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Like-Kind Exchange Outline

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I. LIKE-KIND EXCHANGES

A. Overview

Without Section 1031, 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. Section 1001(b).

B. Basics Of Like-Kind Exchanges

1. General Rules -- Under Section 1031(a)(1), 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.

a. Exclusions

i. Section 1031(a)(2) 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;

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2 All Section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.
(4) interests in a partnership;
(5) certificates of trust or beneficial interests; or
(6) choses in action.

ii. With regard to the exclusion of interests in a partnership from like-kind treatment, it is important to note that, even where the underlying assets of a partnership constitute real property, an exchange of a partnership interest for real property is not like kind under Section 1031 (See MHS Co., Inc. v. Comm'r, 35 TCM 733 (1976), aff'd 575 F.2d 1177 (CA6 1978).) The rationale for this conclusion lies in the fact that the partnership interest is personalty, not realty. However, where a partnership has in effect a valid election under Section 761(a), 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. Section 1031(a)(2).

iii. Rev. Proc. 2000-46, 2000-2 C.B. 438 (Oct. 11, 2000), provides that the IRS will not issue advance rulings or determination letters on whether undivided fractional interests ("UFIs") in real property qualify for like-kind treatment under Section 1031. The IRS adopted this policy in order to "study further the facts and circumstances" relevant to the determination of whether certain arrangements under which taxpayers acquire UFIs in real property constitute separate entities for Federal tax purposes. Assume, for example, that Taxpayers A and B each own a 50 percent UFI in Apartment Complex X. If A and B, either directly or through their agent, provide only customary tenant services (e.g., heat, air conditioning, hot and cold water, unattended parking, normal repairs, trash removal, and cleaning of public areas), then, under Rev. Rul. 75-374, 1975-2 C.B. 261 and Reg. §1.761-1(a), A and B should be treated as co-owners of X and not as partners. If, however, A and B furnish additional services to tenants (e.g., attendant parking, cabanas, gas and electricity), then A and B will likely be treated as partners. Under this latter scenario, the UFI of A or B would be an "interest in a partnership" and, thus, would not qualify as relinquished or replacement property in a like-kind exchange. See also Luna v. Comm'r, 42 T.C. 1067 (1964), where court, in determining whether taxpayers were joint venturers,
considered, in part, whether they (i) intended to join together for the conduct of an undertaking or enterprise, (ii) conducted business under a joint name, and (iii) had mutual control over and mutual responsibility for the enterprise.

iv. Owners of UFIs may avoid the partnership characterization if they enter into a net lease of their property to a third party ("Lessee"), who in turn re-leases the property to tenants. In this structure, the co-owners receive only rental income from the Lessee, which should not result in the creation of a partnership. The co-owners would usually not enter into any type of co-ownership or agency agreement involving the property; instead, their rights concerning the property would be set forth in the lease to the Lessee. This structure may be contrasted with the situation in which the "co-owners" enter into both a co-ownership agreement among themselves and hire a property manager to actively manage the property on their behalf. Even if the property generates only rental income, there is a significant risk that the relationship between the parties would be treated as a partnership.

v. Also with regard to the exclusion of partnership interests from like-kind treatment, the denial of 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.

vi. Dealer property is excluded from like-kind treatment even though the statute does not include the language of Section 1221, "to customers in the ordinary course of his trade or business". 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.

vii. Where dealer property is exchanged, the IRS 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.
b. **Definition of “Solely”** -- The word “solely” does not mean that a taxpayer who receives non-like-kind property in the exchange is entirely outside Section 1031. To the extent that a taxpayer receives non-like-kind property (“boot”), the transaction will be taxable. Section 1031(b).

c. **Held for Use in a Trade or Business**

i. Property held for productive use in a trade or business may properly be exchanged for investment property under Section 1031. Reg. §1.1031(a)-1(a)(1).

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

iii. **Transfers to a Corporation** -- The IRS 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 Section 351 transaction, does not qualify as an exchange under Section 1031(a). 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 Section 1031 exchange of like-kind property.

iv. **Transfers 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 Section 333
liquidation for like-kind property. The issue was whether the taxpayer actually "held" the property for investment prior to the exchange as required by Section 1031(a).

(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 Section 1031(a) 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 (Feb. 12, 1992), where the IRS 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.

v. 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 Section 721, 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 Section 1031(a), the taxpayer must intend, at the time the exchange is consummated, to hold the acquired property for investment.

vi. **Transfer from a Partnership** -- In Crenshaw v. Commissioner, 450 F.2d 472 (CA5 1970), the taxpayer liquidated her investment in a partnership, and received 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 she was not entitled to nonrecognition treatment because all of the steps were engaged in to avoid the taxable sale of her partnership interest to her former partners.

vii. **Gifts** -- The fact that a taxpayer intends eventually to make a gift of the property received in a like-kind exchange does not prevent Section 1031 from applying 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).
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; personal use will cause tax-free treatment to be lost. See Click v. Comm'r, 78 T.C. 225 (1982), where nonrecognition treatment was denied to the taxpayer because her children moved into the acquired residential properties on the date of the exchange and the taxpayer gifted the properties to them seven months later.

d. **Mandatory** -- The applicability of Section 1031 is not elective. Thus, if recognition of gain or loss is desired, the qualifications of a Section 1031 transaction should be avoided.

e. **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).

f. **Personal Property -- Treatment as Like Kind**

   i. One kind or class of personal property may not be exchanged on a tax-free basis for personal property of a different kind or class. Although this is the same standard as for real property, it is imposed far more stringently on personalty. 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).

   ii. 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.

g. **Real Property -- Treatment as Like Kind**

   i. **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 personality under Oregon state law, the exchange of land for the same did not qualify for like-kind treatment under Section 1031.

(b) Nevertheless, state law will not always govern, as where the state law considers the exchanged interest to be real property, but the tax law treats the exchanged interest as a right to future income. 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 Section 1031.

(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 Section 1031. 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 (Oct. 22, 1982).

ii. In Rev. Rul. 92-105, 1992-2 C.B. 204, the IRS held that a taxpayer's interest in an Illinois land trust (or other similar arrangement) constituted real property and could therefore be exchanged for like-kind property.

iii. The fact that one property may be completely developed while the other is raw land will not preclude like-kind treatment. Reg. §1.1031(a)-1(b).

iv. It may logically be 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 IRS has ruled, in connection with Section 1033(g), 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. 67-265, 1967-2 C.B. 270.

(1) The relationship of Sections 1031, 1033(a) and 1033(g) can be summarized as follows:

(a) Section 1031 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) Section 1033(a) 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 Section 1033(g), which applies solely to real property. This provision allows the nonrecognition provisions of Section 1033(a) 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 Sections 1031 and 1033(g) are, or at the least should be, virtually identical with respect to real property. Consequently, interpretations of Sections 1031 and 1033(g) 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 Section 1033(g), see Rev. Rul. 67-255, 1967-2 C.B. 270; Rev. Rul. 71-41, 1971-1 C.B. 223; and Priv. Ltr. Rul. 9118007 (Jan. 30, 1991). These all indicate the unwillingness of the IRS to allow a taxpayer to utilize Section 1033(g) where land is involuntarily converted, but the reacquisition does not include land.
v. 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).

vi. Under Section 1031(h), real property located in the United States and real property located outside the United States are not like kind. Under Section 7701(a)(9), 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. But see Priv. Ltr. Rul. 9038030 (June 25, 1990), holding that the Virgin Islands is included within the United States.

2. Exchanges

a. An exchange is a reciprocal transfer of property, as opposed to a sale of property for consideration and a purchase reinvestment. Substance will prevail over form.

b. 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 there was no exchange because the taxpayers received cash.

c. Another method by which the IRS treats what is called an “exchange” as a sale is to view a series of “separate” transactions as constituting 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).
d. By contrast, what is in form two sales may be treated as an exchange, especially where a loss disallowance is involved. In Allegheny County Auto Mart, Inc. v. Comm'r, 12 TCM 427 (1953), the taxpayer purchased real property that was too small for its 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.

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

i. If the taxpayer already owns the land on which the building is to be constructed by the transferee, the transaction is considered a sale, not an exchange. This is because the transferee has no like-kind property to exchange; the transferee is providing services (the construction of the 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).

ii. 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).

iii. See also Rev. Rul. 75-291, 1975-2 C.B. 333, 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 IRS held that as to X this was a good like-kind exchange, but that as to Y it was not. The problem that Y had was that it acquired the property transferred to X immediately prior to the exchange, and constructed the factory for purposes of the exchange, so that it could not be said to 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 in accord with plans and specifications approved by the taxpayer, solely for purposes of a trade with the taxpayer. Likewise Priv. Ltr. Rul 9149018 (Sept. 4, 1991).

3. **Designations of Replacement Property -- Generally**

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

b. For example, in *Alderson v. Comm*r.* 317 F.2d 790 (CA9 1963), an executed sales contract was amended into an exchange contract for Section 1031 purposes, and the Court held that this was acceptable. 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.

c. 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.

d. 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).

e. See Priv. Ltr. Rul. 8852031 (Sept. 29, 1988), where the IRS held that the fact that the exchanging party does not have title to the property exchanged does not prevent the taxpayer from having a good like-kind exchange. There, the exchanging party was acquiring properties for the exchange from third parties and wanted to avoid double transfer taxes, and so proposed to have the third parties convey directly to the taxpayer. The IRS relied on *W.D. Haden Co. v. Comm*r.*, 165 F.2d 588 (CA5 1948).
f. 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; then the taxpayer exchanged such property for other property acquired by Fireman’s for purposes of the exchange.

i. The Tax Court held that this 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”.

ii. 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.

C. Exchanges With “Boot”

1. Generally

   a. “Boot” is cash or other property not falling in the tax-free category.

   i. 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. Section 1031(b) 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.”

   ii. 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 Section 1031(b) in operation.

b. 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).

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

ii. **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.

iii. It must be remembered in dealing with transactions involving boot that, except in the situation where depreciation recapture may occur, gain recognized will not exceed the amount received as “boot.”

c. 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. Section 1031(c).

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

ii. **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).
As to depreciation recapture under Section 1250(d)(4), the general rule is that, if no boot is received, no ordinary income is recognized under Section 1250 unless the Section 1250 gain, which would have been recognized but for Section 1031, exceeds the fair market value of the Section 1250 property acquired. See Section 1250; 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 Section 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.

2. The Impact of Mortgages

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

i. First, if the transferor transfers property subject to a mortgage -- whether or not the transferee assumes the same -- the amount of the mortgage debt is treated as money received by the transferor for purposes of adjusting the basis under the provisions of Section 1031(d). See Reg. §1.1031(d)-2. The Regulations provide that the amount of the mortgage 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.

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

iii. 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).

b. Where mortgages appear on both sides of the transaction, such mortgages are netted. This feature may make a like-kind exchange an option in coping with distressed property foreclosures and workouts. Reg. §1.1031(d)-2.

i. 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 he transferred over the mortgage on the property he received. However, if he 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).

ii. 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).

iii. 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 his 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 Section 1031. The problem was that the phrase “in anticipation of” was, at best, ambiguous. Did it mean “as a step in the transaction”, or is 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 opposition from the real estate industry, this Proposed Regulation was dropped.

(2) A more conservative plan would be for the transferor to pay down his 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.

iv. 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).

3. **Installment Sales**

   a. The taxpayer may elect the installment method of reporting taxable gain on the exchange if the requirements of Section 453 are met. Subject to the overriding provisions of Section 453(i), Section 453 allows the taxpayer to allocate the gain or loss recognized over the life of the installment obligation so that the amount of the taxes imposed is paid per installment, according to the allocation formula set out in Section 453(b)(2). See Rev. Rul. 65-155, 1965-1 C.B. 356, and Priv. Ltr. Rul. 8453034 (Sept. 28, 1984).

   i. According to Section 453(f)(6), the gain is generally recognized ratably as the taxpayer is paid during the life of the installment note.

   ii. Specifically, the Regs. provide that, if the taxpayer’s basis exceeds the fair market value of the like-kind property received, that excess constitutes “excess basis”. Reg. §1.453-1 (f)(1)(iii).

   b. 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. Reg. §1.453-1(f)(1)(iii).

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

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

**D. Exchanges Between Related Persons -- Triggering Deferred Gain**

1. **Background**
   a. Congress was concerned with basis shifts among related taxpayers to enable otherwise taxable gain to be deferred. 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 Section 1031, 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).

   b. The IRS could have attacked this trade as falling outside Section 1031(a) in all events 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.

   c. However, in order to solve this problem, Section 1031(f) and Section 1031(g) were added to the Code.

2. **General Rules**
   a. If a taxpayer exchanges property with a related person, and (i) there is nonrecognition of gain or loss on the exchange under Section 1031, and before the date which is two years after the date of the last transfer which was part of the exchange either the taxpayer or the related person disposes of the property received in the exchange, then the original exchange is considered as not qualifying for nonrecognition treatment under Section 1031. Section 1031(f)(1).
i. The gain or loss recognized by the taxpayer by reason of Section 1031(f) is taken into account when the property which was received in the exchange is disposed of in a later transaction.

(1) Loss may be limited by the related party rules of Section 267.

(2) Planning possibilities, with considerations of taxable years, immediately come to mind. However, Section 1031(f)(4) notes that Section 1031 does “not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection”.

(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.

ii. In Tech. Adv. Mem. 200126007 (Mar. 22, 2001), the taxpayer purchased replacement properties from a related party in multi-party exchange transactions. The IRS denied nonrecognition treatment under Section 1031(f)(4) because, in part, the structure of the transactions was driven by the intent of the taxpayer and its related party to “cash out” of some of the taxpayer’s investment in appreciated property with a low basis without current tax consequences. Tax planning is not a basis for exception from anti-abuse provisions such as Section 1031(f).

iii. In Priv. Ltr. Rul. 9609016 (Nov. 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 IRS 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 IRS ruled that the exchange would qualify under Section 1031.
iv. 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. Section 1031(g).

b. Under Section 1031(f)(3), a "related person" is any person bearing a relationship to the taxpayer described in Section 267(b) or Section 707(b)(1).

3. Exceptions (Certain Dispositions Not Taken into Account)

a. A disposition will not trigger recognition if it occurs:

i. After the earlier of the death of the taxpayer or the death of the related person (Section 1031(f)(2)(A)); or

ii. In a compulsory or involuntary conversion (under Section 1033) if the exchange occurred before the threat or imminence of such conversion. Section 1031(f)(2)(B).

b. 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. Section 1031(f)(2)(C).

i. The Senate Finance Committee Report indicates that this exception is intended generally to apply to transactions that do not involve the shifting of basis between properties.

ii. Also intended to fall under this exception are:

(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.
E. Simultaneous Exchanges

1. **Description** -- The seller/transferor and the buyer/transferee exchange title to like-kind properties simultaneously, rather than either party receiving its replacement property at a later date.

2. **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 successfully accomplished 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.

3. **Use of an Intermediary** -- In the case of simultaneous transfers of like-kind properties involving a qualified intermediary, effective as to transfers on or after June 10, 1991, the qualified intermediary is not considered the agent of the taxpayer for purposes of Section 1031(a), Reg. §1.1031(b)-2(a).

4. **Like-Kind Transaction Agreement** -- The transferor and transferee enter into a standard purchase and sale agreement (“Sales Agreement”), except that it is desirable, but not necessary, that the Sales Agreement should include provisions whereby both parties covenant to cooperate in the transferor being able to effectuate a like-kind exchange. The following provision may be used as such:

   **Further Assurances.** Buyer hereby covenants and agrees to use its reasonable efforts and diligence to assist and cooperate with Seller in the effectuation of 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 in order to effectuate such Section 1031 transaction; provided, however, that Buyer shall not incur any additional costs, expenses, liabilities, obligations or other financial exposure with respect thereto.

It is important to note that Section 1031 provisions can be added, by amendment if necessary, at any time prior to the actual closing in order to provide for the like-kind exchange.
Deferred Like-Kind exchanges

1. Overview

a. Because of the timing difficulties in finding suitable replacement property, the deferred like-kind exchange has become very popular. It was first 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 like-kind treatment even though the property to be exchanged could be designated by the transferor for up to five years after the transaction and even though, under the deal, the transferor could receive cash instead of replacement property.

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

i. 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

ii. 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.

c. Section 1031(a)(3) was enacted due to concern by Congress that, without these statutory restrictions, the application of Section 1031 to deferred exchanges would give rise to unintended results and administrative problems.

d. 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 in order to take full advantage of the exchange period and close out the deferred exchange after April 15 of such subsequent year. See Christensen v. Comm’r, 71 TCM 3137 (1996), where
taxpayer argued unsuccessfully that, because the four-month filing date extension is automatic, the permissible period for the tax-free exchange should be extended by that period. The Court did not agree because the extension is not truly automatic, but must be specifically requested.

e. In order to constitute a deferred exchange, the transaction must be an exchange (that is, a transfer of property for property, as distinguished from a transfer of property for money). Reg. §1.1031(k)-1(a).

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

a. 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 are subject to attack as constituting the actual or constructive receipt of cash or a cash equivalent. Generally, if a taxpayer transfers relinquished property to another party and then -- either actually or constructively -- receives money or other property before the taxpayer receives like-kind replacement property, the transaction will constitute a sale, rather than a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property. Reg. §1.1031(k)-1(f)(1).

i. 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).

ii. 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).

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

b. There are four safe harbors which, if used correctly by the taxpayer, will not create the actual or constructive receipt of money or other property for purposes of Section 1031(a)(3).

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

   i. 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 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).

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

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

   i. 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).

   ii. 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)-(k)); and
(2) The taxpayer’s rights 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 so limited (the “(g)(6) limitations”) 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, as a contrast to this logical safe harbor, Greene v. Comm’r, 62 TCM 512 (1991). See also, as to taxpayer failures 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 (Aug. 29, 1994), where the escrow was non-interest bearing, but the taxpayer instead received fee waivers from the bank where the escrow was located. Because these benefits were not available until the end of the exchange period, this was held not to violate the safe harbor.

iii. 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).

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

e. Safe Harbor No. 3 (Interest and Growth Factors)

i. In a deferred exchange, the determination of whether a taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives the like-kind replacement property will be made without regard to the fact that the taxpayer is or may be entitled to receive any interest or growth factor with respect to the deferred exchange. However, this rule applies only if the agreement pursuant to which the taxpayer is or may be entitled to the interest or growth factor expressly limits the taxpayer’s rights to receive the interest or growth factor in accordance with the (g)(6) limitations. Reg. §1.1031(k)-1(g)(5).

ii. 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).

iii. 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).
f. **Safe Harbor No. 4 (Qualified Intermediaries)**

i. If the taxpayer's transferee is a "qualified intermediary" and the (g)(6) limitations are satisfied, then such qualified intermediary will not be treated as the taxpayer's agent for purposes of Section 1031. Regs. §§1.1031(k)-1(g)(4)(i) and (ii).

ii. 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,

   b. 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)(iii).

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. See Reg. §1.1013(k)-1(g)(4)(v). See also Rev. Rul. 9034, 1990-1 C.B. 154. It surely is 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.
iii. 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, 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.

iv. Also, 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 may 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.

v. Finally, prior to 180 days after the Settlement Date, the transferor or the qualified intermediary enters into a purchase contract for the replacement property or properties. As a general rule, it is important that the seller of the replacement property agree in writing to cooperate with the transferor in the effectuation of a like-kind exchange.

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

3. The Disqualified Person

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

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

ii. 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 within the two-year period ending on the date of the transfer of the first of the relinquished properties; or
iii. Such person and the taxpayer's agent bear a relationship described in Section 267(b) or 707(b), but substituting 10% for 50% each place it appears. (Although under Prop. Reg. §1.1031(k)-1(k)(4), this provision would not apply to a bank that is a member of a controlled group (as determined under Section 267(f)(1), substituting 10 percent for 50 percent), where a person described in (ii) above is an investment banker or broker that has provided investment banking or brokerage services to the taxpayer within the two-year period and also is a member of the controlled group.)

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

i. The performance of services for the taxpayer with respect to exchanges of property intended to qualify under Section 1031; and

ii. 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).

4. Identification and Receipt Requirements

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

i. The replacement property is not "identified" before the end of the "identification period"; or

ii. The identified replacement property is not received before the end of the "exchange period". Reg. §1.1031(k)-1(b)(1).

b. Definitions --

i. 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).
ii. 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).

iii. 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).

c. Identification of the Replacement Property --

i. 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).

ii. 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).

iii. 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.
iv. The taxpayer may identify more than one property as replacement property. However, 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 --

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

(2) 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).

(3) 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).

(4) 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(c)(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).
v. 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).

vi. 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. If identification was made in a written agreement, then revocation is done only by a written amendment to that agreement or in a written document conforming to the identification requirements.

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

d. Receipt of Identified Replacement Property --

i. 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).

ii. 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)
e. Identification and Receipt of Replacement Property to be Produced

i. Generally, a deferred exchange will not fail merely because the replacement property is not in existence or is being produced (which, under Section 263A(g)(1), 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 (Dec. 20, 1993).

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

   (1) Where improvements are to be constructed on real property, the description will suffice if a legal description is provided for the underlying land and as much detail as is practicable for the construction. Reg. §1.1031(k)-1(e)(2)(i).

   (2) The fair market value of to-be-produced replacement property is its estimated fair market value as of the date it is expected to be received. Reg. §1.1031(k)-1(e)(2)(i).

iii. 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 satisfied 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)-l(e)(iv).

5. **Coordination of Sections 1031(a)(3) and 453**

   a. If a 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

   i. 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)-l(g)(3)), the taxpayer is not considered to have received a payment under Section 453 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

   ii. Under Reg. §1.1031(k)-l(j)(2)(ii), if such cash or cash equivalent is held by a qualified intermediary (under Reg. §1.1031(k)-l(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 Section 453 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.
b. 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).

c. 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 Section 453 and Reg. §15A.453-1(b)(3)(i). Reg. §1.1031(k)-1(j)(2)(ii).

G. Reverse Exchanges

1. Basics -- There may be situations where a transferor needs to receive the replacement property before relinquishing the exchange property. For example, the taxpayer may fear that the 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 deals with this type of transaction. In fact, the preamble to the deferred exchange regulations under Reg. §1.1031(a)(3) stated that Section 1031(a)(3) does not apply to reverse-Starker exchanges, but that the IRS would continue to study the applicability of Section 1031(a)(1) to these transactions. See Preamble, T.D. 8346, 1991-1 C.B. 150, 151.

2. “Parking” Transactions -- In the absence of guidance on reverse exchanges, many taxpayers engaged in so-called “parking” transactions.

a. In the typical parking transaction, referred to as a “swap-last transaction,” the replacement property would be acquired and held by an accommodation party (“AP”) until the taxpayer sold the relinquished property. At that time, the taxpayer and the AP would enter into a like-kind exchange in which the taxpayer transferred the relinquished property to the AP in exchange for the replacement property, and the AP would then transfer the relinquished property to the ultimate transferee.

b. Alternatively, in a “swap-first transaction,” the AP would acquire the replacement property and immediately transfer it to the taxpayer in exchange for the relinquished property, which the AP would hold until the taxpayer could arrange a sale of the relinquished property.
In both the “swap-last” and “swap-first” transactions, the taxpayer and the AP would attempt to enter into agreements so that the AP would be treated as the owner of the property it held for Federal income tax purposes. However, in a “swap-last transaction,” the AP would usually borrow the funds needed to acquire the replacement property from the taxpayer or the taxpayer would guarantee a loan to the AP from a third-party lender. This financing would then be combined with a lease under which the taxpayer would pay rent to the AP equal to the debt service, and the taxpayer could have an option to purchase (and the AP an option to sell) the replacement property. In this structure, there was a risk that the IRS could treat the taxpayer as if it (and not the AP) had the benefits and burdens of ownership of the replacement property. Consequently, taxpayers would usually require that the AP be subject to some risk (e.g., AP would be required to advance 10 percent of funds used to purchase the replacement property).

3. **Reverse Exchange Safe Harbor under Rev. Proc. 2000-37** -- In Rev. Proc. 2000-37, 2000-40 IRB 308 (Sept. 15, 2000), the IRS concluded that a taxpayer should have a workable means of qualifying reverse exchanges under Section 1031. Rev. Proc. 2000-37 (§4.01) states that the IRS will not challenge the qualification of property as either replacement property or relinquished property under Section 1031 if the property is held in a qualified exchange accommodation arrangement ("QEAA"). Property is held in a QEAA if:

a. Qualified indicia of ownership of the property is held by an exchange accommodation titleholder (the "EAT") who is not the taxpayer or a disqualified person. For this purpose, “qualified indicia of ownership” means legal title to the property, other indicia of ownership that are treated as beneficial ownership of the property under applicable principles of commercial law, or interests in an entity that is disregarded as an entity separate from its owner for Federal income tax purposes and that holds either legal title to the property or such other indicia of ownership;

b. At the time qualified indicia of ownership of the property is transferred to the EAT, it is the taxpayer's bona fide intent that such property represent either replacement or relinquished property in a Section 1031 exchange;
c. No later than five business days after the property is enter into a written agreement (the QEAA) that provides that the EAT is holding the property for the taxpayer in order to facilitate a Section 1031 exchange. The QEAA must specify that the EAT will be treated as the beneficial owner of the property for Federal income tax purposes;

d. No later than 45 days after the replacement property is transferred to the EAT, the relinquished property is properly identified in a manner consistent with Reg. §1.1031(k)-1(c);

e. No later than 180 days after the property is transferred to the EAT, such property (i) is transferred (either directly or indirectly through a qualified intermediary, as defined in Reg. §1.1031(k)-1(g)(4)) to the taxpayer as replacement property, or (ii) is transferred to a person who is not the taxpayer or a disqualified person as relinquished property; and

f. The combined time period that the relinquished property and the replacement property are held in the QEAA does not exceed 180 days.

4. **Transactions Outside the Reverse Exchange Safe Harbor**

a. Rev. Proc. 2000-37(§3.02) makes clear that “no inference” is intended with respect to the Federal income tax treatment of reverse exchanges that do not satisfy the terms of this safe harbor, whether entered into prior to or after the effective date of the revenue procedure. Consequently, if the safe-harbor requirements are not satisfied, the determination of whether the taxpayer or the EAT is the owner of the property for Federal income tax purposes will be made without regard to this safe harbor.

b. In *Rutherford v. Comm’r*, 37 TCM 1851 (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 an artificial insemination 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 Section 1031(a) exchange as to Rutherford.

c. In *Bezdjian v. Comm’r*, 845 F.2d 217 (CA9 1988), the taxpayers, Bezdjian, 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, Bezdjians purchased the gas station and, about three weeks thereafter, sold the rental property to a third party. The Ninth Circuit affirmed the Tax Court holding that there was no Section 1031 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.

d. See also Dibsy v. Comm’r, 70 TCM 918 (1995), where the taxpayers’ attempt to claim a reverse like-kind exchange failed. They sold one liquor store and then bought another and tried to tie the two together. 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.

e. In DeCleene v. Comm’r, 115 T.C. 34 (2000), a taxpayer quitclaimed title to L Property to WLC for (i) deferred cash consideration of $142,400, (ii) a commitment by WLC to construct a building on L Property, and (iii) a commitment by WLC to reconvey L Property (with improvement) to the taxpayer in exchange for M Property. The Tax Court concluded that the taxpayer never surrendered beneficial ownership of L Property because it was responsible for all transaction costs and carrying charges. In addition, construction was financed by a note and mortgage guaranteed by the taxpayer that were nonrecourse as to WLC. As a result, the court treated these transactions as a sale of M Property to WLC for $142,400 and not as a sale of unimproved L Property by the taxpayer, followed by a reverse like-kind exchange of M Property for improved L Property.

f. In Priv. Ltr. Rul. 200111025 (Dec. 8, 2000), a taxpayer’s accommodation party acquired and held replacement property more than 180 days before such property was exchanged with the taxpayer’s relinquished property. The taxpayer had intended that a conservation organization purchase the relinquished property, but various political and administrative obstacles prevented this purchase from happening sooner. Despite this delay, the IRS concluded that the taxpayer undertook a valid exchange under Section 1031 because (i) the taxpayer demonstrated its intent to
achieve an exchange, (ii) the properties exchanged were of like kind and for a qualified use, (iii) the steps in the various transfers were part of an integrated plan to exchange the relinquished and replacement properties, and (iv) the accommodation party was not the taxpayer's agent.

H. Leverage After/Before Exchange

1. Leverage After Exchange -- The issue is whether a taxpayer who engages in a like-kind exchange can encumber the replacement property after the exchange and, if so, when. This is an important practical matter because leverage allows the taxpayer to withdraw his equity from the property. The main concern that has been raised is whether a like-kind exchange followed by the receipt of debt proceeds should be viewed as the functional equivalent of the receipt of boot by the taxpayer. However, there is no reason why a taxpayer cannot encumber property after an exchange. Put simply, the receipt of debt proceeds does not give rise to taxable income, and the fact that the debt is incurred immediately after a like-kind exchange should not alter this result. Thus, under the “one nano-second rule,” the taxpayer who acquires replacement property should wait only one nano-second before incurring debt which is secured by the replacement property.

2. Leverage Before Exchange -- A more difficult question is whether a taxpayer can encumber a property immediately before a like-kind exchange. In Priv. Ltr. Rul. 8434015 (May 16, 1984), the IRS concluded that the “effect” of encumbering property before an exchange was to permit the taxpayer to “cash out” of the property without the corresponding tax for money received under Section 1031. The IRS argued that the liability netting rules should not be literally applied to achieve this result. This logic is questionable, however, because, as noted above, it is well established that a taxpayer can encumber property without tax consequences. Furthermore, the regulations are clear that the transferor will recognize gain unless an equal or greater amount of debt encumbers the replacement property received in the exchange. Under the disguised sale rules of Section 707(a)(2)(B), if property is transferred to a partnership subject to a nonqualified liability, or if the nonqualified liability is assumed by the partnership, the transaction is treated as a cash distribution to the transferor to the extent the transferor's liability is reduced. For purposes of this discussion, the key point is that there are no tax consequences under Section 707(a)(2)(B) if and to the extent that the transferor's share of the liability is not reduced. Thus, under this same approach, a taxpayer should be able to encumber its relinquished property immediately before a like-kind exchange if the replacement property is encumbered by an equal or greater liability.
3. **Releverage After Exchange** -- A related issue is raised by the following scenario: (i) taxpayer holds relinquished property encumbered by $100,000 debt; (ii) prior to a like-kind exchange, taxpayer agrees to pay $100,000 to eliminate this debt; and (iii) purchaser releverages the property for $100,000 following exchange. The risk in this scenario is that, under the step transaction doctrine, the purchaser would be treated as if it acquired the property subject to the full $100,000 debt, which would make the property (and the taxpayer) subject to the liability netting rules. The key analysis is whether the lender obligated the purchaser to releverage the property following the exchange. In other words, if the purchaser were legally or economically compelled to releverage the property, then the IRS could treat the lender as if it made a long-term loan secured by the property, and the elimination of the debt and subsequent releveraging would be disregarded.

I. **Like-Kind Exchanges By Partnerships**

1. **Minimum Gain** -- If a partnership sells relinquished property subject to nonrecourse debt on November 1 as part of a Section 1031 exchange, and the partnership does not acquire the replacement property until February 1, this initial sale could give rise to a minimum gain chargeback. Specifically, if the partnership’s basis in the property, immediately prior to the sale, is $70 and the outstanding principal balance of debt secured by the property is $100, then the sale of such property would cause a net decrease in partnership minimum gain during the taxable year of $30. Under Treas. Reg. §1.704-2(f)(1), this net decrease ($30) would be allocated to the partners in the same proportion as their respective shares of partnership minimum gain at the end of the immediately preceding taxable year. Thus, if the partnership has two partners and, pursuant to their partnership agreement, all partnership items are allocated 50:50, then each partner would be allocated $15 of minimum gain chargeback. However, the partnership could avoid the gain recognition that would result from this scenario if the sale of relinquished property were treated as an open transaction and not accounted for as a sale, though there is a risk that the IRS, on audit, would not accept this approach.

2. **Section 752** -- Similarly, if this same partnership were a general partnership, and the relinquished property were subject to recourse debt, the November 1 sale could cause each partner to recognize gain under Sections 752 and 731. For example, if each partner has an adjusted basis in the partnership of $10, and the property is subject to recourse debt of $40, then the sale of such property would decrease each partner’s share of the liabilities by $20, which under Section 752(b) would be treated as a distribution of money to each partner by the partnership. Because these deemed distributions of $20 would be greater than each partner’s adjusted
basis in the partnership, Section 731(a)(1) would require each partner to recognize $10 of gain. As in the discussion of minimum gain, a partnership could avoid this gain recognition if the sale of relinquished property were treated as an open transaction, which did not decrease each partner’s share of the liabilities.

3. **If Partners Do Not Agree** -- It is common when a partnership sells its property that one or more of the partners wants to “cash out” in the transaction, whereas other partners want to “reinvest” though a like-kind exchange. Assume, for example, that Jack, Karen, Luke and Mary are equal partners in the JKLM partnership, the only asset of which is Whiteacre, which is an apartment building worth $10 million. Jack inherited his interest from a deceased parent, and Karen contributed $2.5 million to JKLM for her interest, so they have a stepped-up basis in their partnership interests, but Luke and Mary have a $0 basis in their interests. JKLM made a Section 754 election, so the partnership has a $5 million basis in Whiteacre. A buyer has offered to purchase Whiteacre for $10 million, and all of the partners want to sell. Jack and Karen want to “cash out” with their share of the sale proceeds, but Luke and Mary want JKLM to purchase replacement property so as to defer gain recognition. If JKLM receives half the sale proceeds in cash (and the other half goes to a qualified intermediary), then Luke and Mary would each recognize $1.25 ($5 million/4) of gain. There are three ways to address this situation.

a. One method would involve a special allocation of the gain to the partners who “cash out.” This gain would increase their bases in the partnership interests, so Jack and Karen would also have offsetting capital losses upon the receipt of $2.5 million each in redemption of their interests. The problem is that it is not clear that such special allocations have substantial economic effect. For example, the gain allocation to Karen would increase her capital account to $5 million, but she would receive only $2.5 million from JKLM. Although the capital gain would be offset by a capital loss, it is difficult to justify this special allocation under Section 704(b).

b. A second approach would be for the partnership to distribute undivided tenancy-in-common interests in the property to the partners immediately before the sale. In this example, JKLM would distribute a 25% undivided interest in Whiteacre to Jack and Karen in redemption of their interests immediately before the sale, while Luke and Mary remain as partners in the partnership. Alternatively, undivided interests could be distributed to all of the partners in liquidation of the partnership immediately before the sale to the buyer. These alternatives cause two issues to arise.
First, do the partners satisfy the "held for" test in Section 1031 if they receive their undivided interests immediately before the sale? Second, notwithstanding the dissolution of JKLM, does the relationship between the partners constitute a deemed partnership under Section 761, particularly if there is a significant level of activity involved in the operation and management of Whiteacre? (These issues are discussed earlier in this outline.)

c. The third approach, and one that is frequently used when there is a creditworthy buyer of the relinquished property, is commonly referred to as the "installment note" method. Under this method, the buyer conveys to the seller cash to be used for the purchase of the replacement property plus an installment note which could be distributed to the "cash out" partners in liquidation of their interests. Assume, for example, that a buyer conveyed to JKLM in exchange for the relinquished property $5 million cash (paid to a qualified intermediary) plus an installment note of $5 million. The note would provide for 98-99% of the payments to be made a short time after closing, with the remaining payments to be made after the beginning of the next taxable year. This method works because no gain or loss is recognized by JKLM upon receipt of the installment note. Furthermore, the distribution of the installment note to Jack and Karen in redemption of their interests would not result in the recognition of gain under Section 453. Instead, Jack and Karen would recognize gain only as payments are received on the note. JKLM, comprised of Luke and Mary, would purchase replacement property, which would qualify for nonrecognition under Section 1031 because the partnership held the relinquished property and acquired the replacement property.