) Note: If the taxpayer has identified more properties at the end of the identification period than permitted by the 3-property rule or the 200% rule, then the taxpayer is treated as if no replacement property had been identified by such time. Reg. §1.1031(k)-1(4)(ii). This does not occur, however, as to --

(a) Any replacement property received by the taxpayer before the end of the identification period (Reg. §1.1031(k)-1(c)(4)(ii)(A)); and

(b) Any 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 identified replacement property constituting at least 95% of the aggregate fair market value of all identified replacement properties before the end of the exchange period. Reg. §1.1031(k)-1(c)(4)(ii)(B).

e. Property that is "incidental to a larger item" (such as a tool kit in a truck, or refrigerators, dishwashers and laundry machines in an apartment building) is not treated as separate from that larger item (for identification purposes only) if --

(1) In standard commercial transactions, the property is typically transferred together with the larger item; and
(2) The aggregate fair market value of all such incidental property does not exceed 15% of the aggregate fair market value of the larger item. Reg. §1.1031(k)-1(c)(5).

f. Revocation of an identification of replacement property may occur at any time prior to the end of the identification period. Reg. §1.1031(k)-1(c)(6).

(1) An identification of replacement property made in a written agreement is treated as revoked only to the extent such revocation is made in a written amendment to that agreement or in a written document conforming to the identification requirements.

(2) Otherwise, revocation is made by written document conforming to the identification requirements.

4. Receipt of Identified Replacement Property--

a. Generally, the identified replacement property is considered received before the end of the exchange period if --

(1) The taxpayer in fact receives it before the end of the exchange period; and

(2) The replacement property received is substantially the same property as identified. Reg. §1.1031(k)-1(d)(1). See Priv. Ltr. Rul. 200211016 (March 15, 2002).

b. The "substantially the same property" criterion should be satisfied if at least 75% of the fair market value of the identified replacement property is received. See Reg. §1.1031(k)-1(d)(2), Ex.4(ii).

5. Identification and Receipt of Replacement Property to be Produced --

a. Generally, a deferred exchange will not fail merely because the replacement property is not in existence or is being produced (which, under Sec. 263A(g)(1), I.R.C., includes constructed, built, installed, manufactured, developed or impaired) at the time the property is identified as replacement property. Reg. §1.1031(k)-1(e)(1). See Priv. Ltr. Rul. 9428007 (April 13, 1994) and Priv. Ltr. Rul. 9413006 (December 20, 1993).

b. For purposes of identification, it should be noted that:

(1) Where improvements are to be constructed on real property, a legal description is sufficient if it states the time period for construction and provides as much detail as practicable regarding the underlying land. Reg. §1.1031(k)-1(e)(2)(i).
(2) The fair market value of replacement property to be produced is the estimated fair market value as of the date such property is expected to be received. Reg. §1.1031(k)-1(e)(2)(ii).

c. In determining whether the replacement property received by the taxpayer is substantially the same as the replacement property identified, the following rules apply:

(1) Variations due to usual or typical production changes are not taken into account. Reg. §1.1031(k)-1(e)(3)(i).

(2) If substantial changes are made in the property to be produced, the replacement property will not be considered to be substantially the same as the property identified. Reg. §1.1031(k)-1(e)(3)(i).

(3) Personal property will not be considered substantially the same unless production is completed on or before the day received by the taxpayer. Reg. §1.1031(k)-1(e)(3)(ii).

(4) Real property will be considered substantially the same only if:

   (a) The replacement property received constitutes real property under local law; and

   (b) The replacement 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. Reg. §1.1031(k)-1(e)(3)(iii).

(5) The deferred exchange rules are not met where the relinquished property is transferred in exchange for services (including production services). Accordingly, any additional production occurring after the replacement property is received by the taxpayer will not be treated as the receipt of like kind property. Reg. §1.1031(k)-1(e)(4).

E. Coordination of Sections 1031(a)(3) and 453

1. The Regulations basically provide that, if the taxpayer has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period (as defined in Reg. §1.1031(k)-1(b)(2)(ii)), then

   a. Under Reg. §1.1031(k)-1(j)(2)(i), if the cash or cash equivalent securing a transferee's obligation to transfer replacement property to the taxpayer is held in a qualified escrow account or a qualified trust (under Reg. §1.1031(k)-1(g)(3)), the taxpayer is not considered to have received a payment under Sec. 453, I.R.C. and Reg. §15A.453-1(b)(3)(i) until the earlier of (i) the time that the taxpayer has the immediate ability or unrestricted right to receive or otherwise obtain the benefits thereof, or (ii) the end of the exchange period, and
b. Under Reg. §1.1031(k)-1(j)(2)(ii), if such cash or cash equivalent is held by a qualified intermediary (under Reg. §1.1031(k)-1(g)(4)), the qualified intermediary is not considered the agent of the taxpayer in determining whether the taxpayer has received a payment for purposes of Sec. 453, I.R.C. and Reg. §15A.453-1(b)(3)(i) until the earlier of (i) the time that the taxpayer has the immediate ability or unrestricted right to receive or otherwise obtain the benefits thereof, or (ii) the end of the exchange period.

2. The Regulations apply to a transaction that ultimately fails to qualify as a like kind exchange because sufficient replacement property is either not identified or not transferred to the taxpayer before the end of the replacement period. See Reg. §1.1013(k)-1(j)(2).

3. Furthermore, in order to protect the taxpayer from ultimately not being able to use the installment method if the like kind exchange does not materialize, the evidence of indebtedness of a transferee from the qualified intermediary is treated as if it were the debt of the person acquiring the property from the taxpayer for purposes of Sec. 453, I.R.C. and Reg. §15A.453-1(b)(3)(i). Reg. §1.1031(k)-1(j)(2)(ii).

4. See Smalley v. Comm’r, 116 T.C. 450 (2001). The Court’s analysis in this case focused on the coordination of Secs. 453 and 1031, I.R.C. The taxpayer owned substantial acreage of standing timber in Georgia. The taxpayer transferred the right to cut timber for a term of two years on 95 acres of standing timber in exchange for consideration in the amount of $517,076. The taxpayer entered into a timber contract, a memorandum of contract, a tax-free exchange agreement and an escrow agreement to effect the exchange. The transfer of the standing timber occurred in 1994, when the amount of the purchase price was deposited with an escrow agent. In 1995, the taxpayer acquired a fee simple interest in three parcels of real property with the proceeds of sale held in the escrow account. The tax-free exchange agreement provided that the taxpayer would designate such replacement property to be acquired and transferred to the taxpayer. The purchaser’s obligation to acquire the taxpayer’s replacement property was secured by the amount of cash held in the escrow account.

The Court addressed the issue of whether the taxpayer was required to recognize gain from the sale of the timber cutting rights in 1994. The Court considered whether the taxpayer had actively or constructively received property in 1994. The taxpayer argued successfully that the transaction qualified as a deferred like kind exchange eligible for nonrecognition treatment under Sec. 1031, I.R.C. The terms of the tax-free exchange agreement and escrow agreement satisfied the requirements of Reg. §1.1031(k)-1(g)(3). The taxpayer had the requisite intent to enter into a deferred like kind exchange transaction according to Reg. §1.1031(k)-1(j)(2). Consequently, the taxpayer did not actively or constructively receive the cash purchase price deposited with the escrow agent in 1994.

VII. REVERSE EXCHANGES

A. Basics -- There may be situations in which a transferor needs to receive the replacement property before transferring the property to be relinquished. For example, the
taxpayer may fear that his desired replacement property will be sold to another buyer. There is nothing in the Code which prohibits this type of transaction. However, there is nothing in the Code or Regulations which expressly provides for this type of transaction. The Preamble to the Deferred Like Kind Exchange Regulations states that Sec. 1031(a)(3), I.R.C. does not apply to reverse-Starker exchanges, but that the Service will continue to study the applicability of Sec. 1031(a)(1), I.R.C. to these transactions. See Preamble, T.D. 8346, 1991-1 C.B. 150, 151. See also Rev. Proc. 2000-37, 2000-2 C.B. 308, discussed below.

B. Types of Reverse Exchanges -- There are several variations of the reverse like kind exchange transaction that taxpayers have undertaken in order to avoid concurrent ownership of the replacement property and the property to be relinquished.

1. Pure or True Reverse Deferred Exchange -- In what is referred to as a pure or true reverse exchange, the taxpayer who is the exchangor acquires the replacement property first and subsequently sells the property to be relinquished. No accommodation party participates in the transaction.

2. Park Relinquished Property (Exchange First) -- The accommodation party acquires the replacement property first. The accommodator then simultaneously exchanges the replacement property for the relinquished property with the taxpayer who is the exchangor. The accommodation party holds the relinquished property until the property is sold.

3. Park Replacement Property (Exchange Last) -- The accommodation party acquires the replacement property and holds the replacement property until the exchangor is ready to sell and transfer the property to be relinquished. Subsequently, the exchangor transfers the relinquished property to the accommodation party who transfers the replacement property to the exchangor in a simultaneous or deferred exchange. The taxpayer may provide a loan to the intermediary to fund the down payment, with the remainder financed through the use of a recourse or nonrecourse mortgage. When the taxpayer receives the replacement property, he or she may typically either assume a recourse mortgage or take the property subject to a nonrecourse mortgage.

4. Lease and Option to Purchase -- The taxpayer leases the replacement property with an option to buy and enters into a simultaneous exchange when the purchase option is exercised. However, the lease-option transaction could be recharacterized as a current sale, so additional care is advisable.

C. Level of Risk --

1. The reverse like kind exchange is problematic because it was not officially sanctioned by the IRS until recently in Rev. Proc. 2000-37, 2000-2 C.B. 308. See Reg. §1.1031(k)-1(a) (defining a like kind exchange as one "in which, pursuant to an agreement, the taxpayer transfers property... and subsequently receives property."). But see Priv. Ltr. Rul. 9814019 (December 23, 1998), modified by Priv. Ltr. Rul. 9823045 (March 10, 1998) (utility will acquire power line easement and subsequently transfer existing easement at an indefinite later time).
2. The taxpayer-intermediary relationship may be characterized as a principal-agent relationship with the taxpayer being in constructive receipt of the sale proceeds. Technically, Reg. §1.1031(k)-1 is not intended to apply to reverse exchanges. Consequently, reverse exchanges may be characterized according to basic agency principles and the constructive receipt rules would have similar application. However, it is now more likely that reverse exchanges will qualify for nonrecognition treatment under Sec. 1031, I.R.C. as a result of the new safe harbor provisions of Rev. Proc. 2000-37.

3. In Priv. Ltr. Rul. 200329021 (July 18, 2003), the Service concluded that the taxpayer’s proposed exchange of property held for productive use through a qualified intermediary and an exchange accommodation titleholder conformed with the requirements of the qualified intermediary and qualified exchange accommodation arrangement (QEAA) safe harbor rules provided by Rev. Proc. 2000-37.

Here, Taxpayer, a wholly owned subsidiary of Parent, proposed to create a QEAA by entering into an agreement with Company, which would serve as both a qualified intermediary and an exchange accommodation titleholder in this transaction. Pursuant to the QEAA Agreement, LLC, a single-member LLC wholly owned by Company and disregarded for Federal income tax purposes, accepted an assignment from Parent of a leasehold interest in Site Y (Leasehold Interest) on Date 1. Under the laws of the state where Site Y is located, the Leasehold Interest is considered a real property interest. On the same date of the assignment, Taxpayer also entered an Exchange Agreement with Company even though it did not own the Leasehold Interest. LLC will construct and own a building (Improvements) on Site Y pursuant to Parent’s design. LLC is expected to complete the construction project by Date 2 (a date within 180 days after the earlier of the transfer of Leasehold Interest to LLC or the date LLC acquires title to the Leasehold Interest).

Under the Exchange Agreement, Taxpayer will identify within the 45-day period set forth in Sec. 1031(a)(3), I.R.C., in a written instrument delivered to the Qualified Intermediary (Company), the legal description of the Leasehold Interest and a general description of the Improvements to be constructed on the Leasehold Interests. The Qualified Intermediary will not take title to either the Relinquished Property or the Replacement Property.

Under the QEAA Agreement, Taxpayer will identify, within the 45-day period beginning on Date 1, the Relinquished Property disposed of under the Exchange Agreement as the real property being exchanged for the Replacement Property held under the QEAA Agreement.

Within 180 days after the earlier to occur of (i) the conveyance of the Relinquished Property and (ii) LLC’s acquisition of the Replacement Property in the form of the Leasehold Interest and Improvements, Taxpayer will, under the Exchange Agreement and the QEAA Agreement, acquire the Leasehold Interest and the Improvements to complete the exchange.

In holding that this proposed transaction qualifies for like-kind treatment, the Service observed that, if the planned improvements are not completed within the exchange period,
Taxpayer will recognize gain to the extent of any boot received in the exchange. Also, to the extent that the estimated cost of the Improvements is less than the qualified funds held by Qualified Intermediary, if Taxpayer does not timely identify and acquire additional like-kind replacement property, Taxpayer will receive the remaining funds as boot.

D. Authority Prior to Revenue Procedure 2000-37 --

1. In Rutherford v. Comm'r, 37 TCM 1851-77 (1978), Wardlaw, the transferee, transferred 12 half-blood cows to the taxpayer, Rutherford, in exchange for 12 three quarter-blood cows to be transferred at some later time. The 12 three quarter-blood cows were to be the product of the 12 half-blood cows. The agreement provided for no future cash obligation in the event the half-blood cows could not reproduce. The Tax Court upheld the transaction as a valid Sec. 1031(a), I.R.C. exchange as to Rutherford.

2. In Bezdjian v. Comm'r, 845 F.2d 217 (CA9 1988), the taxpayers, the Bezdjians, were offered ownership of a gas station they operated under a lease. The seller refused to trade the gas station for other rental property owned by the Bezdjians. Therefore, the Bezdjians purchased the gas station and, approximately three weeks thereafter, sold the rental property to a third party. The Ninth Circuit affirmed the Tax Court holding that there was no Sec. 1031, I.R.C. exchange as to the Bezdjians. The Bezdjian case is distinguishable from the Rutherford case. First, the Bezdjians did not have any agreement to exchange properties with anyone. Second, they received the replacement property from a person different than the one to whom they transferred the relinquished property.

3. In Dibsy v. Comm'r, 70 TCM 918 (1995), the taxpayers’ argued unsuccessfully that they had entered into a reverse like kind exchange. The taxpayers owned one liquor store that they sold following the purchase of a second liquor store. The taxpayers attempted to link the purchase and sale of the two liquor stores as part of an integrated like kind exchange transaction. The Court noted that the purchase and sale were not structured as a like kind exchange because (i) the escrow documents from the sale did not refer to a like kind exchange; (ii) there was no evidence to show that a like kind exchange was intended; and (iii) the purchasers of the sold liquor store were not aware that a like kind exchange was intended.

4. See T.A.M. 200039005 (May 31, 2000), where the taxpayer intended to engage in a deferred like kind exchange transaction. The taxpayer entered into a contract for the sale of relinquished property and assigned the contract to an accommodator. It was the responsibility of the accommodator to close the deal for the sale of the relinquished property and to use the proceeds from the sale of the relinquished property to acquire replacement property for the taxpayer. The attempted sale of the relinquished property fell through at closing. The seller of the replacement property demanded to close immediately on the sale of the replacement property. The taxpayer closed on the purchase of the replacement property before selling the relinquished property. The accommodator held title to the replacement property even though the taxpayer had negotiated and financed the purchase. While the accommodator held title to the replacement property, the taxpayer entered into another contract for the sale of the relinquished property and then assigned the contract to the accommodator. The accommodator transferred the replacement property to the taxpayer after the closing of the sale of the relinquished property.
The Service concluded that the taxpayer had entered into a reverse Starker transaction rather than a forward deferred like kind exchange because the taxpayer first acquired the replacement property through the use of an agent and then subsequently sold the relinquished property. The taxpayer was not eligible for nonrecognition treatment under Sec. 1031, I.R.C. because the transaction lacked the interdependence which ordinarily characterizes an exchange.

E. Safe Harbor for Parking Arrangements --

1. Rev. Proc. 2000-37, 2000-2 C.B. 308, sets forth a safe harbor for taxpayers to qualify certain reverse like kind exchanges under Sec. 1031, I.R.C. Generally, in a reverse like kind exchange, sometimes referred to as a "reverse Starker" transaction, the replacement property is acquired before the property to be relinquished is transferred.

2. If a transaction meets the stated requirements of the safe harbor, a taxpayer may treat an accommodation party as the owner of the property for purposes of Sec. 1031, I.R.C. Similarly, property will qualify as either the replacement property or the relinquished property if the requirements are met.

3. Parking Transactions -- The Service recognized in Rev. Proc. 2000-37 that taxpayers have engaged in certain "parking transactions" to facilitate reverse like kind exchanges. In such parking transactions, the taxpayer temporarily stores the replacement property or the relinquished property with an intermediary in order to complete the like kind exchange in either a simultaneous or deferred transaction. The parking transactions described in Rev. Proc. 2000-37 are consistent with the types of reverse exchanges referenced above. However, it is possible that other variations of parking transactions may fall within the scope of the safe harbor.

   a. Parking Transaction No. 1 -- Rev. Proc. 2000-37 references one typical parking transaction in which the replacement property is "parked" with an accommodation party until such time as the taxpayer arranges to transfer the relinquished property to the ultimate transferee in a simultaneous or deferred exchange.

   b. Parking Transaction No. 2 -- In another representative transaction referenced in Rev. Proc. 2000-37, an accommodation party acquires the desired replacement property on behalf of the taxpayer, and then exchanges such property with the taxpayer for the relinquished property in a simultaneous exchange. The accommodation party then holds the relinquished property until the relinquished property can be transferred to a third party.

4. QEAA Requirements -- If property is held in a qualified exchange accommodation arrangement, the Service will not challenge the qualification of property as either replacement or relinquished property, or the treatment of an exchange accommodation titleholder as the beneficial owner. Property is treated as held in a QEAA if the taxpayer meets the following six requirements:

   a. Incidents of Beneficial Ownership -- An exchange accommodation titleholder must hold the incidents of beneficial ownership of the property intended as either the
replacement or the relinquished property. The exchange accommodation titleholder cannot be the taxpayer and must be subject to Federal income tax at all times from the date of acquisition until the property is transferred.

b. **Bona Fide Intent** -- The taxpayer must have a bona fide intent that the property held by the exchange accommodation titleholder is either the replacement or the relinquished property as part of a like kind exchange intended to qualify for nonrecognition treatment under Sec. 1031, I.R.C.

c. **OEAA** -- The taxpayer and the exchange accommodation titleholder must enter into a qualified exchange accommodation agreement no later than five business days after the transfer of beneficial ownership of the property to the exchange accommodation titleholder.

d. **Identification within 45 Days** -- The taxpayer must identify the relinquished property within 45 days after the transfer of beneficial ownership of the replacement property to the exchange accommodation titleholder.

e. **Transfer of Property from EAT within 180 Days** -- The property must be transferred to the taxpayer as the replacement property or to a third party as the relinquished property within 180 days after the transfer of beneficial ownership to the exchange accommodation titleholder.

f. **180 Day Limit for Property Held in OEAA** -- The combined time period during which the replacement property and the relinquished property are held in a QEAA cannot exceed 180 days.

5. Additionally, property may still be treated as held in a QEAA even though subject to certain contractual arrangements including leases, guarantees or indemnification.

F. **Recent Build-to-Suit Decision** --

1. **DeCleene v. Commissioner**, 115 T.C. 457 (2000) -- The taxpayer purchased improved real property (McDonald Street) in 1976 for use in the operation of a trucking business. The taxpayer purchased unimproved real property (Lawrence Drive) on September 30, 1992 and financed the acquisition with a nonrecourse mortgage from a bank. On September 24, 1993, the taxpayer entered into an Exchange Agreement with Western Lime and Cement Co. (WLC). The agreement provided that the taxpayer would transfer the Lawrence Drive property to WLC by quitclaim deed in exchange for WLC's note in the amount of $142,400. The agreement required WLC to construct a building on the unimproved Lawrence Drive property according to the taxpayer's specifications. WLC financed the construction of the building with a loan in the amount of $380,000 guaranteed by the taxpayer.

On December 29, 1993, the taxpayer assumed WLC's construction financing loan as the borrower. Following the construction of the building on the Lawrence Drive property, the taxpayer conveyed the McDonald Street property to WLC. In exchange for the McDonald Street
property, WLC paid off its note on the Lawrence Drive property and reconveyed the Lawrence Drive property to the taxpayer by quitclaim deed. On his Federal income tax return for 1993, the taxpayer treated the transaction as (1) a sale of the unimproved Lawrence Drive property, and (2) a like kind exchange of the McDonald Street property for the improved Lawrence Drive property.

The Court determined that the transaction at issue was a reverse like kind exchange (parking transaction) between the taxpayer and WLC without the participation of a third-party exchange accommodator. Consequently, the transfer of the McDonald Street property resulted in a taxable sale because the burden and benefits of ownership remained with the taxpayer. The transfer of the Lawrence Drive property to WLC by quitclaim deed only conferred bare legal title, did not give rise to any equity interest, and did not place WLC "at risk" with respect to the property. The reconveyance of the Lawrence Drive property effectively restored bare legal title with the taxpayer's beneficial ownership that was retained while WLC constructed the new building.

The Court held that the parking transaction in *DeCleene* did not qualify for nonrecognition treatment under Sec. 1031, I.R.C. and the transfer of the McDonald Street property constituted a sale because:

a. The taxpayer did not locate and identify the Lawrence Drive property in order to acquire it as replacement property;

b. The taxpayer purchased the Lawrence Drive property, without the participation of an exchange intermediary, one year or more before relinquishing the McDonald Street property;

c. The taxpayer transferred title to the anticipated replacement property to the acquiror of the relinquished property rather than to a third party exchange facilitator; and

d. The holding of title to the Lawrence Drive property by WLC did not bear any economic significance.


In this situation, the taxpayer, an S corporation, sought to relocate its business, through a like-kind exchange, to a parcel of unimproved land currently leased by another related S corporation. To this end, the taxpayer proposed to enter into the QEAA with EAT, and to enter an exchange agreement with a qualified intermediary (QI). As part of the overall transaction, the second S corporation would sublease the real property for fair market rental to a limited liability company (LLC) wholly owned by EAT. The taxpayer then would lend funds to LLC to construct improvements necessary for the relocation of the taxpayer's business. In addition, the taxpayer would assign its rights and interests in the real property where its business was currently located to QI, which would use the proceeds from the sale of the taxpayer's property to
pay EAT for all of its interests in LLC. The EAT will use these proceeds from QI to pay LLC, which is managing the construction of the premises for the taxpayer’s new business location, and to repay the loan from the taxpayer. Finally, QI will direct EAT to transfer its interest in LLC, which holds title to the real property where the taxpayer’s new business will be located, directly to the taxpayer.

The Service ruled that the proposed transaction conformed with the requirements of the safe harbor rules for QIs and QEAAs. Because the QI and EAT employed in this transaction were not considered the taxpayer’s agents, the taxpayer was not in actual or constructive receipt of money or other property prior to receiving the replacement property. Accordingly, the taxpayer did not recognize any gain or loss on the exchange. However, if the planned improvements on the subleased property are not completed within the exchange period, then, as pointed out by the Service, the taxpayer will recognize gain to the extent of any boot received in the exchange.

G. Joint Committee on Taxation Recommendations for Simplification --

1. Election to roll over gain -- In April 2001, the Joint Committee on Taxation published recommendations for simplification of the like kind exchange provisions. In the first recommendation, the Joint Committee proposed that a taxpayer should be permitted to elect to roll over gain from the disposition of appreciated business or investment property described in Sec. 1031, I.R.C. The taxpayer would be entitled to make the election if the taxpayer acquired the like kind property within 180 days before or after the date of disposition (but not later than the due date of the taxpayer’s income tax return). The election would allow taxpayers to reinvest the proceeds from the sale of business or investment property directly into other like kind property. A taxpayer would recognize gain only to the extent that proceeds from the property sold are not reinvested in eligible replacement property. The proposed election would reduce the taxpayer’s burden of compliance with the current complicated statutory and regulatory requirements. The proposed election also would eliminate the need to use an intermediary and would reduce transaction costs. Joint Committee Print, Vol. II: Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System 300-305 (April 2001).

2. Holding period and use requirements -- The Joint Committee also proposed to simplify the holding requirement under Sec. 1031, I.R.C. The recommendation proposes that, in the case of certain transactions, the holding period and use of property transferred in a like kind exchange should be broadened to include both the taxpayer’s and the prior transferor’s holding period and use of property. Specifically, the transferor’s holding period and use of property would “tack” to the extent that (1) property is contributed to a corporation in a Sec. 351, I.R.C. transaction or to a partnership under Sec. 721, I.R.C.; (2) a corporation acquires property in connection with a reorganization under Sec. 368, I.R.C.; (3) a partnership distributes property to a partner; or (4) a corporation distributes property in a transaction subject to Sec. 332, I.R.C. The recommendation is also intended to prevent (1) relinquished property from being converted from personal use to investment or (trade or business) use before an exchange, or (2) replacement property from being converted from investment (or trade or business) use to personal use after an exchange. Joint Committee Print,
VIII. CHECKLIST FOR DEFERRED LIKE KIND EXCHANGE

Sample Checklist of Steps to Accomplish a Deferred Exchange

YES ___ NO ___ 1. Have you identified a replacement property? If yes, continue. If no, will you be able to identify such a property within the deferred exchange time limits?

YES ___ NO ___ 2. If Transferee does not own a suitable replacement property, will Transferee acquire one? If yes, use a qualified escrow or trustee. If no, continue with this checklist.

YES ___ NO ___ 3. Is the Transferee a related party? Related parties are generally entities which are owned by the same interests. If answer is yes or you are unsure, please review the rules of Section 1031(f).

YES ___ NO ___ 4. Does your property have a mortgage? If yes, a decision must be made as to its disposition:
   A. ___ paid off prior to exchange.
   B. ___ being assumed/taken subject to in transfer.

Note: If mortgage is being assumed/taken subject to, please review the rules of Reg. § 1.1031(b)-1(c).

YES ___ NO ___ 5. Was the property which is to be exchanged (1) acquired for the purposes of effectuating a like-kind exchange or (2) acquired as part of a portfolio purchase and is undesired? If yes, the property may not qualify to be used in a like-kind exchange.

YES ___ NO ___ 6. In the case of property which is being disposed of by a REIT, has the property been held for at least four years? If no, please review the rules of Section 857(b)(6)(C).

YES ___ NO ___ 7. Is the replacement property of like kind? Although the like-kind rules are permissive relative to the type of real estate exchanged, if personal property will be
exchanged incidental to the exchange of real property, such property will be boot unless it also is exchanged for like-kind property.

YES _____ NO _____

8. Is the replacement property going to be property which is to be produced or constructed? **If it is, please review the rules of Reg. § 1.1031(k)-1(e).**

9. How will your settlement costs be paid?

   A. _____ Payment with separate funds
   
   B. _____ Transferee will be paying all settlement costs
   
   C. _____ Payment with settlement proceeds

   **If choice is C., the transaction may not be tax-free to the extent of such costs.**

DONE _____

10. **Verify that the Qualified Intermediary is not your agent. If you are unsure, please review Reg. § 1.1031(k)-1(k)(2).**

DONE _____

11. **Verify that the Qualified Intermediary is not an attorney, accountant, investment banker, broker, real estate agent or employee who has (1) acted for you in the 2 years prior to your expected settlement date, and (2) performed services other than routine institutional services or services related to a like-kind exchange. If you are unsure, please review Reg. § 1.1031(k)-1(k)(2).**

DONE _____

12. **Verify that the Qualified Intermediary does not bear a direct family relationship or affiliation to you or your agents. If you are unsure, please review Reg. § 1.1031(k)-1(k)(2).**

DONE _____

13. **Verify that you will have no rights to receive, pledge, borrow or otherwise obtain the benefits of the cash or cash equivalents held in the escrow or trust. If you do or you are unsure, please note that such rights will disqualify the like-kind exchange.**

YES _____ NO _____

14. **Will you be using security or guarantee arrangements? If so, the following forms of security or guarantee arrangements are acceptable:**

- 52 -
A. A mortgage, deed of trust or other security interest (other than cash or its equivalent) in your property.

B. A letter of credit (1) issued by a bank or a financial institution which is (2) non-negotiable, (3) nontransferable, and (4) that may not be drawn upon in the absence of default.

C. A third-party guarantee.

If other forms of security are used, consult your tax advisor.

**DONE**

15. Verify that you do not have an immediate ability or unrestricted right to receive money or other property from this security or guarantee arrangement. Please note that such rights will disqualify the like-kind exchange.

**YES**  **NO**

16. While the proceeds are held with the Qualified Intermediary, will there be interest or some other growth factor?

**YES**  **NO**

17. Is this interest or growth factor calculated based on the time period that such proceeds are held by the Qualified Intermediary? If no, please consult your tax advisor.

**DONE**

18. Verify that you do not have an immediate ability or unrestricted right to receive this interest or growth factor. Please note that such rights will disqualify the like-kind exchange.

19. Choose one of the alternative courses of action. (Method 1 is preferred).

**DONE**

(1) You enter into an Exchange Agreement with a Qualified Intermediary, and this Intermediary and the Transferee enter into a sales agreement.

**DONE**

(2) You enter into a sales agreement for your property with the Transferee. You provide, at a minimum, in the Sales Agreement for the Transferee's cooperation in effectuating a like-kind exchange. You must then assign the contract to the Qualified Intermediary.
20. At the date of settlement on the disposition of your property, verify there are two settlement sheets one which transfers the property from you to the Qualified Intermediary and one which transfers the property from the Qualified Intermediary to the Transferee.

21. At the date of settlement on the disposition of your property, the settlement sheet for the transfer from the Transferee to the Intermediary should be modified to provide:

A. Proceeds from Transferee are to be paid to the Intermediary. Set forth in a footnote of Settlement Sheet the following: “Transferor and Transferee hereby acknowledge that Transferor has not received any of the Escrow Proceeds in connection with the transactions described herein, and that such Escrow Proceeds are to be used by Transferee to acquire and convey (or cause to be acquired and conveyed) to Transferor property which is intended to qualify as ‘like-kind’ pursuant to the Internal Revenue Code of 1986 and the Treasury Regulations thereunder.”

B. Proceeds are designated as “Escrow Proceeds” of Qualified Intermediary as opposed to “Due to Seller.”

22. At the date of settlement on your property, the Qualified Intermediary may deliver to you a designation letter instructing you to convey title to Transferee.

23. Within 45 days of the settlement on your property, you must properly identify replacement property as follows:

A. Unambiguously describe the property through a (1) legal description, (2) street address, or (3) distinguishable name.

B. Identify the property in a written document signed by the appropriate person at your company.

C. Send the letter either to (1) the person obligated to transfer the replacement property or (2) any other person involved in the transaction who is not a disqualified person.
D. If several alternative properties were identified, the following requirements must be met:

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<th>YES</th>
<th>NO</th>
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(1) Are three or less properties identified? **If more than three properties will be identified, then you must satisfy one of the following requirements:**

<table>
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<tr>
<th>YES</th>
<th>NO</th>
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(a) If more than three properties were identified, did you revoke any designations so that the number of nonrevoked properties was three or less?

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<tr>
<th>YES</th>
<th>NO</th>
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(b) Were the designations properly revoked with a written, signed letter sent to the person to whom the identification statement was sent not later than 45 days since the settlement date on your property. If answers to (a) and (b) are no, go to question (c).

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(c) Identify properties whose values are less than or equal to 200% of the fair market values of the properties relinquished on the settlement date of your property. Consult your tax advisor.

24. Choose one of the alternative courses of action (**Method 1 is preferred**):

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(1) The Qualified Intermediary must enter into a direct contract with the seller of the replacement property within 180 days after the settlement date on your property.

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<th>DONE</th>
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(2) You enter into a purchase agreement for the replacement properties and assign the contract to the Intermediary. Verify that the Seller agreed to permit assignment either in the sales agreement, by consent, or at a minimum by agreeing in writing to cooperate in effectuating a like-kind exchange.

| DONE |

25. Settlement must occur on the replacement property within 180 days of the settlement date on your property.
26. At the date of settlement on the replacement property, verify there are two settlement sheets one which transfers the property from the seller to the Intermediary and one which transfers the property from the Intermediary to you.

27. Verify that both settlement sheets are modified to provide:

A. Purchaser is both you and the Intermediary (as an Accommodation Purchaser).

B. Intermediary (as Accommodation Purchaser) authorizes and instructs Seller to convey the replacement property to you pursuant to a Designation letter.

28. At the date of settlement on the replacement property, the Intermediary may deliver to the Seller an instruction and designation letter instructing Seller to convey title to you.

29. The proceeds held by the Intermediary must not be held by you or subject to your control or enjoyment.