The Like Kind Exchange: Everything You Need to Know, Whether or Not You Wanted to Ask

Stefan F. Tucker
THE LIKE KIND EXCHANGE:
EVERYTHING YOU NEEDED TO KNOW,
WHETHER OR NOT YOU WANTED TO ASK

By: Stefan F. Tucker
Tucker, Flyer & Lewis,
a professional corporation
Washington, D.C.
August 18, 1995
# TABLE OF CONTENTS

| I. | OVERVIEW | 1 |
| II. | BASICS OF LIKE KIND EXCHANGES | 1 |
| | A. General Rules | 1 |
| | B. Exchanges | 4 |
| | C. Designations of Property -- Generally | 8 |
| III. | EXCHANGES WITH "BOOT" | 9 |
| | A. Generally | 9 |
| | B. The Impact of Mortgages | 12 |
| IV. | EXCHANGES BETWEEN RELATED PERSONS -- TRIGGERING DEFERRED GAIN | 15 |
| | A. Background | 15 |
| | B. General Rules | 15 |
| | C. Exceptions (Certain Dispositions Not Taken into Account) | 16 |
| V. | SIMULTANEOUS EXCHANGES | 17 |
| | A. Description | 17 |
| | B. Difficulties of Simultaneous Exchange | 17 |
| | C. Use of an Intermediary | 17 |
| | D. Like Kind Transaction Agreement | 17 |
| VI. | DEFERRED LIKE KIND EXCHANGES | 18 |
| | A. Overview | 18 |
| | B. Identification and Receipt Requirements | 19 |
| | C. Actual and Constructive Receipt of Money or Other Property -- The Safe Harbors | 23 |
| | D. The Disqualified Person | 28 |
| | E. Coordination of Sections 1031(a)(3) and 453 | 29 |
| VII. | REVERSE EXCHANGES | 29 |
| | A. Riskiness | 29 |
| | B. Basics | 29 |
| | C. Three Types of Reverse Exchanges | 30 |
| | D. Problem | 30 |
| | E. Argument | 30 |
| | F. Judicial Response | 30 |
| | G. Example of Means of Avoiding Reverse Like Kind Exchanges | 31 |
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.

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) interests in a partnership,

      (4) certificates of trust or beneficial interests, or

      (5) choses in action.

   b. 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 Sec. 1031, I.R.C. (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.

   c. Also with regard to the exclusion of interests in partnership 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.

   d. Dealer property is excluded from like kind treatment even though the statute does not include the language of Sec. 1221, I.R.C., "to customers in the ordinary course of his
trade or business." 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.

e. 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. But see Priv. Ltr. Rul. 9038030 (June 25, 1990), holding that the Virgin Islands is included within the United States.

f. It should be noted that 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. For example, a corporation in the messenger service business could not trade its used delivery trucks for an office building to be used as its headquarters. See Reg. §1.1031(a)-1(b). See also, for "additional rules for exchanges of personal property", Reg. §1.1031(a)-2.

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. To the extent a taxpayer receives non-like kind property ("boot") the transaction will be taxable. Sec. 1031(d), I.R.C.

3. Held for Use in a Trade or Business

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 investment purposes during at least 2 taxable years before a like kind exchange is attempted.

4. The applicability of Sec. 1031, I.R.C. is mandatory, not elective. Thus, if recognition of gain or loss is desired, the qualifications of a Sec. 1031, I.R.C. transaction should be avoided.

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).
6. 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 personality 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, as where the state law considers the exchanged interest to be real property, but the tax law considers 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 Sec. 1031, I.R.C.

(2) For many purposes under the Code, 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).

b. 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).

c. 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 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.

(1) The relationship between 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. Sec. 1033(g), I.R.C. 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 as regards 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. In this regard, see Priv. Ltr. Rul. 9031015 (May 4, 1990).

d. 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).

B. Exchanges

1. Generally, the question of what constitutes an exchange is one in which substance is more important than form, although this is not always so. For example, a transaction couched in terms of an exchange may be deemed a sale. See Rogers v. Comm'r, 44 T.C. 126 (1965), holding that, where the taxpayers entered into an option agreement to sell property and subsequently entered into an agreement to effect an exchange of the property subject to the option for other property, the optionee's exercise of his option to purchase had the effect of negating any exchange between the taxpayers and the third party because a sale to the optionee had taken place.

2. Another method by which the Revenue Service 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).

3. 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), ownership of the taxpayer’s leased property was changed on two occasions. To avoid further rent increases accompanying changes in ownership, 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.

4. Another situation involving the meaning of "exchange" is presented when the property received in an exchange qualifying under Sec. 1031, I.R.C. is immediately transferred to a corporation in a valid Sec. 351, I.R.C. transfer.

a. 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.

b. 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.

c. 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 the parent corporation and immediately transferred to its subsidiary was held not to be a Sec. 1031, I.R.C. exchange of like kind property.

5. 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.

a. 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".

b. 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 consummated, to hold the acquired property for investment. *Comm'r v. Magneson*, 753 F.2d 1490, 1493 (CA9 1985).

(1) 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.

(2) The Ninth Circuit sought to distinguish Rev. Rul. 75-292 by pointing out that (a) a corporation is a distinct entity, while a partnership is an association of its partners/investors, and (b) 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.

6. 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.

a. 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 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.

b. 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.

c. 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. See also Priv. Ltr. Rul 9252001 (Feb. 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 non-recognition of gain treatment, since the taxpayer did not "cash in" on the investment in the relinquished property.
7. The trade of real property for the construction of a building on land to the taxpayer's specifications may, depending on whose land such building is constructed, be a sale or an exchange.

   a. 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), holding that there could be no like kind exchange of a completed structure used as a bottling plant for a plant yet to be constructed where the agreement provided that the contractor would build the plant in exchange for cash and the old facilities and transfer such new plant upon its completion. 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. 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 Service 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.

8. 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 on the theory that the property will not be held for investment.

   a. 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.
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).

b. 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 taxpayer gifted the properties to them seven months later.

C. Designations of Property -- Generally

1. 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.

2. For example, in Alderson v. Comm’r, 317 F.2d 790 (CA9 1963), an executed sales contract was amended into an exchange contract for Sec. 1031, I.R.C. 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.

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 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).

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; then the taxpayer exchanged such property for other property acquired by Fireman’s for purposes of the exchange.

a. 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."

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.
In Leach, cash and like kind property were received by the
taxpayer in an exchange, and the Court held that gain was
recognized only to the extent of the cash received.

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 gives 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. 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".

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. 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. Subject to the overriding provisions of Sec. 453(i), I.R.C., Sec. 453, I.R.C. 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 Sec. 453(b)(2), I.R.C. 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 life of the installment note.

b. 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).

c. 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).

(1) 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.

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

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

6. As to depreciation recapture under Sec. 1250(d)(4), I.R.C., the general rule is that, if no boot is received, no ordinary income is recognized under Sec. 1250, I.R.C. unless the Sec. 1250, I.R.C. gain, which would have been recognized but for Sec. 1031, I.R.C., exceeds the fair market value of the 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.

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 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 Sec. 1031(d), I.R.C. See Reg. §1.1031(d)-2. The Regs. 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. The net effect of the provision is to limit the impact of mortgages assumed by the exchanging parties to the rules under Sec. 1031(d), I.R.C. governing basis, with the provisions of Sec. 1031(b), I.R.C. governing boot being inapplicable. See Rev. Rul. 59-229, 1959-2 C.B. 180; Reg. §1.1031(a)-1. See also Priv. Ltr. Rul. 8328011 (February 28, 1983), stating that in an exchange mortgage liabilities and non-mortgage liabilities are netted together.

   b. Second, if the transferor acquires property subject to a mortgage, or assumes the mortgage 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. Where mortgages appear on both sides of the transaction, such mortgages are netted. 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 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.

b. The impact of such an exchange may potentially have an adverse impact on the transferee, who still receives boot, because the receipt of cash or other boot is not offset by any excess of the mortgage on the property received over the mortgage on the property transferred. See Coleman v. Comm'rx, 180 F.2d 758 (CA8 1950), where the taxpayer and a third person entered into a written agreement for the exchange of farms pursuant to which the taxpayer assumed a mortgage and received $14,000 in cash. Under the terms of the exchange agreement, the taxpayer was not obligated to apply $14,000 to the mortgage indebtedness on the farm of the third person and could not do so because of the terms of the mortgage. The Eighth Circuit held that the $14,000 in cash received on the exchange was not exempt from taxation, but was boot under Sec. 112(c)(1), I.R.C. (the predecessor to Sec. 1031(b), I.R.C.)

c. See also Rev. Rul. 79-44, 1979-1 C.B. 265, where the taxpayer assuming a mortgage received a promissory note from the other party, and was held to have realized income to the extent of the note's value. But see Priv. Ltr. Rul. 8003004 (September 19, 1979), where the Service took a liberal stance with respect to the treatment of boot received as part of a like kind exchange. The issue was whether the taxpayers could offset the boot received when their mortgages on the exchanged property were assumed by the boot paid to the other party (who had assumed the mortgages). The boot paid was in the form of a refinancing of the other party's mortgage. Applying the Regs., the Service concluded that the boot received could be offset by the boot paid, thus reducing the amount of gain the taxpayers had to recognize in connection with the exchange.

(1) In this situation, the transferee could increase his mortgage, if practicable, to receive cash and in that way equalize the mortgages, thus assisting both the transferor and the transferee. See Priv. Ltr. Rul. 8248039 (August 27, 1982), approving this technique.

(a) See Simon v. Comm'rx, 32 T.C. 935 (1959), aff'd 285 F.2d 422 (CA3 1960); Magnolia Dev. Corp. v. Comm'rx, 19 TCM 934 (1960); and Rev. Rul. 73-555, 1973-2 C.B. 159, pointing out that the technique of increasing the transferor's mortgage in order for him to receive cash -- thus equalizing the mortgages to be assumed in the exchange -- may be viewed as two
sales transactions, thereby invoking the tax consequences of Sec. 1031, I.R.C.

(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) Alternatively, the transferor could pay down his mortgage prior to the exchange, again in order to equalize the mortgages on both sides.

d. 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 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, even though A has other uses for the money, which he could obtain through refinancing after the exchange on a tax-free basis. Finally, A's basis is $100,000 less $50,000 cash, plus $50,000 gain recognized, plus the $50,000 mortgage difference, which equals $150,000. 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, and his basis is $100,000 less zero for the boot and netted mortgage amount, plus zero for the amount of gain recognized.

e. In the foregoing example, it should be recalled for planning purposes that, as to A, gain should be recognized only when he has substantial tax losses of the same character. At such time, A experiences an increased basis for purposes of depreciation in future taxable years.

f. The Service has ruled that a transferor may refinance the property received from the transferee in order to offset any boot received from the transferee as a result of his assumption of the transferor's mortgage. Priv. Ltr. Rul. 8003004 (September 19, 1979). In that situation, the cash received by the transferor in the refinancing was used to pay off the mortgage assumed by the transferee; moreover, such refinancing
and payment occurred while the properties were being held in escrow.

IV. **EXCHANGES BETWEEN RELATED PERSONS -- TRIGGERING DEFERRED GAIN.**

A. **Background**

1. Congress was concerned with basis shifts among related taxpayers. For example, assume that two wholly owned subsidiaries of a holding company own parcels of undeveloped real estate. Each parcel is unencumbered. 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 $100,000 ($900,000 less $800,000).

2. The Service could have attacked this trade as falling outside Sec. 1031(a), I.R.C. 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.

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. If a taxpayer exchanges property with a related person, and (i) there is nonrecognition of gain or loss on the exchange under Sec. 1031, I.R.C. (but for Sec. 1031(f)) and (ii) 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 Sec. 1031, I.R.C. Sec. 1031(f)(1), I.R.C.

   a. The gain or loss recognized by the taxpayer by reason of Sec. 1031(f), I.R.C. is taken into account when the property which was received in the exchange is later disposed of. Sec. 1031(f), I.R.C.

   (1) Loss may be limited by the related party rules of Sec. 267, I.R.C.
(2) Planning possibilities, with considerations of taxable years, immediately come to mind.

(a) However, Sec. 1031(f)(4), I.R.C. notes that 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 purposes of this" Sec. 1031(f), I.R.C.

(b) The Conference Committee Report (H.R. 5835; Oct. 29, 1990, relating to the Revenue Reconciliation Act of 1990) also points out, as an avoidance technique, the use of the unrelated third party as an intermediary. In this situation, using Corporations X, Y and T as 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.

b. 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.

2. Under Sec. 1031(f)(3), I.R.C., a "related person" is any person bearing a relationship to the taxpayer described in Sec. 267(b), I.R.C. or Sec. 707(b)(1), 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) 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 Conference Committee Report indicates that this exception is intended generally to apply to transactions that do not involve the shifting of basis between properties.
b. 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.

V. SIMULTANEOUS EXCHANGES

A. Description -- Basically, the seller/transferor and the buyer/transferee exchange title to like kind properties simultaneously, rather than either party receiving his, her or its replacement property at a later date.

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 them. 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.

C. 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 Sec. 1031(a), I.R.C. Reg. §1.1013(b)-2(a).

D. 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 Sec. 1031, I.R.C. provisions can be added, by amendment if necessary, at any time prior to, or even at the time of, the actual closing in order to provide for the like kind exchange.

VI. DEFERRED LIKE KIND EXCHANGES

A. Overview

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 Ore 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.

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 to 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 in order to take full advantage of the
exchange period and close out the deferred exchange after April
15 of such subsequent year.

5. 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).

6. 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") 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).

B. 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).

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).
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 before the end of the identification period --

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). Identifying property which is being constructed must be pursued with as much detail and specificity as is practicable.

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. 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).

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 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) If identification was made in a written agreement, then renovation 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.

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).

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).

b. 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 at the time is provided 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)(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)(iv).

C. 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 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--whether actually or constructively--receives money or other property before the taxpayer actually 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).

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 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).

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 4 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 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. (See, as a sorry contrast to this logical safe harbor, Greene v. Comm'r, 62 TCM 512 (1991).)

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 (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 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,

(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)(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. See Reg. §1.1031(k)-1(g)(4)(v). See also Rev. Rul. 90-34, 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.
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 this step be accomplished prior to the transferor entering into a Sales Agreement with the transferee. If this is done first, the qualified intermediary can directly negotiate 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 permit (either in the exchange agreement or by written consent) an assignment of the exchange agreement to the transferee or that such seller agree in writing to cooperate with the transferor in the effectuation of 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.

6. Safe Harbor No.4 (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).

d. However, the Treasury has not yet addressed the proper method of reporting interest income from money held in trust or escrow.

D. 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 performing services as the taxpayer’s employee, attorney, accountant, investment banker or broker; or

   c. Such person and his or her 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, investment banker or broker, or real estate agent or broker, within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction.

3. 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:

   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).

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 Final 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).

VII. REVERSE EXCHANGES

A. Riskiness -- One major problem with the reverse like kind exchange is that it is not currently sanctioned by the IRS.

B. Basics -- There may be situations where a transferor must receive the replacement property before relinquishing the exchange property. 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. The identification and exchange periods of Sec. 1031(a)(3), I.R.C. limit treatment of the replacement property only.

C. Three Types of Reverse Exchanges

1. Reverse Regs. -- The seller (person owning the real estate that the transferor wants to receive in the exchange (replacement property)) transfers the replacement property to an accommodator (person, meeting the criteria for "qualified intermediary", hired by the transferor to purchase, sell, trade and/or temporarily hold the various properties in the exchange) for cash. When a transferee (person desiring the transferor's property (relinquished property) for the relinquished property is found, the accommodator transfers the replacement property to the transferor in exchange for the relinquished property and subsequently transfers the relinquished property to the transferee in exchange for cash.

2. Biggs Reverse -- The seller transfers the replacement property to an accommodator for cash. When a transferee for the relinquished property is found, the accommodator transfers the replacement property to the transferee in exchange for cash. The transferee exchanges the replacement property with the transferor for the relinquished property.

3. Simple Reverse -- The seller transfers the replacement property to the transferee in exchange for cash. Then, the transferee transfers the replacement property to the transferor in exchange for the relinquished property.

D. Problem -- The greatest threat to the first two reverse like kind exchanges is the risk of the accommodator being characterized as an agent of the transferor. This would destroy the like kind exchange since the transferor would be considered in constructive receipt of the replacement property.

E. Argument -- While there is nothing in the Code which sanctions these types of transactions, Starker may be cited as support.

F. Judicial Response --

1. 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 Sec. 1031(a), I.R.C. exchange as to Rutherford.

2. In Bezdjian v. Comm'r, 845 F.2d 217 (CA9 1988), the taxpayers, 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, 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 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.

G. Example of Means of Avoiding Reverse Like Kind Exchanges

1. Assume that transferee wants to sells his property ("Replacement Property") for its fair market value of $100. Transferor offers his property ("Exchange Property") with the same fair market value in exchange for the Replacement Property. However, the transferee wants cash. Transferor may accomplish a reverse like kind exchange as follows:

2. Steps

a. Transferor lends $100 to intermediary.

b. Qualified intermediary purchases the Replacement Property for $100 from transferee.

c. Qualified intermediary gives transferor $100 mortgage on the Replacement Property to secure the $100 loan.

d. Until a purchaser for the Exchange Property is found, transferor enters into a triple net lease with qualified intermediary, with transferor obtaining all the burdens and benefits of the Replacement Property.

e. When a purchaser for the Exchange Property is found, transferor transfers the Exchange Property to the purchaser. The purchaser pays $100 to qualified intermediary. Qualified intermediary delivers the Replacement Property plus the $100 (to pay off the loan) to transferor.