STRUCTURING 1031 EXCHANGES

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STRUCTURING 1031 EXCHANGES

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STRUCTURING 1031 EXCHANGES\textsuperscript{1,2} 

by

Ronald A. Shellan\textsuperscript{3}

1. INTRODUCTION

1.1 Requirements for Nonrecognition. Section 1031 is an exception to the general rule that gain must be recognized on the sale or other disposition of property. Section 1031 provides that no gain or loss will be recognized on the exchange of property held in a trade or business or for investment for like-kind property held in a trade or business or for investment. The mandatory nature of the rule can sometimes disallow a loss. \textit{United States v. Vardine}, 305 F2d 60 (2d Cir 1962). The general requirements for a Section 1031 exchange are:

1.1.1 Qualified property. Both the property exchanged and the property received in a tax-free exchange must be held either for investment or for productive use in a trade or business. Certain excluded property will not qualify for exchange treatment, including stocks, bonds, notes, securities, and partnership interests.

1.1.2 Like kind. The property transferred and the property received must be of like kind for the exchange to be nontaxable.

1.1.3 Exchange. There must be an exchange of qualified property for like-kind qualified property.

1.1.4 Boot treatment. If property that is not qualified or not of a like kind is received, it is treated as boot. Receipt of boot will not disqualify an exchange, but the boot will be taxed to the Exchanger to the extent of the gain realized. Treas Reg § 1.1031(b)-1.

\begin{itemize}
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\item \textsuperscript{2} This document should not be construed as legal advice or legal opinion on any specific facts or circumstances. The content is intended for general informational purposes only, and you are urged to consult a lawyer concerning your own situation and any specific legal questions you may have.
\item \textsuperscript{3} Ronald A. Shellan has been designated as a SuperLawyer. He is a partner of the Portland, Oregon, law firm of Miller Nash LLP. Mr. Shellan is a 1972 graduate, \textit{magna cum laude}, of the University of Washington, where he received a B.A. in accounting. He graduated in 1975 from Willamette University College of Law, where he was associate editor of the \textit{Willamette Law Review}. Mr. Shellan is a certified public accountant and has served twice on the board of directors of the Oregon Society of Certified Public Accountants. He is a former chair of the Taxation Section of the Oregon State Bar. He is also the founding chair of the Portland Tax Forum.
\end{itemize}
1.2 **The Players and Common Terms.**

1.2.1 Accommodator - The other party to an exchange. Generally, an Accommodator is an entity that serves as an intermediary in accomplishing a tax-free exchange. The Accommodator can be a Seller, Buyer, contractor, or developer. Most Accommodators are corporations whose only function is to act as intermediaries in tax-free exchanges. Unless otherwise noted, this outline assumes that an Accommodator is a Qualified Intermediary under Treas Reg § 1.1031(k)-1(g)(4).

1.2.2 Buyer - The person who buys Relinquished Property from the Exchanger through an Accommodator.

1.2.3 First Leg - The first transaction of an exchange. For a forward-deferred exchange, it is the transfer of the Relinquished Property to the Accommodator, who will sell it to the Buyer.

1.2.4 Second Leg - The second transaction of an exchange. For a forward-deferred exchange, it is the transfer of the Replacement Property from the Seller to the Accommodator, who will in turn convey it to the Exchanger.

1.2.5 Relinquished Property - Property owned by the Exchanger that will be conveyed to the Accommodator, to be sold to the Buyer.

1.2.6 Replacement Property - Property owned by the Seller that will be purchased by the Accommodator and conveyed to the Exchanger in the exchange.

1.2.7 Seller - The person who sells Replacement Property to the Exchanger through an Accommodator.

1.2.8 Exchanger - The person who wants to obtain tax-free-exchange treatment by exchanging his Relinquished Property for Replacement Property owned by the Seller.

1.2.9 Identification Period - The period during which the Exchanger must identify Replacement Property in a deferred tax-free exchange. The Identification Period starts on the day the Exchanger transfers the Relinquished Property and ends at midnight on the 45th day thereafter.

1.2.10 Exchange Period - The period during which the Exchanger must acquire Replacement Property in a deferred tax-free exchange. The Exchange Period starts on the date the Exchanger transfers the Relinquished Property and ends on the earlier of the 180th day thereafter or the due date (including extensions) of the Exchanger's tax return.
1.2.11 Summary of relationship of key parties:

<table>
<thead>
<tr>
<th>OWNS</th>
<th>WANTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exchanger</td>
<td>Relinquished Property</td>
</tr>
<tr>
<td>Seller</td>
<td>Replacement Property</td>
</tr>
<tr>
<td>Buyer</td>
<td>Cash</td>
</tr>
</tbody>
</table>

1.3 **Example of Advantages.** A tax-free exchange generally combines the advantages of tax deferral, which is often permanent, with the advantages of leveraging. In the following example, the Exchanger (Helen), assuming a low 3 percent inflation rate over ten years, was $260,619 ahead of Sam, who decided to sell for cash and pay his taxes.

<table>
<thead>
<tr>
<th></th>
<th>Helen</th>
<th>Sam</th>
<th>Helen's Advantage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale Proceeds</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$ 0</td>
</tr>
<tr>
<td>Basis</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Realized Gain</td>
<td>200,000</td>
<td>200,000</td>
<td>0</td>
</tr>
<tr>
<td>Tax (Federal and State, 34%)</td>
<td>0</td>
<td>68,000</td>
<td>68,000</td>
</tr>
<tr>
<td>After-Tax Proceeds</td>
<td>200,000</td>
<td>132,000</td>
<td>68,000</td>
</tr>
<tr>
<td>Reinvestment Property (20% down)</td>
<td>1,000,000</td>
<td>660,000</td>
<td>340,000</td>
</tr>
<tr>
<td>New Mortgage</td>
<td>800,000</td>
<td>528,000</td>
<td>(272,000)</td>
</tr>
<tr>
<td>Exchanger's Equity</td>
<td>200,000</td>
<td>132,000</td>
<td>68,000</td>
</tr>
<tr>
<td>Property Value in 10 Years (3% inflation)</td>
<td>1,343,916</td>
<td>886,985</td>
<td>456,931</td>
</tr>
<tr>
<td>Mortgage Balance After 10 Years (10% Interest)</td>
<td>577,391</td>
<td>381,078</td>
<td>(196,313)</td>
</tr>
<tr>
<td>Equity</td>
<td>$766,525</td>
<td>$505,907</td>
<td>$260,618</td>
</tr>
</tbody>
</table>
2. QUALIFIED PROPERTY

Qualified property is property held in the Exchanger's trade or business or held for investment. Trade or business property can be exchanged for investment property, and investment property can be exchanged for trade or business property. Treas Reg § 1.1031(a)-1(a). The use of the property by the other party to the exchange is irrelevant. Rev Rul 75-291, 1975-2 CB 332. In other words, it is not important whether the other party to the exchange plans to use the Relinquished Property in his trade or business, for investment, or for any other purpose. It is important only that the Exchanger use the Relinquished Property and the Replacement Property for investment or in his trade or business. Acquiring property only to complete an exchange will not meet the requirement that the Relinquished Property is held for investment. Rev Rul 75-291, 1975-2 CB 332; Rev Rul 77-297, 1972-2 CB 304.

2.1 Excluded Property. Under IRC § 1031(a)(2), qualified property can never include the following types of property:

2.1.1 Stock in trade or other property held primarily for sale (this can include real property held by a developer or other dealers in real property);

2.1.2 Stocks, bonds, or notes;

2.1.3 Securities or other evidence of indebtedness;

2.1.4 Interest in a partnership (unless the partnership elects out of partnership status under IRC § 761(a)); or

2.1.5 Choses in action (e.g., a lawsuit).

2.2 Mixed-Use Property.

2.2.1 Business use of personal residence.

2.2.1.1 Rev Rul 82-26, 1982-1 CB 115, held that if a personal residence was partially used for business, the transaction must be bifurcated. The portion used for business could qualify for tax-free treatment pursuant to an exchange under IRC § 1031, with the remainder eligible for a tax-free sale under IRC § 1034. See also Rev Rul 59-229, 1959-2 CB 180.

2.2.1.2 Priv Ltr Rul 8508095 (Nov. 29, 1984) held that the acquisition of a home with a home office in exchange for other property qualified as a tax-free exchange under IRC § 1031.

2.2.1.3 An exchange of a lot held for investment plus .5 acre of a 1.8-acre property used by the Exchanger as his residence was held to be taxable to the extent of the value of the .5 acre of property.
2.2.1.4 The Oregon Tax Court in Bittner v. Department of Revenue (July 20, 1999), held that a 54-acre parcel of property would be considered to be the taxpayer's residence even though most of the land was used for growing and harvesting trees. The court strongly considered the intent of the taxpayer in holding the property and found it persuasive that the taxpayer had sold the property as a residence and had not realized it had a higher value as timberland. The tax issue was whether the property could be treated as a residence for purposes of the gain rollover provisions of Section 1034 of the Internal Revenue Code (since repealed).

2.2.1.5 An excellent analysis of structuring a sale of a residence and adjoining acreage can be found in Michael M. Megaard & Susan L. Megaard, Reducing Taxes on the Disposition of a Personal Residence With Acreage, 20 J Real Est Tax'n 269 (1993). See also, Daughtrey et al., How Much Acreage Can Be Included Under the New Sale of Principal Residence Rules, 90 J Tax'n 294 (1999).

2.2.2 **Vacation home.** A vacation home which is not rented will not qualify as either Relinquished Property or Replacement Property because the property was not held for investment. Moore, TC Memo 2007-134. The IRS has provided a safe harbor for vacation homes that seems to have been inspired by the 14-day rule found in IRC §280A. In Rev Proc 2008-16, 2008-10 IRB 547 (see Weller, Welch and Marques, “IRS Issues Safe Harbor for Exchanges of Vacation Homes,” 109 JTax 5 (July 2008), the IRS stated that it will not challenge the status of a vacation home as investment property if:

2.2.2.1 For Relinquished Property, the Exchanger held the property for 24 months immediately prior to the exchange and rented it at least 14 days.

2.2.2.2 For Replacement Property, the Exchanger held the property for 24 months immediately after the exchange and rented it at least 14 days.

2.2.2.3 The Exchanger did not personally use the vacation home more than 14 days or 10 percent of the days that it was rented.
2.2.3 **Conversion to business or investment use.**

In Rev Rul 57-244, 1957-1 CB 247, the IRS held that residential property may be converted into qualified exchange property if the Exchanger has converted his use of the property as a personal residence.

2.2.3.1 Simply renting out a residence will not automatically qualify it for exchange treatment. *Bolaris v. C.I.R.*, 776 F2d 1428 (9th Cir 1985).

2.2.3.2 The intent of the Exchanger to realize post conversion appreciation, even if not reasonable, will be respected. *Newcombe v. C.I.R.*, 54 TC 1298 (1970).

2.2.3.3 On conversion of a residence to rental property, the basis will be the lesser of the property's fair market value or its adjusted basis. *J. Clark Bundren v. Comm.*, TCM 2001-2 (Jan. 5, 2001).

2.2.4 **Residence Sale Exclusion Issues.**

2.2.4.1 Under Section 121, gain from the sale of a principal residence may be excluded. The exclusion is limited to $250,000 ($500,000 for a joint return). The exclusion is only available if the property was owned and used as the taxpayer's principal residence for at least two years during the five-year period ending on the date of the sale.

2.2.4.2 If a residence is acquired as part of a tax-free exchange, the Section 121 exclusion of gain on sale of a principal residence will not be available for any gain recognized during the 5-year period starting with the date the residence was acquired. American Jobs Creation Act of 2004 (HR 4520, Section 840).

2.2.4.3 Revenue Procedure 2005-14, 2005-_______ (Jan 27, 2005) has certain rules which affect how the IRC § 121 exclusion interacts with the IRC § 1031 exclusion. The rules are as follows:

2.2.4.3.1 IRC § 121 is applied to exclude realized gain prior to IRC § 1031.

2.2.4.3.2 IRC § 1031 may be applied to exclude gain attributable to depreciation deductions for periods after May 6, 1997, but IRC § 121 cannot. IRS § 121(d)(6).
2.2.4.3.3 Boot received is first allocated to IRC § 121. Any remaining boot will generate taxable boot income to the extent of gain realized.

2.2.4.3.4 The revenue procedure discusses three different situations.

a. First, is the situation of a single property which was first a principal residence and then was converted into a rental.

b. Second, there is the situation of a residence and a separate cottage used for business. This situation is treated as two separate properties instead of a single property and the cottage would never receive a benefit under IRC §121.

c. Third, is the situation where a single residence is partially used for business. In this situation, the revenue procedure provides that income that would otherwise be recognized (such as boot generated income) does not need to be recognized to the extent that IRC §121 is available.

2.2.4.3.5 When computing basis for the Replacement Property, the basis would include any gain excluded under IRC § 121.

2.2.4.4 Below is a schedule analyzing how both IRC § 121 and IRC § 1031 operate together.
2.2.5 **Residence held by irrevocable trust.** Can an irrevocable trust exchange a residence that is occupied rent-free by a trust beneficiary? If we were not dealing with a trust, it would be clear that residential real estate used as a personal residence does not qualify as tax-free exchange property. Does the fact that the property is being held by a trust, which is strictly governed by the terms and provisions of the trust, convert the trustee's intent in holding the property to that of a trade or business? In Priv Ltr Rul 7943152 (July 30, 1979), property used by a trust as a principal residence of one of the trustee beneficiaries was held to be qualified property notwithstanding the fact that the trust allowed the beneficiary of the trust to use the house as a residence. Two private letter rulings suggest that the trust's purpose and use in holding the property are important. In Priv Ltr Rul 8429039 (Apr. 17, 1984), the trustee planned to enter into a tax-free exchange. The Replacement Property that the trust was to receive was a personal residence. In a prior letter ruling with respect to the same matter, it had been determined that the transaction would not qualify as a tax-free exchange because the trust had not represented that it would hold the residence for productive use in a trade or business or for investment for a period of not less than two years after the exchange. In Priv Ltr Rul 8429039, the trust did represent that it would hold the residence for two years for the required purposes, and the IRS, as a result of the representation, ruled that the transaction would
qualify as a tax-free exchange. Similarly, in Priv Ltr Rul 8126070 (Mar. 31, 1981), the trust planned to enter into a tax-free exchange. The only unusual fact was that shortly after the exchange, the trust, in accordance with its terms, would be liquidating. The IRS held that that fact would not prevent the trust from holding the property for investment or in its trade or business and thus determined that the transaction would qualify as a tax-free exchange. Significantly, in both Priv Ltr Rul 8429039 and 8126070, the IRS looked to the taxpayer's use of the Replacement Property and did not suggest that the taxpayer, because of the fact that it was a trust, could automatically take the position that its holding of the property qualified as holding it for investment or using it in its trade or business.

2.3 Exchange in Combination With Another Tax-Free Transfer. A second tax-free transfer (such as a gift or transfer from or to a corporation or partnership before or after the exchange) may be subject to IRS attack on the basis that the Exchanger did not intend to "hold" the Relinquished Property or the Replacement Property for investment or in his trade or business. The following cases and ruling illustrate several key points:

- Even though it may not always win, the IRS almost always takes the position that any combination of an exchange and another tax-free transaction is taxable.
- It is best to wait as long as possible between the exchange and the other tax-free transfer.
- It is much better if the Exchanger lives in the Ninth Circuit because many Ninth Circuit court rulings are favorable to the Taxpayer.

2.3.1 Corporate transaction combined with exchange.

2.3.1.1 Exchange followed by corporate liquidation.

2.3.1.1.1 Regals Realty, 43 BTA 194 (1940), aff'd, 127 F2d 931 (2d Cir 1942), held that an exchange by a corporate Exchanger followed by a corporate liquidation would not be tax-free because of the failure of the corporate Exchanger to "hold" the Replacement Property for investment after the exchange.

2.3.1.1.2 Maloney v. C.I.R., 93 TC 89 (1989), approved an exchange by a corporation followed by a one-month tax-free liquidation under IRC § 333 (this section has now been repealed).
2.3.1.2 Corporate liquidation followed by exchange.

2.3.1.2.1 Bolker v. C.I.R., 81 TC 782 (1983), aff’d, 760 F2d 1039 (9th Cir 1985), approved a one-month tax-free liquidation under IRC § 333 (this section has now been repealed) followed by a tax-free exchange by the shareholder. This is a Ninth Circuit case.

2.3.1.2.2 Contrary to Bolker, Rev Rul 77-337, 1977-2 CB 305, held that an exchange followed by an IRC § 333 one-month tax-free liquidation would not be allowed.

2.3.1.3 Exchange followed by transfer to corporation. This type of exchange was not allowed in Rev Rul 75-292, 1975-2 CB 333.

2.3.1.4 Exchange followed by corporate reorganization. An exchange followed by a corporate reorganization was allowed in Priv Ltr Rul 9850001 (Aug. 31, 1998).

2.3.2 Partnership transaction combined with exchange.

2.3.2.1 Partnership liquidation followed by exchange.

2.3.2.1.1 In Miles H. Mason, 57 TCM (P-H) ¶ 88, 273 (1988), the tax court approved a partnership liquidation immediately followed by an exchange.

2.3.2.1.2 In Crenshaw v. United States, 450 F2d 472 (5th Cir 1971), a redemption transaction followed by an exchange was treated as a sale.

2.3.2.1.3 In Chase v. C. I. R., 92 TC 874 (1989), the partnership attempted to liquidate the partnership, but failed because the deed was not recorded and the partnership bank accounts continued to hold all partnership income and pay all partnership expenses. The later exchange by one of the partners was held taxable. Chase is a poorly reasoned and confusing decision, which probably stands only for the proposition that if you botch things badly enough, the court will punish you for it.

2.3.2.1.4 A partnership liquidation followed by an IRC § 1033 condemnation rollover was allowed in

2.3.2.1.5 A partnership entered into an agreement to sell Relinquished Property. Before completing the sale, it liquidated and all of its rights with respect to the Relinquished Property were transferred to corporation. The Service ruled that corporation "cannot merely step into the shoes of the partnership for section 1031 purposes." . . ."Consequently, an attribution of the requisite intent to hold property under section 1031 from a partnership to a 'succeeding' corporation appears to be a logical stretch that is virtually without any support." Field Service Advice 1995-12 (May 30, 1995).

2.3.2.2 Exchange followed by transfer to partnership. The tax court allowed an exchange followed by an immediate transfer of the Replacement Property to a partnership (in which the Exchanger was a general partner) under the theory that there was a continuity of investment and the contribution was merely a change of form of ownership. Magneson v. C.I.R., 753 F2d 1490 (9th Cir 1985). Magneson may no longer be good law. See fuller discussion in Section 12.2.

2.3.2.3 Exchange followed by partnership liquidation. An exchange by a partnership failed when Replacement Properties were acquired individually by the partners. Tech Adv Mem 9818003 (Dec. 24, 1997).
2.3.3 **Trust transaction combined with exchange.**

2.3.3.1 Exchange followed by liquidation of trust. A like-kind exchange by a testamentary trust was approved even though the trust was scheduled to terminate shortly after the exchange because the trust beneficiaries had reached predetermined ages. Priv Ltr Rul 200521002. In Priv Ltr Rul 200651030 (Dec 22, 2006), the IRS approved an interesting scenario. First, the trust executing a purchase a sale agreement to sell real estate. The trust then liquidated into an LLC of the trust beneficiaries. The LLC was allowed to complete the exchange despite the fact that it held the property for sale pursuant to the purchase and sale agreement. This was allowed because the LLC was held to be functionally the equivalent and an extension of the prior trust.

2.3.3.2 Exchange followed by transfer to trust. Priv Ltr Rul 9110007 (Nov. 26, 1990) held that property received in an exchange could immediately be transferred to a living trust. The transfer was a mere change in the form of the investment. The ruling noted that living trusts are not treated as separate taxable entities.

2.3.4 **Gift transaction combined with exchange.**

2.3.4.1 Exchange followed by gift. An exchange followed by a gift nine months later was allowed by the tax court after it determined that there had been no prearranged plan to make the gift at the time of the exchange. Wagensen v. Commissioner, 74 TC 653 (1980).

2.3.4.2 No exchange when intended to gift. Exchange treatment was not allowed when the Exchanger acquired two houses as the Replacement Property. The Exchanger allowed her children to live in the houses rent-free for seven months. She eventually gave the houses to the children. The court found that there was a current intent to gift the houses to the children. Click v. C.I.R., 78 TC 225 (1982).

2.3.5 **Transfer to single-member LLC combined with exchange.**

2.3.5.1 Exchange followed by transfer to LLC. An exchange followed by a transfer to a single-member LLC (ignored by tax purposes) was approved in Priv Ltr Rul 2001-31014 (2001).
2.4 **Property Held for Sale.**

2.4.1 **Basic rule.** Section 1031 of the Internal Revenue Code provides that a tax-free exchange is not available for "stock in trade or other property held primarily for sale." IRC § 1031(a)(2)(A). The courts have struggled with the meaning of the term "primarily" in determining whether the property was "held primarily for sale." In George M. Bernard, 36 TCM (P-H) ¶ 67, 176 (1967), it was held that the term "primarily" meant "of first importance" or "principally." This view was also approved by the court in Land Dynamics, 47 TCM (P-H) ¶ 78, 259 (1978). See also Malat v. Riddell, 383 US 569, 86 S Ct 1030, 15 L Ed2d 102 (1966) (17 AFTR2d (P-H) ¶ 66-182, 66-1 USTC (CCH) ¶ 9317).

2.4.2 **Contrasted to capital assets.** A capital asset excludes "stock in trade" or "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." IRC § 1221(1). Some courts appear to have ignored in real estate cases the requirement that the property not be held for sale "to customers." Guardian Industries v. C.I.R., 97 TC 308, 317 n 2 (1991), aff'd, 1994 US App LEXIS 7242 (6th Cir 1994); William D. Little, 63 TCM (RIA) ¶ 93, 281 (1993). The language in Section 1031 is similar to, but not the same as, the Section 1221 provision defining a capital asset. A key distinction is that the definition of a capital asset requires that the property be held for sale to customers in the ordinary course of business, while this requirement is lacking in Section 1031. In Ethel Black, 35 TC 90 (1960), the Exchanger was denied exchange treatment with respect to a house that she had purchased, repaired, and sold. Because the taxpayer had at all times attempted to sell this property, it was "held primarily for sale." The tax court determined that it was not necessary for the court to decide whether the Exchanger was conducting a trade or business or holding the property for sale in the course of the taxpayer's trade or business. On the other hand, as previously mentioned, in the capital gains area some courts have ignored the "to customers" requirement. See Guardian Industries v. C.I.R., 97 TC 308, 317 n 2 (1991), aff'd, 1994 US App LEXIS 7242 (6th Cir 1994). Thus, it may be more difficult to show that property is not held primarily for sale in the exchange area because the IRS is not burdened with also showing that the property was held for sale in the course of the taxpayer's trade or business.

2.4.3 **When is intent measured?** One issue that courts have wrestled with in this area is the point at which the intent of the taxpayer is measured. It is fairly clear that that point is the date of the sale or exchange of the property. Pre- or post-exchange use of the property is not necessarily dispositive of the intent of the taxpayer on the date of the sale. In Stanley H. Klarkowski, 34 TCM (P-H) ¶ 65, 328 (1965), the Exchanger
held the replacement property for six years. The court found, however, that the Exchanger had acquired the property with the intention of reselling it and would not have held the property for six years if he had been successful in obtaining a zoning change. Certainly, the Exchanger's prior use of the property has evidentiary value. Guardian Industries v. C.I.R., 97 TC 308, 317 n 2 (1991), aff'd, 1994 US App LEXIS 7242 (6th Cir 1994). The Exchanger can change its intent. In Rev Rul 57-244, 1957-1 CB 247, the Exchanger had purchased property in order to construct residences. But the efforts were abandoned, and the Exchanger apparently continued to hold the property for investment purposes. Five years later, the exchange of the lots was held to be tax-free. See also Suburban Realty Co. v. United States, 615 F2d 171 (5th Cir 1980); Eline Realty Co. v. C.I.R., 35 TC 1, 5 (1960).

2.4.4 Factors in determining whether property is held for sale. Courts have been proficient in creating lists of factors to be considered in determining whether property is held for sale. Many courts enumerate seven or eight factors in making their determination, but these factors always seem to boil down to one of three tests, which are acknowledged as the most important factors previously mentioned. Biedenharn Realty Co. v. United States, 526 F2d 409 (5th Cir) (en banc), cert. denied, 429 US 819 (1976); Suburban Realty Co. v. United States, 615 F2d 171 (5th Cir), cert. denied, 449 US 920 (1980). Obviously, the courts look at all three factors and weigh them together in determining whether a property is held for sale. No particular factor can be viewed alone. The three factors are:

2.4.4.1 The frequency, number, and extent of the real estate transactions entered into by the Exchanger;

2.4.4.2 The development activity of the Exchanger, such as subdividing, grading, and making property improvements; and

2.4.4.3 The nature and extent of the efforts by the Exchanger to sell the property.

2.4.5 Sales history. Of primary importance in determining whether a particular property held by an Exchanger is held for sale is the nature, extent, and sales history of the taxpayer with respect to other properties that he owns. Unfortunately, there is no bright-line test as to how many sales over what period of time. But the cases do seem to sort themselves into a numbers game—the more property sales by the Exchanger, the likelier it is that the court will find that the property is held for sale.

2.4.5.1 Cases approving capital gains/exchange treatment.
2.4.5.1.1  **Byram v. United States**, 705 F2d 1418 (5th Cir 1983). In *Byram*, the taxpayer held raw land that was sold off during a three-year period. During this period, the taxpayer had 22 separate land sales. The Fifth Circuit held that such sales activities were not sufficient to treat the taxpayer as a dealer, and the taxpayer received capital gains treatment.

2.4.5.1.2  **Loren F. Paullus v. C.I.R.**, 70 TCM (RIA) ¶ 96, 419 (1996). In *Paullus*, a Section 1031 case, the Exchanger was in the golf course business. The court reasoned that this business occasionally included the holding and selling of real estate. During a 12-year period, the taxpayer had sold seven properties. The court allowed the transaction to be treated as a tax-free exchange.

2.4.5.1.3  **Charles R. Gangi**, 56 TCM (P-H) ¶ 87, 561 (1987). A very interesting case, and one with a surprising result, is *Charles R. Gangi*. In *Gangi*, the taxpayer owned a 36-unit apartment building that it had built. It held that property for eight years and then converted it into a condominium. The cost of converting the apartments into condominiums was about $30,000 in addition to other costs of sale of approximately $100,000. The taxpayer had a model unit staffed by a real estate agent and had sales brochures and other printed materials. It sold 26 units, and the taxpayer, which was a partnership, thereafter liquidated. All the units were eventually sold. The court held that the property would be treated as capital gains property because of the taxpayer's intent in actual holding of the property for a long period.

2.4.5.1.4  **Bramblett v. C.I.R.**, 960 F2d 526 (5th Cir 1992). Another case that approved capital gains treatment on a limited number of sales over a five-year period is *Bramblett v. C.I.R.* In *Bramblett*, there were only five sales over a three-year period. The taxpayer had made no improvements to the property, had hired no brokers, and had not maintained a sales office on the property. The court held that the sale was entitled to capital gains treatment.
2.4.5.2 Cases not approving capital gains/exchange treatment.

2.4.5.2.1 No one-bite rule. If the Exchanger had a clear intent to resell the property at the time that it was acquired, even if there is only one sale, the property does not qualify for a tax-free exchange. For example, in *S & H, Inc. v. C.I.R.*, 78 TC 234 (1982), the court held that there was no single-transaction exception to the rule that property held for sale cannot qualify for capital gains treatment. The court's decision was reaffirmed in *Morley v. C.I.R.*, 87 TC 1206 (1986). In Morley, the taxpayer purchased a 180-acre tract of land at the top of the real estate market. The real estate market fell, however, and the taxpayer was unable to sell the property and eventually lost it in a foreclosure. The court held that the property was not held for investment for purposes of the investment interest rules. IRC § 163(d).

2.4.5.2.2 *Suburban Realty Co. v. United States*, 615 F2d 171 (5th Cir 1980). Other taxpayers have pushed the envelope as to whether they are holding property primarily for sale. In *Suburban Realty Co.*, the taxpayer sold 240 lots over a 32-year period. The court held that the taxpayer was not entitled to capital gains treatment. Likewise, in *Biedenharn Realty Co. v. United States*, 526 F2d 409 (5th Cir) (en banc), cert. denied, 429 US 819 (1976), the taxpayer was denied capital gains treatments after having sold 1,000 lots in its trade or business, including 37 lots through brokers, in a three-year period. This taxpayer also obtained a subdivision map and added streets and utilities. The court did not have much trouble denying Biedenharn Realty Co. capital gains treatment.

2.4.5.2.3 *William D. Little*, 63 TCM (RIA) ¶ 93, 281 (1993). Another taxpayer pushing the envelope was the taxpayer in Little. From 1984 to 1986, the taxpayer had completed 163 purchases and 321 sales of property. In 1986, the year at issue, the taxpayer sold 31 properties and reported the gain as a capital gain. The court denied long-term capital gains treatment.
2.4.5.2.4  W. R. Royster, 54 TCM (P-H) ¶ 85, 258 (1985), aff'd on other issues, 820 F2d 1156 (11th Cir 1987). During a 19-year period, the taxpayer in W. R. Royster had more than 40 sales of both improved and unimproved property and was involved in the sale of or giving options with respect to 14 separate subdivision properties. In 1971, the taxpayer owned 100 different subdivision properties. The court held that the taxpayer was a dealer and engaged in the trade or business of selling real estate and thus was not entitled to capital gains treatment.

2.4.5.2.5  Neal T. Baker Enterprises, Inc. v. C.I.R., 1998 TCM (RIA) ¶ 98, 302 (Aug. 19, 1998). The Exchanger's tax returns indicated that his work was "Real Estate Subdivision and Development." The Exchanger acquired land and subdivided it into 62 lots. He built out 14 lots into single-family homes and sold them to separate purchasers. Then the Exchanger obtained consent from the local authorities to develop the remaining 48 lots into single-family homes. The Exchanger's attempt to exchange the 48 lots in a single transaction to a Buyer was disallowed by the tax court on the basis that the Relinquished Property was held for sale.

2.4.5.3  Relationship to Other Activities.

2.4.5.3.1  The mere fact that someone is a dealer with respect to other property that the dealer owns does not necessarily mean that other properties held by the taxpayer will not qualify for a tax-free exchange. Margolis v. C.I.R., 337 F2d 1001 (9th Cir 1964). In Oscar M. Fraley, 64 TCM (RIA) ¶ 93, 304 (1993), the taxpayer was a building contractor. He purchased a tract of land with an existing house and rented it for three years. He then moved the house off the property and continued to hold the property for an additional three years. The only sales activity with respect to the property was placing a build-to-suit sign on the property. Capital gains treatment was allowed.
2.4.5.3.2 Sometimes a taxpayer will attempt to use a separate corporation or other legal entity to separate the taxpayer's investment activities from the sales activities of affiliated entities. The taxpayer in William D. Little, 63 TCM (RIA) ¶ 93, 281 (1993), apparently attempted to not be treated as a dealer for capital gains purposes by organizing a wholly owned S corporation to enter into its dealer transactions. The taxpayer, however, intermingled his activities with those of the corporation. Further, the taxpayer had 31 sales of property in the year of the tax controversy. The court held that the taxpayer could not treat its gain as a long-term capital gain. In this instance, a separate corporation was not effectively used to differentiate the investment sales from dealer-type sales.

2.4.6 Development activities. The second most important factor that courts have traditionally looked at to determine whether property is held primarily for sale is the nature and extent of the taxpayer's development activities. Such activities include subdividing the property, adding streets, roads, and sewers, obtaining rezoning, and fixing up the property. In essence, the courts are looking to the extent that the gain of the sale was attributable to the taxpayer's own efforts as opposed to external factors.

2.4.6.1 Section 1237. Section 1237 of the Internal Revenue Code provides that mere subdivision of property will not prevent a property from receiving capital gains treatment. Section 1237 has four requirements. First, the property cannot previously have been held by the taxpayer primarily for sale to customers. Second, no other real property can be held by the taxpayer primarily for customers in the ordinary course of business in the year of the sale. Third, no substantial improvements can be made to the property. Fourth, the property must have been held by the taxpayer for five years. Because of its many restrictions, Section 1237 has limited utility for taxpayers. See James R. Hamill, Capital Gains for the Casual Subdivider: Can Section 1237 Be Used as a Safe Harbor in the Post-RRA 93 Environment?, 21 J Real Est Tax'n 253 (1994). Although Section 1237 is not directed to tax-free exchanges, there can be little doubt that courts would agree with the indicated congressional intent that the mere subdivision of real estate should not cause property to be treated as held primarily for sale and thus not qualified as Replacement or Relinquished Property in a tax-free exchange.
2.4.6.2 **Subdivision only.** In fact, the law probably was not changed by the 1993 passage of Section 1237. In *Buono v. C.I.R.*, 74 TC 187 (1980), the taxpayer acquired raw land, subdivided it, and sold the property in a bulk sale to a developer. The court held that the mere act of subdividing the property did not prevent the taxpayer from claiming capital gains treatment for the sale.

2.4.6.3 *Sanders v. United States,* 740 F2d 886 (11th Cir 1984). Substantial improvements to property make it very difficult for a taxpayer to be able to claim that the property was not held primarily for sale. The taxpayer in *Sanders* sold off farmland that the taxpayer had improved by subdividing it, paving the streets, and providing water and power to the property. In addition, the court determined that the taxpayer had had "frequent and substantial sales" of lots. The court found that capital gains treatment was not available to the taxpayer.

2.4.6.4 *Victor Harder,* 59 TCM (MM) ¶ 90,371 (1990). Likewise, the taxpayer in *Victor Harder* acquired 14 acres of land, subdivided it, installed gutters, curbs, streets, and sidewalks, and brought water and sewer to the property. Again, capital gains treatment was denied to the taxpayer. See also *Hyman Podell,* 55 TC 429 (1970).

2.4.6.5 *Ethel Black,* 35 TC 90 (1960). A very familiar scenario is when the Exchanger acquires property with the intention of fixing it up and selling it. Many individuals make a living buying old houses, refurbishing them, and eventually selling them. This was the case in *Ethel Black.* In *Black,* the taxpayer was denied exchange treatment with respect to a house that she had purchased, repaired, and sold. The court determined that the tax-free exchange treatment was not available because the Exchanger had at all times attempted to sell the property.


2.4.7 **Sales effort.** The third factor that courts have used to determine whether the taxpayer held real property primarily for sale relates to the sales efforts of the taxpayer, including advertising, use of sales personnel, use of a business office to handle sales efforts, and the extent of the taxpayer's involvement, time, effort, supervision, and control over the sales activities. Although the sales effort was a contributing factor, it does not appear that the sales effort was decisive in many of the cases. For example, in *W.R. Royster,* 54 TCM (P-H) ¶ 85,258 (1985), aff'd on other issues.
820 F2d 1156 (11th Cir 1987), the taxpayer maintained a real estate office and posted signs advertising the sales of lots. This, along with 40 sales of improved and unimproved properties by the taxpayer, was enough to have the taxpayer treated as a dealer. Likewise, in Victor Harder, 59 TCM (MM) ¶ 90,371 (1990), the taxpayer employed advertising to market lots and had full-time sales agents stationed at a sales office on the property. This fact, along with extensive development activities, resulted in ordinary income treatment for the taxpayer.

2.4.8 **Incidental property.** If property is fundamentally held by the Exchanger for investment, the fact that an incidental portion of the property may be held for sale is not determinative. For example, unharvested crops have been held not to be inventory as part of a tax-free exchange. Asjes v. C.I.R., 74 TC 1005 (1980). Unmined coal that was exchanged with the land that it was located on was also held not to be inventory held for sale and thus not qualified for tax-free exchange treatment. Butler Consolidated Coal Co. v. C.I.R., 6 TC 183 (1946). A contrary result was reached by the tax court with respect to unharvested oranges exchanged with the underlying real property in Verito v. C.I.R., 43 TC 429 (1965). The court determined that this was essentially an exchange of unharvested oranges and not an exchange of real property with an incidental inclusion of unharvested oranges.

2.5 **Unproductive Property.** Property can be treated as investment property even though it is not currently producing any income. Treas Reg § 1.1031(a)-1(b).

2.6 **Distressed Properties.** An Exchanger who owns properties that are financially distressed or in foreclosure may be able to take advantage of the provisions of IRC § 1031. Properties with no equity can be exchanged in a tax-free transaction.

**Example:** Exchanger owns Relinquished Property with a fair market value of $4 million. It has nonrecourse liabilities against it of $7 million, and the Exchanger's basis in the property is $5 million. If the property were deeded to the mortgagee, the Exchanger would have taxable income of $2 million because there are liabilities ($7 million) in excess of Exchanger's basis in the Relinquished Property ($5 million). Taxpayer can transfer the Relinquished Property to an Accommodator, who can surrender it to the mortgagee. The Exchanger can direct the Accommodator to purchase Replacement Property. The Replacement Property must have at least $7 million in debt against it to avoid boot income from relief of indebtedness. The problem with this method is that the Exchanger must have enough resources to purchase a property with at least $7 million in debt against it that will produce sufficient cash flow to service the debt, or the Replacement Property may be lost in its own taxable foreclosure.

Another problem: If the debt is recourse debt, the under secured portion of the debt will result in debt cancellation income. Rev Rul 90-16, 1990-1 CB 12.
Certainly, a sham transaction will not be recognized by the IRS. For example, if the Replacement Property purchased with a nonrecourse note and the face amount of the debt were increased over the property's fair market value to an amount greater than the debt on the Relinquished Property in order to avoid boot income, there is no doubt that the IRS would take the position that the debt on the Replacement Property did not exceed the fair market value of the Replacement Property.

2.7 **Trade or Business.**

2.7.1 **Definition of trade or business.** The regulations do not define what constitutes productive use in a trade or business. If property is to qualify as trade or business property, however, the Exchanger must be in a trade or business. For example, conversion of foreign currency into U.S. dollars by someone who is not in the business of being a foreign currency dealer is not a tax-free exchange because neither property was held by the Exchanger in his trade or business. Rev Rul 74-7, 1974-1 CB 198. The concept of trade or business has been held to include all uses of property essential to commerce. National Outdoor Advertising Bureau, Inc. v. C.I.R., 32 BTA 1025 (1935).

2.7.2 **Lack of intent.** An Exchanger was denied tax-free-exchange treatment on the exchange of two trucks because the court found that the trucks to be traded had not been depreciated. The failure to depreciate the trucks showed a lack of intent to hold the property in the Exchanger's trade or business. David B. Downing, 58 TCM (P-H) ¶ 89,447 (1989).

3. **LIKE-KIND REQUIREMENT**

An exchange is tax-free only if the Relinquished Property is exchanged for Replacement Property that is of "like kind." "Like kind" refers to the nature or character of the property and not to its grade or quality. Treas Reg § 1.1031(a)-1(b).

3.1 **Real Property.**

3.1.1 **General.** "The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale." Treas Reg § 1.1031(a)-1(b).

3.1.2 **State Law.** Whether property is treated as real property is generally controlled by state law. Oregon Lumber Company, 20 TC 192 (1953). However, if an interest in real property is actually only a right to future

### 3.1.3 Long-term leases.

#### 3.1.3.1 Thirty-year leases are of like kind to a fee interest in real estate. *Century Elec. Co. v. C.I.R.*, 192 F2d 155 (8th Cir 1951); Treas Reg § 1.1031(a)-1(c); Rev Rul 60-43, 1960-1 CB 687; Rev Rul 76-301, 1976-2 CB 241; Priv Ltr Rul 8304022 (Oct. 22, 1982). Leases of a shorter duration than 30 years are not of like kind to a fee interest in real estate. *Capri, Inc. v. C.I.R.*, 65 TC 162 (1975).

#### 3.1.3.2 In determining whether a lease is of a sufficient term that it is equivalent to a fee interest in real property, renewal options are considered to be exercised. Rev Rul 78-72, 1978-1 CB 258.

#### 3.1.3.3 Real property subject to a long-term lease (i.e., the lessor's reversionary interest) is still treated as real property and can be exchanged for other real property as part of a tax-free exchange. Rev Rul 76-301, 1976-2 CB 241; *Koch v. Commissioner*, 71 TC 54 (1978).

#### 3.1.3.4 Government ten-year renewable leases, which from a practicable point of view were of unlimited duration, were held eligible for exchange with realty. Priv Ltr Rul 9126007 (Mar. 27, 1991).

#### 3.1.3.5 A "carve out" of a lease interest will not be treated as a tax-free exchange. For example, if a fee owner of property exchanges a 30-year lease in the property for a fee interest in other real estate, the Replacement Property will be treated as prepaid rental income and the transaction will be fully taxable. Rev Rul 66-209, 1966-2 CB 299; Pembroke v. C.I.R., 23 BTA 1176 (1931), aff'd, 70 F2d 850 (DC Cir 1934).

### 3.1.4 Real estate contracts. A vendee's interest in a real estate contract is of like kind to a fee interest in real estate. *Starker v. United States*, 602 F2d 1341 (9th Cir 1979); *Biggs v. C.I.R.*, 69 TC 905 (1978), aff'd, 81-1 USTC (CCH) ¶ 9114 (5th Cir 1980). A vendor's interest in a real estate contract, however, is equivalent to a secured promissory note and cannot be the subject of a tax-free exchange. *Coupe v. Comm.*, 52 TC 394 (1969).

### 3.1.5 Standing Timber. Whether property interests are treated as real estate or personal property is determined by state law. *Aquilino v. United States*,
363 US 509, 80 S Ct 1277, 4 L Ed2d 1365 (1960). Under Oregon law, standing timber can be sold as real property or as a cutting contract. The applicable timber deed provisions are analyzed below:

3.1.5.1 **Obligation to sever.** Oregon state court cases turn on the obligation of the grantee to sever the timber. Where the terms of the contract require severance of the timber, the interest is in goods under the Uniform Sales Act or its successor the Uniform Commercial Code or simply defined as personalty. See, e.g., *Paullus v. Yarbrough*, 219 Or 611, 347 P2d 620 (1959). The *Paullus* court adopted the position that "growing trees . . . may be converted into 'goods' . . . not only when it is agreed that title shall pass after severance, but also when the contract is one of present sale; if such contract provides for severance." 219 Or at 629 (quoting Burdick on Sales 30 (3d ed)). However, where the contract is silent on severance, the Supreme Court has held the contract to be the sale of real property enforceable in equity. *Reid v. Kier*, 175 Or 192, 152 P2d 417 (1944). Thus for purposes of state law, the key to determining whether an interest in timber is one of property or personalty is whether the terms of the contract require severance.

The United States Tax Court considered a contract in which land was exchanged for an equal value of timber. *Oregon Lumber Company*, 20 TC 192 (1953). The contract read that the United States agreed to exchange the described property and the taxpayer "agree[d] to cut and remove, an equal value in National Forest timber" from a designated area. The court concluded that the agreement was for an exchange of the taxpayer's land for the right to cut and remove standing timber within a prescribed period of time. Interpreting Oregon law, the court found that where the exchange of land for timber to be removed within a definite time was a contract in goods and not realty.

The Oregon Tax Court took the analogy one step further. In *Shull v. State Tax Commission*, 1 OTR 445 (1963), the court held that even where the contract was silent on removal and the period in which the transfer can be removed is a relatively short 2-1/2 years, the right to remove timber is personalty, not an interest in real property. The court reasoned that the "practical realities" of the contract require the person receiving the timber right to sever the timber in order to realize his investment. The court found the rule in *Paullus* to be "mechanistic" and looked beyond the form of the contract to the substance of the transaction. Thus the court compared the rights to be exchanged and found that timber rights
which required "active business operations in order to earn any income" were not of like kind with a property right and therefore the exchange was not like-kind for tax exempt purposes.

In a 1995 Private letter ruling, the IRS considered a similar agreement whereby taxpayers exchanged standing timber for three tracts of timberland. Priv Ltr Rul 9525002 (Feb. 23, 1995). However, unlike the agreement in Shull, the interest here was conveyed by timber deed. The deed conveyed the right to remove any timber lying or standing on the designated property for a period of two years. The IRS determined that the timber deed was an interest in personal property because the transferee received a limited right in the timber, that is, the two year duration "amounted to a de facto restriction on the number of trees that could be removed."

3.1.5.2 Term of agreement. The term of the agreement also appears to be a consideration for courts in the characterization of timber rights. Oregon courts have adopted the position that "where the trees are sold in the prospect of separation from the soil immediately or within a reasonable time" the timber is considered a sale of goods. See, e.g., Reid, 175 Or at 205 (quoting Goodnough Mercantile & Stock Co. v. Galloway, 171 F 940, 951 (D Or 1909)). The contracts considered by the courts in the above cases vary in length of the agreement. For instance, in the Reid case, the agreement permitted logging on the land for an approximate three year period. The court found that the time frame did not result in a requirement of "immediate" separation and thus did not transform the timber into goods under the Uniform Sales Act.

At the other extreme, the U.S. Tax Court considered three exchanges in Oregon Lumber, ranging in duration from less than one year to 19 years, and the court found all three to be "reasonable," Because the time limits were "reasonable" the court found that the transaction was one involving the exchange of land for standing timber to be removed within "a definite time" and thus was a transfer of goods rather than realty. It is important to note that all three exchanges in Oregon Lumber required that the timber be severed.

The Oregon tax court gave the length of the agreement more direct scrutiny in Shull v. State Tax Commission, 1 OTR 445 (1963). In making its presumption that the person receiving the timber right will have to sever promptly even in the absence of contractual
language requiring severance, the court noted that the timber right at issue in the case was of "such short duration," or two and one-half years. Thus there is some indication that the court might consider a long-term timber right to be real property right because the need to sever promptly in order to recognize value from the transaction would be alleviated.

3.1.5.3 Price based on volume at point of severance. Determining the price of the timber at the point of severance creates a risk that the timber right will be interpreted as a sale of goods or personalty. Although the Oregon Supreme Court reaffirmed the principle that a sale of standing timber was an interest in real property in Anderson v. Moothart, 198 Or 354, 256 P2d 257 (1953), the court nonetheless found an agreement in which the purchasers were given the right to the growing timber to be paid by volume at the time it was removed from the land to be an interest in personalty. The court reasoned that the timber was not sold as it was standing, but only when it was severed from the property. Thus the interest was held to be in personal property and the agreement was not enforceable as a real property interest.

3.1.5.4 Marking specific trees. Both the Paullus and the Oregon Lumber Company cases involved timber contracts where some of the timber rights were determined by marking specific trees, and in both cases, the courts found that the agreements were interests in personal property. In Paullus, the rights were in "pole timber" and all of the standing "merchantable red fir and white fir timber." The court reasoned that the designation of timber was a means by which the owner of the underlying property could protect young crops for future harvest. This reasoning is consistent with the court's determination that the contract was one for personal property, rather than real property. The outcome of the case turned on the contract language which required severance, therefore the marking of timber is not determinative in the case, but the court's reasoning seems to suggest that the marking of timber is indicative of retention of interest in the property right.

Similarly, the Oregon Lumber Company case did not turn on the issue of marked timber versus an unlimited right in the standing timber, but here again the court concluded that the contract involved goods rather than realty. The contract provided for an exchange of a specified volume of timber which was of an equivalent value to the appraised value of the property exchanged.
Like in *Paulus*, the marking of timber did not determine the court's holding, but because the court took a substance over form approach, it could certainly contribute to the conclusion that the right exchanged was in goods rather than property.

By analogy, the grant of an undivided interest in a percentage of timber attached to specified property may also indicate a personal property, rather than real property interest. Particularly in an arrangement whereby the grantor retains control to choose which timber is to be cut, the arrangement is a mechanism by which the owner of the underlying property retains control. In fact, the only real difference between marking trees before transfer and granting an interest in a percentage of standing timber is one of timing. However, the courts have not directly considered this issue.

3.1.5.5  **Suggested structure.** It must be recognized that there are no cases approving an exchange of a timber deed (no matter what the terms) for a fee interest in property. Caution therefore must be exercised. But the absence of cases does not mean it cannot work. A timber deed must be structured so that it is not a cutting contract. If so structured, the property should be treated as real property under Oregon law. For a timber deed to be treated as real property, the timber deed must not obligate the party receiving the timber deed to remove any timber from the property. Second, the value of the timber deed should be determined before severance to avoid the conclusion that the timber is purchased only after severance and transformation and transformed into personal property. Third, although arguably not determinative, it would be prudent not to mark particular trees to be conveyed by the timber deed. Finally, the period during which the trees can be harvested should clearly exceed two or two and a half years. The longer the better. Perhaps ten years or longer would be prudent.

3.1.6  **Conservation easement; Development Rights.** An agricultural conservation easement was held to be of like kind to real estate. Priv Ltr Rul 9215049 (Jan. 15, 1992); Priv Ltr Rul 9851039 (Sept. 15, 1998), Priv Ltr Rul 200201007 (Oct. 2, 2001); Priv Ltr Rul 200649028 (_______, 2006). Note that often an exchange may not be required as current law allows the proceeds from the sale of an easement to be applied to the basis of the land prior to recognizing gain. See McKee, *Income Tax Consequences of Dispositions of Development Rights in Property*, Dec. 2002 J of Tax'n. Development rights can be exchanged for a fee interest in real estate. Priv Ltr Rul 200805012.
3.1.7 **Scenic easement.** A scenic easement that was realty under local law can be exchanged for other real estate. Priv Ltr Rul 9621012 (Feb. 16, 1996).

3.1.8 **Riparian rights.** Water rights that are held to be real estate under state law are of like kind to a fee interest in realty. Rev Rul 55-749, 1955-2 CB 295. But water rights limited in duration (50 years) are not like kind to real property. Wiechens v. U.S., (9th Cir 2002).

3.1.9 **Mineral rights.** Mineral rights that are real estate under state law were held to be of like kind to a fee interest in realty. C.I.R. v. Crichton, 122 F2d 181 (5th Cir 1941).

3.1.10 **Outdoor advertising signs.** Outdoor advertising signs that are elected to be treated as real property under Section 1033(g)(3) were treated as like kind to other real property. Priv Ltr Rul 200041027 (July 19, 2000).

3.1.11 **Option.** It appears that an option to purchase real estate is not like kind to real estate. But, Field Service Advice 1995-12 (May 30, 1995) ruled that an option is like kind to other real estate, while disallowing the exchange for other reasons. The Service cited Koch v. Commissioner, 71 TC 54 (1978), which examined whether the Exchanger's money was "still tied up in real property of the same class or character as they owned before the exchange." 71 TC at 66.

3.1.12 **Earnest Money Agreement.** There are several cases which support the holding that a contract with rights to purchase real property does qualify as like-kind to real estate for the purpose of an IRC § 1031 like-kind exchange. In Starker v. U.S., 44 AFTR 2d 79-5525, the Ninth Circuit held that such an arrangement qualified for an IRC § 1031 treatment. In Starker, the taxpayer transferred real property to a corporation in exchange for the corporation's contractual agreement to provide the taxpayer with "suitable" real property to be designated by the taxpayer. The Court stated that the contractual right to receive like-kind property should not be treated any different from the ownerships rights of real property themselves.

In Biggs v. Comm., 47 AFTR 2d 81-484, the taxpayer and his wife assigned their contractual right to acquire real property to the other party and the other party sold and assigned their right to acquire real property to a corporation. Based on those facts, the Court held that the situation was similar to Starker and that the analysis the Court used in Starker regarding the title versus right-to-purchase problem was consistent with their own analysis in determining that the exchange of a contract right to purchase real property for real property does qualify for an IRC § 1031 exchange when properly structured.
In *Brauer v. Comm.*, 74 TC 1134, following *Biggs*, the Tax Court held that where the taxpayer transferred his property to the purchaser in exchange for the latter's contractual right to buy the exchange property and for cash in the form of checks which by prearrangement taxpayer endorsed over to an escrow agent which paid the owner of the exchange property the purchase price called for under the sales contract.

3.1.13 **Remainder interest.** A remainder interest in realty was held to be of like kind to a fee interest in realty. Priv Ltr Rul 9143053 (July 30, 1991).

3.1.14 **Cooperatives.** Cooperatives generally qualify as real estate. Priv Ltr Rul 200631012 (August 4, 2006); Priv Ltr Rul 200137032 (June 15, 2001). If the interest in the cooperative is deemed real estate under local law (California), it can be converted tax-free into condominium units. Priv Ltr Rul 8445010 (July 30, 1984). If the interest is not deemed to be real estate under local law (New York), then it cannot be converted tax-free. Rev Rul 66-40, 1966-1 CB 227.

3.1.15 **Foreign property.** Property located outside the United States is not of like kind to property within the United States. Treas Reg § 1.1031(h).

3.1.15.1 Priv Ltr Rul 9038030 (June 25, 1990) provides that the Virgin Islands are property within the United States for purposes of this rule. See also Priv Ltr Rul 200040017 (Oct. 10, 2000). The requirements of IRC § 932(a) must also be met.

3.1.15.2 Foreign property, however, is of like kind to other foreign property and can be the subject of an exchange.

3.1.15.3 Personal property looks to the location of predominant use in determining whether it is foreign or domestic personal property. See Priv Ltr Rul 200602034 which held that intangible personal property was also subject to the rule.§

3.1.16 **Partition.** A partition has been held to be a tax-free exchange whereby a co-owner exchanges an undivided interest in the whole property for an exclusive fee interest in a portion of the property. Rev Rul 73-476, 1973-2 CB 300; Priv Ltr Rul 8933019 (May 19, 1989).

3.1.17 **Co-owners.** Co-owners in real estate can exchange their interests with each other whereby a co-owner exchanges an undivided interest in the whole property for an exclusive fee interest in a portion of the property. Rev Rul 79-44, 1979-1 CB 265; Rev Rul 73-476, 1973-2 CB 300. A one-sixth interest in 16 parcels for the remaining balance of three properties was approved. Priv Ltr Rul 9609016 (Nov. 22, 1995).
3.2 **Personal Property.** Depreciable tangible personal business property can be exchanged only for property of like kind. Property is deemed to be of like kind if it is in the same Product Class or General Asset Class. Treas Reg § 1.1031(a)-2. See generally Gwendolyn Griffith, Section 1031 Exchanges of Personal Property and Multiple Assets, 47 Tax Law 53 (1993).

3.2.1 **General Asset Class.** The General Asset Classes are as follows:

- 3.2.1.1 Office furniture, fixtures, and equipment;
- 3.2.1.2 Information systems (computers, etc.);
- 3.2.1.3 Airplanes, provided that they are not used commercially;
- 3.2.1.4 Automobiles, including taxis;
- 3.2.1.5 Buses;
- 3.2.1.6 Light general-purpose trucks;
- 3.2.1.7 Heavy general-purpose trucks;
- 3.2.1.8 Railroad cars and locomotives;
- 3.2.1.9 Tractor units; and
- 3.2.1.10 Trailers and trailer-mounted containers.

3.2.2 **Product Class.** Product Classes are from Division D of the Standard Industrial Classification Manual (1987) (SIC Manual). These are four-digit codes. Any Product Class ending in "9" (a miscellaneous category) is not considered property within a Product Class. In Field Service Advisory 199941005, the Service held that the Exchanger could not simply exchange equipment for equipment unless it was of a like kind, but must use the SIC code classifications. The Service also noted that assets listed in more than one SIC code could be treated by the Exchanger as being of a like kind to assets in any one of the SIC codes, whichever is most beneficial to the Exchanger. OSHA has a Web site that provides for an easy search of SIC codes: [http://www.osha.gov/oshstats/sicser.html](http://www.osha.gov/oshstats/sicser.html).

3.2.3 **Intangible personal property.** No classes are provided for intangible personal property. Such property may be exchanged only if it is of like kind. Goodwill of two different businesses may never be of like kind. Treas Reg § 1.1031(a)-2(c)(2). For example, FAA 20074401F held that subscriber and advertising accounts and masthead of two different newspapers were goodwill and could not be exchanged tax free. However, Newark Morning Ledger Co., 507 US 546 (1993), in a
depreciation case, held that newspaper subscriber lists were not goodwill. Mitigation credits for restoring wetlands have been held to be like-kind to other mitigation credits. Priv Ltr Rul 9612009 (Dec. 18, 1995). Priv Ltr Rul 200602034 provided a very strict test to allow exchanges of patents, trademarks, trade names and similar intangible personal property requiring not only that the nature of the properties exchanged must be like-kind (patent for a patent), but that the underlying property must also be like kind (steel manufacturing blast furnace patent for a steel manufacturing blast furnace patent). The ruling is so narrow as to make it almost impossible to complete a tax-free exchange of such property.

3.2.4 **Nondepreciable personal property.** No classes are provided for nondepreciable personal property. Such property may be exchanged only if it is of like kind.

3.2.5 **Multi-Asset exchanges.** In an exchange of multiple properties, the properties are divided into exchange groups consisting of all Relinquished Property or Replacement Property that is either of like kind or in a like class (same General Asset Class or Product Class). Once separated, the normal exchange rules apply. See Treas Reg § 1.1031(j)-1; Williams v. McGowan, 152 F2d 570 (2d Cir 1945); Rev Rul 55-79, 1955-1 CB 370.

3.2.6 **Livestock.** For some reason, livestock of different sexes cannot be of like kind. Treas Reg § 1.1031(e)-1.

3.2.7 **Coins.** An exchange of coins of different countries was held to qualify for tax-free treatment. Rev Rul 76-214, 1976-1 CB 218. Yet, an exchange of a rare coin for a coin whose only value was its gold content was taxable because the two coins were not of like kind. Rev Rul 79-143, 1979-1 CB 264. In addition, an exchange of a rare coin for coins that were circulating funds was taxable. Federal Life Insurance Co., 76 TC 8 (1981).

3.2.8 **Communication Licenses.** An exchange of a television license for a radio license was approved in Tech Adv Mem 200035005 (May 11, 2000). The Service stated that whether the two licenses are like kind depends on the nature and character of the underlying property. The Service reasoned that each license was issued by the FCC to confer a right to use a portion of the electronic spectrum, regardless of whether the spectrum was ultimately used to transmit radio or television signals.

3.3 **Sale or Purchase of Real Estate Versus Business Assets.** Generally, Exchangers want to exchange real estate for real estate. Therefore, when selling real estate as part of a business sale, they want to allocate as much of the purchase price to the real estate as is possible. There are two fundamentally different types of situations in which this issue is important:
3.3.1 **Real estate that is also a business.** Certain types of real estate essentially constitute a business in and of itself. Examples of these are:

- Shopping Center
- Motel/Hotel
- Quarry
- Golf Course

In these types of transactions, it is easy to separate the real property from the tangible personal property, such as the furniture and bedding used in a motel. It is very difficult, however, to separate the real estate from its goodwill, including the value of the name, telephone number, and work force in place.

3.3.1.1 **Separating goodwill.** It is probably not necessary to allocate goodwill from real estate of this nature. Pursuant to IRC § 197, goodwill can be amortized over a period of 15 years. When Congress passed IRC § 197, it was concerned that taxpayers would attempt to divide goodwill from its associated real estate and amortize the goodwill over a very short 15-year period versus the much longer depreciation periods available for real estate. The regulations provide that for tax purposes, goodwill is not a separate asset from real estate:

3.3.1.1.1 "Section 197 intangibles do not include any interest in land. For this purpose, an interest in land includes a fee interest, life estate, remainder, easement, mineral right, timber right, grazing right, riparian right, air right, zoning variance, and any other similar right, such as a farm allotment, quota for farm commodities, or a crop acreage base." Prop Treas Reg § 1.197-2(c)(3).

3.3.1.1.2 Section 197 assets also do not include the value of leases. For example, purchasing a shopping center does not include a separate allocation for the value of the leases, even if the value of the real estate is increased because of the existence of a favorable lease. Prop Treas Reg § 1.197-2(c)(8).

3.3.1.2 **Larry L. Beeler v. C.I.R., 71 TCM (RIA) ¶ 97,073 (1997).** In Beeler, the IRS argued that the Exchanger had sold not only a mine used to quarry sand, but also business-operating permits, goodwill, and the going-concern value of the sand mine. The Exchanger eventually exchanged the sand mine for other property, and the IRS attacked the transaction. The court did
not agree with the IRS's argument because the Exchanger convinced the court that it had purchased the property not as a sand mine, but as a future site for a garbage dump. There is thus some inference that if the Exchanger could not have prevailed on this issue, the IRS might have been successful with its argument.

3.3.2 **Real estate sold with a business.** A much different problem is raised when real estate is a mere component of a business. In this situation, the real estate must be separately valued, including any goodwill component of the real estate. If possible, the allocation should be included in the purchase and sale agreement. The allocation of the value of each component of a business will be controlled by the provisions of IRC § 1060.

4. **EXCHANGE REQUIREMENT**

Section 1031 applies only to transactions in which the Relinquished Property and the Replacement Property are exchanged.

4.1 **Exchange Defined.** The regulations define "exchange" as follows: "Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only." Treas Reg § 1.1002-1(d).

4.2 **Sale Versus Exchange.** A sale followed (even immediately) by a separate purchase will be treated as a taxable sale. In Carlton v. United States, 385 F2d 238 (5th Cir 1967), the Exchanger sold the Relinquished Property and was assigned the right to purchase the Replacement Property by the Seller. The purchase of the Replacement Property was completed by the Exchanger. Although the Exchanger used the sale proceeds to purchase the Replacement Property, tax-free exchange status was not allowed. But see Allegheny County Auto Mart, Inc., 12 TCM 427 (1953), which held that a sale of Relinquished Property followed by the purchase of Replacement Property with the same party would be treated as a tax-free exchange.

4.3 **Trade-In Transactions.** Many trade-ins are not "structured" at all. The Exchanger merely transfers the Relinquished Property to a dealer as a sale and executes a separate contract to acquire Replacement Property. Despite the lack of "paperwork," such transactions have been treated as exchanges. Redwing Carriers, Inc. v. Tomlinson, 399 F2d 652 (5th Cir 1968); Rev Rul 61-119, 1961-1 CB 395.

4.4 **Change in Identity of Exchange Parties.** In general, if the Exchanger enters into an exchange with another party, there can be no change in the identity of either party during the exchange. In a deferred exchange, the identity of both
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Parties should ordinarily be the same during the First and Second Legs of an exchange. For example, in Tech Adv Mem 9818003 (Dec. 24, 1997), the IRS disallowed an exchange as not being reciprocal, as required by Treas Reg § 1.1031(d)-1 in a case in which a partnership sold the Relinquished Property and individual partners purchased separate Replacement Property. If a majority of the individual partners had purchased the same Replacement Property, it could be argued that the partnership continued in the name of the remaining partners. See Tech Adv Mem 199907029 (Sept. 30, 1998). This issue has been more extensively litigated in Section 1033 cases. See Feinberg v. C.I.R., 377 F2d 21 (8th Cir 1967) (Relinquished Property sold by corporation and Replacement Property purchased by shareholders); Fuchs v. Commissioner, 80 TC 506 (1983) (Relinquished Property sold by partnership and Replacement Property acquired by a partner); J. Carl Hill, 66 TC 701 (1976) (Relinquished Property sold by corporation and Replacement Property purchased by shareholders); Rev Rul 73-72, 1973-1 CB 368 (Relinquished Property sold by corporation and Replacement Property acquired by shareholder). Issues and exceptions are explored below:

4.4.1 **Corporate merger.** If the Exchanger corporation completes the First Leg of an exchange and thereafter merges out of existence in a tax-free reorganization, it appears that the acquiring corporation can complete the exchange. Tax Management 1991-79. See also Priv Ltr Rul 9800001 (Aug. 31, 1998) which discusses a merger shortly following receipt of the Replacement Property by the Exchanger. See also Priv Ltr Rul 2001-51017 (Sept. 17, 2001) and Priv Ltr Rul 9751012.

4.4.2 **Death.** If the Exchanger dies after completing the First Leg of a tax-free exchange, the Second Leg can be completed by his estate. See Priv Ltr Rul 9829025 (July 17, 1998). This conclusion is also based on court decisions under IRC § 1033, relating to condemnations. In re Goodman's Estate, 199 F2d 895 (3d Cir 1952); Estate of John E. Morris v. C.I.R., 55 TC 636 (1971), nonacq., 1978-2 CB 4, aff'd per curiam, 454 F2d 208 (4th Cir 1972). Priv Ltr Rul 9829025 (July 17, 1998) approved a community property revocable living trust completing the Second Leg of an exchange following the death of one of two grantors. The Replacement Property was treated as being entitled to a basis adjustment under IRC §§ 1014(a) and 1014(b)(6). The ruling also held that the Replacement Property was not income with respect to a decedent under Section 691 to the surviving spouse.

4.4.3 **General partnership into limited partnership.** An exchange was held tax free when a general partnership sold the Relinquished Property, Partnership, and a limited partnership that succeeded to all the assets and liabilities and that was by the same partners acquired the Replacement Property. Priv Ltr Rul 199935065 (May 28, 1999).
4.4.4 Partnership Technical Termination. The IRS has held that a technical termination of a partnership into a new partnership immediately following an exchange did not effect its tax-free treatment. Priv. Ltr. Rul. 200812012.

4.4.5 Living trust. A typical revocable living trust that many Exchangers use as part of their estate planning is ignored as a separate entity for tax purposes. A revocable living trust is characterized by the power of the grantor/Exchanger to revoke the trust at any time prior to death. The grantor/Exchanger is also the sole beneficiary of the trust and is often the trustee. This type of trust is known as a grantor trust. Based on the general principles of Helvering v. Clifford, 309 US 331, 60 S Ct 554, 84 L Ed 788 (1940), a person may be treated as the owner of property for taxation purposes if he has transferred it formally to someone else, but retained effective ownership for himself. IRC § 671 provides that when the grantor of a trust has retained certain rights with respect to the trust, such as the right of revocation, then "the grantor . . . shall be treated as the owner of [that] portion of [the] trust." Priv Ltr Rul 8234048 (May 25, 1982) ruled that an exchange in which the Relinquished Property was owned by the Exchanger and Replacement Property was acquired by the Exchanger's living trust was tax free. See also Rev Rul 2004-86, 2004-33 IRB 191, which held that an ownership interest in a grantor trust would be treated for Section 1031 purposes as if the trust beneficiary owned the trust property.

4.4.6 Addition of spouse. Under many circumstances, it is possible for one spouse to own the Relinquished Property and end up acquiring the Replacement Property with his spouse.

4.4.6.1 The portion of the exchange proceeds used to purchase the spouse's portion of the Replacement Property might be considered to be boot. In addition, if the Exchanger identified the entire Replacement Property, he might not have met the requirements under the deferred exchange rules that he actually receive the identified property since he identified the entire property and received only half of it.

4.4.6.2 Alternative approaches might include:

4.4.6.2.1 Having the spouse not acquire title to the property. If the financial institution providing the acquisition loan wants the spouse to be obligated under the loan, the spouse can guarantee the loan or sign the note, but not the trust deed.
4.4.6.2.2 Having the spouse acquire an undivided 1 percent interest in the property with the spouse’s separate funds. Then the spouse can sign the note and trust deed.

4.4.6.2.3 Having both spouses take title to the Replacement Property and following closing transfer the property to the Exchanger spouse. The argument is that the Replacement Property was held by the spouse only for a day to facilitate closing and that the true intent of the transaction was for the Exchanger spouse to hold the Replacement Property following closing.

4.4.7 **Single-member limited liability company.** The Relinquished Property can be sold by the Exchanger and the Replacement Property can be acquired by a limited liability company in which the Exchanger is the sole member. A limited liability company with only a single member is disregarded and is not considered to be a separate entity for tax purposes. Therefore, the existence of the limited liability company must be ignored for tax purposes. Treas Reg § 301.7701-3(b)(1). See also Priv Ltr Rul 9751012 (Dec. 19, 1997), 9807013 (Feb. 13, 1998), 9850001 (Aug. 31, 1998), Priv Ltr Rul 20011823 (Jan. 31, 2001).

4.4.7.1 Exchanger acquired all of the interests in a limited partnership and was treated as having acquired the property owned by the partnership. Priv Ltr Rul 200807005; Rev Rul 99-6, 1999-1 CB 432.

4.4.7.2 The Exchanger can complete an exchange by causing a limited liability Exchanger owns to sell Relinquished Property and causing another limited liability Exchanger owns to acquire the Replacement Property. Priv Ltr Rul 200732012.

4.4.8 **Multi-member limited liability company.** In general, a multi-member limited liability company will be treated as a partnership under the "check-the-box" regulations.

4.4.8.1 The IRS has held, however, that a multi-member limited liability company will be treated as qualified to receive Replacement Property if the limited liability company was created as a "bankruptcy-remote entity" and the other member was affiliated with the financing available to the entity and the member was in place as a member only for purposes of obtaining the financing. See Priv Ltr Rul 199911033 (Mar. 22, 1999). This result was obtained under the theory that the member who was affiliated with the limited liability company's
financing source was ignored and thus the entity, for tax purposes, was treated as a single-member limited liability company.

4.4.8.2 Rev Proc 2002-69, 2002-44 IRB 1 (Oct. 9, 2002) provides that a limited liability company (or any other entity that is not treated as a corporation) that is owned by husband and wife as community property will be treated by the IRS as a disregarded entity for tax purposes. Thus, the husband and wife can acquire the property as replacement property through a limited liability company even if they owned the relinquished property in their individual names. No income tax return needs to be filed by them as the limited liability company is ignored for income tax purposes. The law must be carefully reviewed to determine whether the interest in the limited liability company is community property. For example, if an Illinois couple purchased property in California, would it be community property if held in an Illinois limited liability company? What if a California limited liability company was used? What if the couple used to live in Washington and used proceeds from the sale of Washington community property to purchase the California property?

4.4.9 **Change in Accommodator.** It is unclear whether the identity of an Accommodator can change between the First and Second Legs of an exchange. Curiously, the regulations under Section 1031 provide that in a deferred exchange, the right of the Exchanger to terminate the Accommodator under state law will not prevent the exchange from qualifying under the safe-harbor rules. Treas Reg § 1.1031(k)-1(g)(4)(vi). Does this imply that a change in Accommodators between the legs of an exchange will not invalidate the exchange?

4.4.10 **Multiple property exchange transactions.** The IRS has on occasion approved computer matching of Relinquished Property and Replacement Property in industries such as automobile rentals. Priv Ltr Rul 200109022 (Nov. 19, 2001).

4.5 **Two Exchanges or One?**

4.5.1 **Will the sale of Blackacre and Whiteacre be treated as a single exchange transaction or two?** If the transactions are treated as two exchanges, there are many significant differences in the tax treatment of the transactions. A discussion follows:
4.5.2 **Why does it matter?**

4.5.2.1 **Identification requirement.** If treated as two sales, the Exchanger can make his 45-day designation and use the three-property rule whereby he can identify three possible replacement properties. Thus, the Exchanger can select three properties for Blackacre and three properties for Whiteacre or use the 200 percent test for each property. An additional wrinkle is that if the transaction is treated as two sales, and the Exchanger wants to use proceeds from both sales to purchase the Replacement Property, the Exchanger would identify an undivided 50 percent interest (or other appropriate percentage) in the potential Replacement Property with respect to the sale of Blackacre, and an undivided 50 percent interest in the potential Replacement Property with respect to the sale of Whiteacre.

4.5.2.2 **Receipt requirement.** If treated as two sales, and the Exchanger identified a particular Replacement Property and eventually acquired it, he may have violated the receipt requirement. The violation may have occurred because he identified a particular Replacement Property, but used the proceeds from the sale of Blackacre to purchase one-half of it, and the proceeds from the sale of Whiteacre to purchase the other half. He therefore did not acquire what he identified because he identified the entire Replacement Property, but acquired only half of it.

4.5.2.3 **Boot rules.** Assume that the potential or realized gain on the sale of Blackacre is $1 million and that the potential or realized gain on the sale of Whiteacre is $50,000. Further assume that in the exchange, the Exchanger took out $150,000 in cash boot. If structured as two exchanges, the $150,000 in cash boot can be allocated to the exchange of Whiteacre. Thus, the Exchanger would have only $50,000 of gain because boot is taxable only to the lesser of the boot received or the gain realized. If taxed as a single transaction, the Exchanger would have $150,000 of taxable boot because the combined gain realized on both transactions would be $550,000, which would cause all the boot to be taxable.

4.5.2.4 **Exchange-installment sale combinations.** This is really a variation of the boot rules discussed above. Assume that Whiteacre and Blackacre are each worth $1 million and that each has a basis of $400,000. Assume that they are sold for a $1 million note and $1 million in Replacement Property. If structured as two sales with the $1 million note allocated to one
of the sales, the gain on the note will be $600,000. If treated as a single exchange, the gain on the note will be $1 million because the note would be treated as boot in an exchange and no basis could be allocated to it.

4.5.2.5 **G6 rules.** The G6 rules (from Treas Reg § 1.1031(k)-1(g)(6)) provide that an Exchanger cannot withdraw funds from an Accommodator until after the Identification Period, if no Replacement Property is identified, after receipt of all identified Replacement Property, or after the end of the Exchange Period. These periods will vary if the Exchanger believes he has two exchanges with two Relinquished Properties and the IRS ultimately determines that the transaction will be treated as a single exchange.

4.5.3 **What factors determine whether the transaction is treated as a single exchange or as two exchanges?**

4.5.3.1 **Documentation.** The transactions should be documented as two exchanges. It is much more likely that a transaction will be treated as two sales, and thus two exchanges, if it is documented as two sales with two separate sales agreements. At least two commentators have suggested that separate like-kind exchanges be documented by and as separate transactions. Robert L. Whitmire, *Planning Tax-Deferred Property Transactions* § 5.05[5] (1995); Terence Floyd Cuff, *Tax-Free Real Estate Transactions*, 24 J Real Est Tax'n 216 (1997). It would also be helpful if the two sales agreements are not entered into as of the same date. It also is better if the two sales transactions do not have as conditions of closing the sale of the other property. It also matters whether the transactions were negotiated as two separate transactions or as a single transaction. Unfortunately, there are very few legal precedents as to whether treatment as two separate sales will be respected:

4.5.3.1.1 The allocation was approved in Rev Rul 68-13, 1968-1 CB 195, because the allocation of a down payment to a particular asset was stated in the contract of sale and resulted from bona fide negotiations.

4.5.3.1.2 In *Paul Serdar*, 55 TCM (P-H) ¶ 86,504 (1986), the tax court contemplated whether the transfer of two parcels of land should be considered one or two transactions under the old 30 percent down payment rule for installment sales. The court held that the...
sales should be treated separately because they were negotiated as two different transactions.

4.5.3.1.3 In Sayre v. United States, 1 AFTR2d (P-H) ¶ 58-805, at 2035 (SD W Va 1958), the Exchanger transferred farmland and a house for cash and farmland. Although the Exchanger matched the cash for the house and the farmland for the farmland, the court rejected the allocation approach.

4.5.3.1.4 In Joe Kelly Butler, Inc. v. C.I.R., 87 TC 734 (1986), the court ruled that it was one bulk sale of assets because a single agreement covered all the assets.

4.5.3.1.5 Master Exchange Agreement. The IRS has approved "master exchange agreements" in which a single contract created procedures whereby separate, multiple like-kind exchanges were recognized by the IRS. Priv Ltr Rul 9447008 (Nov. 25, 1994); Priv Ltr Rul 9627014 (July 5, 1996); Priv Ltr Rul 9812013 (Dec. 12, 1997); Priv Ltr Rul 9826003 (Mar. 27, 1998). In the first two letter rulings, the taxpayer transferred its rights in rental vehicles to a bank trust department, which acted as an intermediary. The vehicles were transferred to the bank in separate exchange groups and then sold by the bank. Most of the vehicles were subject to repurchase agreements, under which the manufacturer bought back the vehicle for a minimum amount. The manufacturer also supplied the Replacement Properties, which were of a like kind to the relinquished exchange group. Thus, vehicles that constituted one or more exchange groups were often repurchased by a single manufacturer, which in turn supplied the replacement vehicles. The taxpayer sought a ruling that:

"Taxpayer's transfer of each group of relinquished vehicles and Taxpayer's corresponding receipt of designated replacement vehicles in accordance with the Exchange Agreement will each constitute a separate and distinct exchange transaction for federal income tax purposes."
The IRS approved the transactions as separate and distinct like-kind exchanges.

4.5.3.2 **Two buyers.** Selling the two properties to two different buyers is a key factor in the transactions being treated as two exchanges. It is likely that a sale of two properties by a single Exchanger to two unrelated buyers will be treated as two exchanges. If the two buyers are related, the risk that the transaction will be treated as a single exchange is increased.

4.5.3.3 **Closing timing.** The timing to close the transactions is important. It is more likely that the transactions will be treated as two separate transactions if they are closed on different dates. This is especially true if there is a single buyer. Obviously, if the two transactions close a day apart, it is more likely that the transactions will be treated as a single transaction than if the two sales were closed four months apart.

4.5.3.4 **Single economic / business unit.** If the two properties are adjacent to each other, it is much more likely that they will be treated as a single exchange. But if the properties are part of a single economic unit and have a separate practical use, or even if not adjacent, single exchange treatment becomes more likely. For example, many farms consist of various properties that are not necessarily contiguous. Were the properties treated as a single economic unit on the Exchanger's tax return? Section 4 of Rev Proc 2002-22, 2002-14 IRB 733 provides some guidance on what is a parcel of real property for exchange purposes. It provides that each parcel constituting the property must be viewed together as a single business unit for it to be considered a single exchange property. It also provides that the IRS will generally consider contiguous parcels as single business units. It goes on to provide that non-contiguous parcels will also qualify as a property "where there is a close connection between the business use of one parcel and the business use of another parcel." The revenue procedure gives an example of an office building and a parking garage that services the office building will be considered to be a single parcel.

4.5.3.5 **Escrow.** It probably does not matter if more than one escrow company is used to close the transactions. Clearly, however, the transactions should be closed in separate escrows, with separate escrow instructions and separate closing statements.

4.5.3.6 **Accommodator.** Certainly the transactions should be documented using two exchange agreements. Would it help to
use two different Accommodators? Perhaps, because it would be additional evidence that the Exchanger was treating the transactions as two separate transactions. Except for the "window dressing" effect, it seems that it should not really matter, any more so than using two brokers or two attorneys to document the transactions.

4.5.3.7 **Listing agreement.** A single listing agreement is evidence of a single sale, especially if there is a single buyer or there are multiple related buyers.

4.5.3.8 **Advertising.** If the properties were advertised as a single sale by the broker, it is more likely that the transactions will be treated as a single sale and thus a single exchange. The advertising is evidence as to whether the properties were part of a single economic unit.

5. **TREATMENT OF BOOT**

5.1 **Boot Defined.** Boot in a tax-free exchange is the receipt of property that is neither qualified property nor like-kind property. Examples of boot include the receipt of:

5.1.1 Cash;

5.1.2 Nonqualified property, such as stocks or partnership interests;

5.1.3 Relief from indebtedness;

5.1.4 Non-like-kind property, such as the receipt of a washing machine in an exchange involving real estate; and

5.1.5 Property not intended to be used by the Exchanger in his trade or business or held for investment.

5.2 **Taxation of Boot.** Boot received in a tax-free exchange is taxable to the Exchanger to the extent of the total gain realized in the transaction. Gain realized is the fair market value of the property less its adjusted basis. To avoid receipt of boot in an exchange, generally:

5.2.1 The Replacement Property must have a fair market value equal to or greater than the Relinquished Property; and

5.2.2 The debt on the Replacement Property (or debt on Replacement Property plus the cash invested by the Exchanger into the exchange transaction) must be equal to or greater than the debt on the Relinquished Property.
Example. An Exchanger exchanges real estate Relinquished Property with a fair market value of $12,500 and a basis of $10,000 for real estate Replacement Property with a fair market value of $9,000, an automobile worth $2,000, and $1,500 cash. The gain realized in the transaction is $2,500 ($12,500 fair market value of the Relinquished Property less its basis of $10,000). The boot received is $3,500, composed of the $1,500 in cash and an automobile valued at $2,000. The gain recognized is $2,500, which is the lesser of the boot received ($3,500) or the gain realized ($2,500). Treas Reg § 1.1031(d)-1(c).

5.3 **Offsetting Cash Boot Received With Cash Boot Given.** It is unclear whether cash boot received can be offset by the payment of cash boot in an exchange. In Rev Rul 72-456, 1972-2 CB 468, the IRS held that cash boot received could be offset by brokerage commissions paid. In Barker v. C.I.R., 74 TC 555, 570 (1980), the court held that while an Exchanger could not receive cash and thereafter invest in like-kind property on a tax-free basis, an Exchanger could net the cash received in an exchange that was used, as required by the exchange agreement, to pay down debt against the Exchanger's Relinquished Property. In Coleman v. C.I.R., 180 F2d 758 (8th Cir 1950), the Exchanger was required to recognize gain on cash received because the Exchanger was not under a binding obligation to use the cash to pay down the debt on the Relinquished Property. In 1991, the IRS promulgated Treas Reg §1.1031(k)-1(j)(3), Example 2, that provides that a taxpayer is not able to offset cash boot given for cash boot received. The example involved a deferred exchange but calls into question whether any cash boot received can ever be offset by relinquished cash.

5.4 **Offsetting Boot Received With Debt Increases.** Boot received by the Exchanger, except for relief-of-indebtedness boot, cannot be offset by assuming indebtedness on the Replacement Property or acquiring the Replacement Property subject to indebtedness. Treas Reg § 1.1031(d)-2. See Rev Rul 79-44, 1979-1 CB 265, a case in which the Exchanger was held to have income on the receipt of a promissory note in an exchange even though the Replacement Property was subject to debt equal to the amount of the note received. See Frederick W. Behrens, 54 TCM (P-H) ¶ 85,195 (1985).

5.5 **Relief From Indebtedness.**

5.5.1 **General rule.** An Exchanger is treated as having received boot if liabilities on the Relinquished Property are assumed by the other party to the exchange. Treas Reg § 1.1031(d)-2.

5.5.1.1 **Netting of liabilities exception.** Although the relief of liabilities is generally treated as boot, it is not treated as boot to the extent that the Replacement Property received by the Exchanger is subject to liabilities. Treas Reg § 1.1031(d)-2. See also Tech Adv Mem 8003004 (Sept. 19, 1979); C.I.R. v. North
Shore Bus Co., 143 F2d 114 (2d Cir 1944). The tax court in Wittig v. C.I.R., 1995 TCM (RIA) ¶ 95,461 (Sept. 27, 1995), briefly held that the Exchanger must acquire the Replacement Property subject to existing debt and that the Exchanger could not place new debt on the Replacement Property at the time of closing. The decision was withdrawn by order dated November 9, 1995, confirming the view that the debt can be placed on the Replacement Property before the Exchanger acquires it, or the Exchanger can put new debt on the Replacement Property as part of the closing of the acquisition of the Replacement Property. See also Barker v. Comm., 74 TC 555 (1980); Priv Ltr Rul 9853028 (Sept. 30, 1998), which is contrary to Wittig. In Priv Ltr Rul 200019017 (May 12, 2000) the Service has also ruled that the partnership debt-relief recognition rules under Section 752(b) are overridden by the nonrecognition rules of Section 1031 (at least if both legs of the exchange are completed during the same tax year).

5.5.1.2 Giving cash or other property reduces relief of debt boot. If the Exchanger pays cash to the other party to the exchange, the Exchanger can offset boot received only in the form of relief of indebtedness. Treas Reg § 1.1031(d)-2; Blatt v. Comm., 67 TCM 2125 (1994). See also Rev Rul 79-44, 1979-1 CB 265, where the Relinquished Property was subject to liabilities. The relief from indebtedness income of the Exchanger was offset by the Exchanger's giving his promissory note to the other party to the exchange. To strictly come within this rule, the Exchanger should transfer the Relinquished Property to the Accommodator before the indebtedness on it is paid off.

5.5.1.3 No general application. The rule that provides that boot in the form of relief of liabilities can be offset by paying cash or taking the Replacement Property subject to new mortgages does not apply to any other situation.

5.5.2 Example. The Exchanger exchanges the Relinquished Property, which is subject to an $80,000 debt, for Replacement Property, subject to indebtedness of $150,000, and $40,000 in cash. The boot received is $40,000. The relief from indebtedness of $80,000 is ignored because it is totally offset by the $150,000 indebtedness on the Replacement Property. If the Replacement Property was not subject to any indebtedness, the Exchanger could avoid the boot of $80,000 from relief of indebtedness by paying $80,000 in cash to the Seller.
5.5.3 **Paying off unsecured debt in an exchange—is it boot?**

5.5.3.1 Must the debt be secured against the Relinquished Property to qualify as debt for purposes of Section 1031? In other words, can an Exchanger use cash proceeds in a tax-free exchange to pay his credit card debt and unsecured line of credit? The answer appears to be yes!

5.5.3.2 There is no specific requirement that the debt the Exchanger will be relieved of must be secured by the Relinquished Property. Yet two requirements do need to be met.

5.5.3.2.1 First, the liability cannot be just any liability, but must probably meet the requirements set forth below.

a. A temporary regulation suggests that a liability for IRC § 1031 purposes is an obligation that gave rise to:

"(1) the receipt of cash by the debtor; (2) an increase in the tax basis of an asset held by the debtor; (3) a deduction taken into account in computing taxable income under the debtor's accounting method; or (4) an expenditure that is not deductible in computing taxable income and is not properly taken into account as an addition to basis."

Temp Treas Reg § 1.752-1T(g) (Dec. 30, 1988).

b. Additionally, the obligation must be free from significant contingencies in order to be considered a liability under IRC § 1031. In other words, the liability must satisfy the "all the events" test to constitute a legitimate liability.

5.5.3.2.2 Second, the liability must be assumed in the exchange.

a. Exactly what does the regulation mean when it provides that the liability must be "assumed"? Again, an analogous regulation provides insight. Treas Reg § 1.704-1(b)(2)(iv)(c) states:

"Liabilities are considered assumed only to the extent the assuming party is thereby subjected to personal liability with respect to such obligation, the obligee is aware of the assumption and can directly enforce the assuming party's obligation, and, as between the assuming party and the party from
whom the liability is assumed, the assuming party is ultimately liable.”

b. The assumption requirement in most exchanges is met by simply using the exchange proceeds to pay off the liability as part of the closing. For liabilities not secured by real property, however, the liability must be formally assumed by a written agreement.

c. In a typical deferred exchange, the Exchanger's mortgage will be paid off as part of the closing by the other party to the exchange or by an Accommodator. The other party to the exchange or the Accommodator assumes the mortgage by paying it off and relieving the Exchanger of the obligation. It would not be acceptable if the Exchanger, on the other hand, received $1,000 in the exchange and used the funds to pay off his credit card debt.

5.5.3.3 Certain types of liabilities:

5.5.3.3.1 Accounts payable of a cash-basis Exchanger would not qualify as a liability for IRC § 1031 purposes. See Rev Rul 88-77, 1988-2 CB 128.

5.5.3.3.2 Credit card debt and short-term loans, however, appear to qualify as liabilities. See William J. Granan v. C.I.R., 55 TC 753 (1971); Rev Rul 78-38, 1978-1 CB 67.

5.5.3.3.3 A judgment, even if secured by the property, might not qualify if the basis of the debt did not meet the requirements referred to above. Therefore, a judgment debt to pay off a divorced spouse's property settlement, or a judgment debt to pay off a tort claim, even if secured by a judgment lien filing against the Relinquished Property, may simply be treated as boot income and cannot be offset by assumption of debt against the Replacement Property.

5.6 Boot Questions and Answers. The following is a list of some tough Section 1031 boot issues and our best thinking as to what the answers to these questions are:

5.6.1 Off-closing statement. Can the Exchanger avoid receipt of cash boot when purchasing the Replacement Property by having amounts charged to the Seller, such as rent prorates, paid out of closing from the Seller to the Exchanger?
No. Cash received from the Seller of the Relinquished Property, whether the cash shows up on the closing statement or is handled out of escrow, is boot. Cash boot cannot be offset by debt assumed (e.g., the obligation to provide rented space). This practice, which appears to be quite common, simply makes it harder for the IRS to catch the Exchanger who fails to report the boot received.

5.6.2 **Property taxes.** If property taxes are paid on the closing of the sale of the Relinquished Property, does this create taxable boot?

Yes. Property taxes are a liability or obligation of the Exchanger that are generally paid at the closing. The payments clearly provide a value to the Exchanger in that the Buyer would pay less for the Relinquished Property if the property taxes had not been paid off.

5.6.3 **Offsetting property taxes.** If property taxes are paid upon the sale of the Relinquished Property, need the boot income be recognized if the total debt with respect to the Replacement Property is equal to or greater than the debt on the Relinquished Property including the property taxes?

No. Liabilities of which the Exchanger has been relieved should include property taxes, which are a nonrecourse debt (the obligation is limited to the asset, and the Exchanger has no personal obligation to pay the obligation). The property tax debt against the Relinquished Property is offset by debt with respect to the Replacement Property.

5.6.4 **Property tax deduction.** If property taxes are paid on the sale of the Relinquished Property, are they deductible by the Exchanger?

There is no authority on this issue. It appears that if the property taxes are boot (because the debt on the Relinquished Property exceeded the debt on the Replacement Property, and that boot is allocated to the property taxes), then the taxes are deductible. But if the property taxes were not taxable boot to the Exchanger, they would not be deductible because they were not paid by the Exchanger, but were paid by the Accommodator (through the Buyer), who assumed the property taxes by acquiring the Replacement Property subject to those property taxes.

5.6.5 **Other obligations as debt.** What kinds of obligations other than property taxes can be treated as a liability on the sale of the Relinquished Property?

Other obligations might include the mortgage, accrued but unpaid interest due on the mortgage, prepayment penalties due on the mortgage, and the obligation to pay back refundable deposits owing to renters. What about rent prorates? Are they not payment for an obligation to rent the property to the end of the month? The answer is unclear.
5.6.6 **Environmental assessment.** Is payment of a Phase I environmental assessment with respect to the purchase of the Replacement Property boot?

The payment for a Phase I environmental assessment should not be boot if the intent in obtaining the environmental assessment was to determine whether the property should be purchased. The cost of acquiring property, including the Phase I environmental assessment, is included in the basis of the property. But if the only purpose for obtaining the Phase I environmental assessment was to obtain financing, then it probably will not qualify and will be treated as boot.

To ensure that the cost is not treated as boot, the earnest money agreement should include a provision that the acquisition is subject to receipt of an acceptable Phase I environmental assessment.

5.6.7 **Appraisal.** Is the cost of obtaining an appraisal to purchase the Replacement Property boot?

In general, the cost of obtaining an appraisal would not be boot as long as its sole purpose was not to obtain financing to purchase the Replacement Property. As suggested in the answer to the question above, the earnest money agreement to purchase the Replacement Property should include a provision that the purchase is subject to receipt of an acceptable appraisal on the Replacement Property.

5.6.8 **Loan fees.** Is the cost of paying loan fees, such as points to purchase the Replacement Property, boot?

Yes. Loan fees cannot be included in the basis of the Replacement Property. Therefore, any payment made from proceeds of a tax-free exchange for this purpose would be taxable boot.

5.6.9 **Accommodator fee.** Is the payment of an exchange accommodation fee boot?

It is unclear. But the IRS could easily argue that such a fee was not an expense of sale but a fee that should be boot and deducted under IRC § 162 or 212.
5.6.10 **Selling expenses.** What type of selling expenses can be paid? Selling expenses paid out of the exchange balance probably will not be treated as boot by the Exchanger. Such expenses include commissions, inspections, title insurance premiums, escrow fees, transfer taxes, recording fees, and legal expenses. See Rev Rul 72-456, 1972-2 CB 468, in which the IRS held that cash boot received in an exchange is reduced by commissions paid.

5.6.11 **Allocating Debt.** Can debt be allocated to not apply to the Replacement Property?

The answer is unknown. Here is how the question can come up. For example, Relinquished Property is real property and is sold for $1 million and is subject to $300,000 in debt. Assume that the Replacement Property is $1 million in real property and $200,000 in personal property. Assume further that there is financing of $500,000 in debt against the Replacement Property. To avoid the $200,000 in personal property being treated as taxable boot, it may be possible to structure the purchase of the personal property so that $200,000 of debt is allocated to purchase the personal property. This might be done with a separate closing statement in which the Exchanger and not the Accommodator is the purchaser and the source of funds to purchase the personal property is $200,000 of the debt. If the debt is secured by the Replacement Property, the IRS might argue that it must be treated as being used to fund the purchase of the Replacement Property and not the personal property.

5.7 **Techniques to Reduce Boot.** There are a number of situations in which paying down a mortgage or borrowing funds in contemplation of an exchange may reduce or eliminate the receipt of taxable boot:

5.7.1 **Pay down mortgage prior to exchange.** One way to avoid the receipt of boot as a result of the excess of liabilities on the Relinquished Property over the liabilities on the Replacement Property is to pay down the mortgage on the Relinquished Property prior to the exchange.

5.7.1.1 **Example.** If the Exchanger's Relinquished Property is subject to a $150,000 mortgage and the Replacement Property is subject to a $120,000 mortgage, then the Exchanger will have received $30,000 of boot because the Exchanger has been relieved of a net amount of $30,000 of indebtedness. The boot income of $30,000 can be avoided by paying down the mortgage by $30,000 on the Relinquished Property prior to the exchange.

5.7.1.2 **Do not pay down mortgage from proceeds from sale of Relinquished Property.** If the Exchanger pays down the mortgage with the proceeds from the sale of the Relinquished
Property at the closing of the sale of the Relinquished Property, or sometime thereafter, the Exchanger will be treated as having received boot. But in the much-criticized decision of the tax court in Barker v. C.I.R., 74 TC 555, 570 (1980), the court held that an Exchanger could net the cash received in an exchange that was used pursuant to the exchange agreement to pay down debt against the Exchanger's Relinquished Property.

5.7.1.3 Pay Down, Borrow Back Transaction. One form of this transaction is that the lender agrees that it will accept a pay down of the mortgage and re-loan the proceeds to the buyer of the Replacement Property – a “pay down, borrow back” transaction. There is no reason this should not work. However, if there is a side deal that the buyer must borrow the funds back, the IRS would rightly ignore the loans and treat the loan as having not been paid down at all.

5.7.2 Seller pays down mortgage. If the equity (the value less mortgages) of the Replacement Property is less than the equity in the Relinquished Property, the Exchanger at the close of the exchange must ultimately receive the decrease in equity in the form of boot. To avoid receiving this boot, the Exchanger can negotiate with the owner of the Replacement Property to use some of the cash that would have been paid to the Exchanger before closing to pay down the indebtedness (and thus increase the equity) on the Replacement Property.

Example: Assume that the Relinquished Property is valued at $100,000 and is subject to a $50,000 mortgage. Assume further that the Replacement Property is worth $100,000 but is subject to a $70,000 mortgage. On sale of the Relinquished Property, the Accommodator will be holding $50,000, but will need only $30,000 cash to acquire the Replacement Property. The extra $20,000 will be distributed to the Exchanger as taxable boot. But if the Seller, prior to the closing, pays down the mortgage on the Replacement Property by $20,000, from $70,000 to $50,000, the Exchanger can complete the exchange without receiving $20,000 of taxable boot.

5.7.3 Exchanger borrows prior to exchange. If the equity in the Replacement Property is less than the equity in the Relinquished Property, the Exchanger, prior to the exchange, can borrow money against the Relinquished Property to balance out the equities. This solution is limited; i.e., the liabilities against the Relinquished Property cannot be increased to the extent that they exceed the liabilities against the Replacement Property, or the excess will be treated as boot to the Exchanger. Borrowing before an exchange may be successfully challenged by the
IRS, which may contend that the pre-exchange borrowing is part of a step transaction that when viewed as one transaction requires that the loan proceeds be treated as cash boot. Long v. Comm, 77 TC 1045 (1981); Simon v. Comm, 32 TC 935 (1959), aff'd 285 F2d 422 (3rd Cir 1960). It can be argued that such a result ignores the general rule that loan proceeds are tax-free and that the Exchanger will have to amortize the loan with after-tax income. Another technical argument that buttresses this position can be found in the partnership disguised sale rules. If a partner transfers property to the partnership, under IRC §707(a)(2(B) after pulling cash out in the form of a loan, it will be treated as a sale, but not if the partner assumes partnership debt equal to or greater than the debt against the property before funds were borrowed against it. In this situation, there was no reduction in debt.

5.7.3.1 In Fred L. Fredericks, 65 TCM (RIA) ¶ 94,027 (1994), the Exchanger refinanced the property two weeks after executing a contract to sell it and less than a month prior to the exchange. The IRS lost the case, but only when the Exchanger was able to prove that it had started the process of refinancing the Relinquished Property two years before the exchange. It is thus recommended that any pre-exchange borrowing be completed prior to executing an agreement to sell the Relinquished Property. See also Long v. C.I.R., 77 TC 1045 (1981); Priv Ltr Rul 8434015 (May 16, 1984); Priv Ltr Rul 200019014 (Feb. 10, 2000).

5.7.3.2 In Garcia v. C.I.R., 80 TC 491 (1983), acq., 1984-1 CB 1, the owner of the Replacement Property increased the debt on it immediately before exchanging the property with the Exchanger in order to equalize the liabilities on the Replacement Property with the liabilities on the Relinquished Property. The IRS argued that the Exchanger had income because it would have been relieved of liabilities in excess of the liabilities it was assuming. The court ruled against the IRS, basing its decision on the fact that the loan transaction had "independent economic substance," possibly because the loan was from an independent institutional lender.

5.7.4 Exchanger borrows after exchange. There is virtually no authority in this area. The IRS lost when it attempted to cast facts to fit this scenario. Frederick W. Behrens, 54 TCM (P-H) ¶ 85,195 (1985).

5.8 Actual and Constructive Receipt. If an Exchanger actually or constructively receives funds, they will be taxed as boot to the Exchanger. The Exchanger is in actual receipt of funds if the funds are credited to the Exchanger's account or set
aside for the Exchanger or made available so that the Exchanger can draw on the funds.

5.8.1 **Agency.** If the Accommodator or another party to the exchange is the Exchanger's agent, then the Exchanger cannot engage in a tax-free exchange. For an exchange to be successful, the Exchanger must exchange with another party. If the Accommodator is the Exchanger's agent, the Exchanger is not exchanging with another party. In addition, if the Exchanger's agent is in receipt of any funds, then the Exchanger will be deemed to have constructively received the funds. Treas Reg § 1.1031(k)-1(f)(2). Agency may be difficult for the IRS to establish. In Fred L. Fredericks, 65 TCM (RIA) ¶ 94,027 (1994), the IRS argued that an Accommodator was the agent of the Exchanger because the Accommodator was the wholly owned subsidiary of the Exchanger. The court held that no agency existed because the actions of the Accommodator, which included acquiring Replacement Property and building improvements on the Replacement Property, for which the Accommodator received a $750,000 development fee, had independent economic significance. In an exchange transaction designed to meet the safe-harbor requirements, Exchangers may take solace that if a court later determines that the Accommodator was not a Qualified Intermediary because of a forbidden relationship between the Exchanger and the Accommodator (such as being a related party), the fee earned by the Accommodator may, if Fredericks is to be relied on, help persuade the court that no agency relationship exists.

5.8.2 **Receipt of Check Payable to Accommodator.** If the Exchanger receives a check payable to the Accommodator for the sale of the Relinquished Property which is forwarded to the Accommodator, the Exchanger is not deemed to be constructive receipt of the check proceeds. Priv Ltr Rul 9826033 (Dec. 12, 1997).

5.8.3 **Examples of cases in which constructive receipt was found.**

5.8.3.1 Michael Hillyer v. C.I.R., 69 TCM (RIA) ¶ 96,214 (1996). The Exchanger sold property and deposited the cash proceeds with an escrow agent "for the direction of the corporation in the acquisition of replacement properties." 69 TCM ¶ 96,214, at 1565. The Exchanger eventually did receive Replacement Property meeting all requirements for a deferred exchange. It was held that the transaction was fully taxable, however, because the sales proceeds "were actually received by the [Exchanger] and thereafter were transferred to the bank under the so-called escrow agreement." 69 TCM ¶ 96,214, at 1568.
5.8.3.2 Maxwell v. United States, 88-2 USTC (CCH) ¶ 9560 (SD Fla 1988). The Exchanger sold Relinquished Property and provided for the funds to be deposited into escrow to be used to purchase Replacement Property. The escrowed funds were available to the Exchanger by terminating the escrow. The escrow documents did not even mention that the transaction was to be structured as a like-kind exchange. The court held that the Exchanger had entered into a fully taxable transaction.

5.8.3.3 Priv Ltr Rul 9052019 (Sept. 28, 1990). An Exchanger sold property and identified Replacement Property within the 45-day Identification Period. The sale proceeds were deposited into a savings account. The funds in the account were later used to acquire Replacement Property. The IRS had no problem determining that the transaction was taxable.

5.8.3.4 Klein. In Keith K. Klein, 64 TCM (RIA) ¶93,491 (1993), the tax court had no trouble in holding that the Exchanger had a fully taxable exchange because the Exchanger had deposited proceeds from the sale into an escrow account that was under his unrestricted control.

5.8.3.5 Big Hong eng. In Big Hong eng v. C.I.R., 71 TCM (RIA) ¶ 97,248 (1997), the Exchanger was found to have had constructive receipt of exchange proceeds when they were deposited in a bank account of the Exchanger's wholly owned corporation.

5.8.4 **Simultaneous exchanges safe harbor.** In a simultaneous exchange, if the Accommodator is a Qualified Intermediary, the Accommodator will not be considered an agent of the Exchanger. Treas Reg § 1.1031(b)-2(a). See Article 6 below.

5.9 **Forward-Deferred Exchanges Safe Harbor.** The regulations contain safe harbors from exchange funds being taxed as boot if the Accommodator is a Qualified Intermediary. These items are discussed below:

5.9.1 **Security or guaranty arrangements.** The regulations provide four safe harbors in forward-deferred exchanges in which constructive receipt and agency will not be found. There should be no negative inference if the Exchanger fails to follow the safe-harbor requirements. In the security arrangements described below, it is not at all clear that the Exchanger would have a constructive-receipt problem even if the safe harbor rules had not been adopted. Treas Reg § 1.1031(k)-1(g). The following types of security arranged to secure the obligation of the Accommodator to transfer Replacement Property will not create constructive receipt:
5.9.1.1 **Mortgage, trust deed, or other security interest in property.** The use of a mortgage, trust deed, or other security arrangement is somewhat impractical. It is not likely that the Accommodator will hold the Relinquished Property except for an instant as part of a closing. Even if the property has been held by the Accommodator, recording a security interest in the property will often require obtaining the consent of senior lien holders. If this form of security is used, the exchange agreement should contain a liquidated-damages provision so that there will be an ascertainable amount due at the foreclosure sale.

5.9.1.2 **Standby letter of credit, which may not be drawn upon in absence of default of Accommodator** (Priv Ltr Rul 9149018 (Sept. 4, 1991)). Any standby letter of credit must meet the requirements of Treas Reg § 15A.453-1(b)(3)(iii). Standby letters of credit are difficult, expensive, and impractical. Furthermore, there is a serious flaw in the regulations, because the standby letter of credit can be drawn only if the Accommodator fails to transfer the Replacement Property. Apparently, the letter of credit cannot be drawn if the Accommodator:

5.9.1.2.1 Fails to pay over cash surplus after purchasing the Replacement Property;

5.9.1.2.2 Files for bankruptcy or becomes insolvent; or

5.9.1.2.3 Fails to acquire Replacement Property and transfer it to the Exchanger because the Exchanger was unable to negotiate the purchase of the Replacement Property, not because of a default of the Accommodator.

5.9.1.3 **Third-party guaranty.** A guaranty is a very practical form of security, if the guarantor has the requisite financial strength.

5.9.1.4 **Qualified escrow accounts and trusts.** If the obligation of the Accommodator to acquire Replacement Property is secured by a qualified escrow account or trust, the funds will not be deemed to have been constructively received by the Exchanger. A qualified escrow or trust is a means to secure the Accommodator's obligations. It is not a substitute for an Accommodator. A qualified escrow or trust will probably prevent the Accommodator from stealing funds, but these arrangements will not withstand a bankruptcy of the Accommodator unless there is perfection under local law.
Perfection may require a security agreement, financing statement, possession (which may be outside the safe harbors of constructive receipt), or other steps required under local law. Accommodators must keep in mind reporting requirements for qualified escrows under Prop Reg § 1.468B-6. See Levine & Wintraub, Tax and Reporting Rules for Escrows and Trusts Used in Deferred Like-Kind Exchanges, 90 J Tax’n 332 (1999). A qualified escrow or trust is an arrangement in which:

5.9.1.4.1 The escrow agent or trustee is not the Exchanger or a disqualified person;

5.9.1.4.2 The Exchanger under the arrangement does not have the right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the account or trust. The Exchanger can have the right to withdraw funds after the Identification Period if no Replacement Property is identified, after receipt of all identified Replacement Property, at the end of the Exchange Period, or after a major contingency relating to the exchange that is out of the control of the Exchanger.

5.9.2 **Interest and growth factor.** The right of the Exchanger to receive interest or the growth factor of assets in the hands of the Accommodator will not cause the Exchanger to be in constructive receipt of the assets held by the Accommodator. Treas Reg § 1.1031(k)-1(g)(5). The interest will be fully taxable to the Exchanger, however. Treas Reg § 1.1031(k)-1(h). Note also that the Exchangers generally must recognize imputed income under IRC §7872 on the funds held by the Accommodator. The Applicable Federal Rate (“AFR”) is a special rate equal to the lesser of the short-term AFR or the 13-week T Bill rate. An exemption that will apply to most deferred exchange transactions is available for “loan” amounts that are less than $2 million and which are outstanding for less than six months.

5.9.3 **Withdrawal of funds.** The Exchanger can withdraw funds only if he does not violate any of the safe-harbor requirements (referred to as the G6 requirements) and the payment is pursuant to the written exchange agreement.

5.9.3.1 Payment can be made only:

5.9.3.1.1 After the Identification Period, if no Replacement Property is identified;
5.9.3.1.2 After receipt of all identified Replacement Property;

5.9.3.1.3 At the end of the Exchange Period; or

5.9.3.1.4 After a major contingency relating to the exchange that is out of the control of the Exchanger (such as destruction of the property, a zoning change, or regulatory approval) that is provided for in the exchange agreement ("Major Contingency Requirement").

5.9.3.2 If an Exchanger has the right to withdraw funds, the safe-harbor protection is lost, whether or not funds are actually withdrawn. Note that an Exchanger "may receive money or other property directly from a party to the transaction other than the qualified intermediary without affecting" the safe-harbor rules. Treas Reg § 1.1031(k)-1(g)(4)(vii). Thus, if a Buyer pays funds directly to the Exchanger in a closing, the safe-harbor protections should still be available. Treas Reg § 1.1031(k)-1(g)(6). See Michael Hillyer v. C.I.R., 69 TCM (RIA) ¶ 96, 214 (1996) (Exchanger's exchange failed because the G6 requirements in the escrow agreement were not met).

5.9.3.3 The Major Contingency Requirement can be drafted as part of the exchange agreement and could include the following concepts:

5.9.3.3.1 Potential Replacement Property has been properly identified within the Identification Period;

5.9.3.3.2 The Identification Period has expired;

5.9.3.3.3 A written earnest money agreement has been entered into to purchase each potential identified Replacement Property; and

5.9.3.3.4 With respect to each potential identified Replacement Property, either:

a. The potential identified Replacement Property has been acquired by the Accommodator, or

b. There is a material and substantial contingency in the written earnest money agreement to acquire the potential identified Replacement Property
that has not been satisfied and that is beyond the control of the Exchanger and any disqualified person as provided for in Treas Reg § 1.1031(k)-1(k).

5.9.3.4 Examples of Major Contingency Requirements and whether they will or will not work:

5.9.3.4.1 Works: Earnest money agreement requires marketable title, and title is not marketable.

5.9.3.4.2 Works: Earnest money agreement provides that the property must be capable of being financed, and the bank will not finance it because of environmental problems.

5.9.3.4.3 Works: Earnest money agreement provides that the property must appraise out at a particular value and it does not.

a. Works: Earnest money agreement provides that a Phase I environmental assessment indicates that the Replacement Property has no environmental problem and the Exchanger does not purchase the property because of the results of the Phase I assessment.

b. Will not work: The exchange agreement cannot provide that the Exchanger has negotiated in good faith with the Seller of the Replacement Property and is unable to reach an agreement for the purchase of the property. Priv Ltr Rul 200027028 (July 21, 2000). See Weller, Early Distribution From 1031 Exchange Accounts-Another Look at a Strange New Ruling, 93 J Tax'n 2 (2000).

c. Will not work: Earnest money agreement provides that a condition to purchasing the Replacement Property is that a Phase I environmental assessment that is satisfactory to the Exchanger in his sole discretion be obtained, and the transaction is terminated because the Exchanger determined to not purchase the Replacement Property because of the results of the environmental assessment. This is a condition in the control of the Exchanger.

d. Will not work: There is no earnest money on the Replacement Property, and thus the Exchanger cannot purchase it.

e. Will not work: The property is sold by the Seller to another buyer. It still could potentially be purchased by the Exchanger.

f. Will not work: The earnest money agreement provides that the property must pass an inspection or due-diligence review that is satisfactory to the Exchanger. This is a condition in the control of the Exchanger.
g. Will not work: The earnest money agreement for a $1 million Replacement Property provides that a condition of closing is that the refrigerator in Unit 10 (whose value is $50) be in working order, and the property is not purchased because this condition is not satisfied. The condition is not material and substantial.

5.10 **Section 1250 Recapture.**

5.10.1 **Section 1250 Property Defined.** Section 1250 property is the building or its structural components, located on real property, that is eligible for depreciation under § 167. IRC § 1250(c) (This section defines § 1250 property as any property that is not § 1245 property. Section 1245 property does not include buildings or its structural components. IRC § 1245(c)(3)).

5.10.2 **Calculation.** Section 1250 normally requires recapture of "Additional Depreciation," the excess of accelerated depreciation over straight-line depreciation, on the disposition of § 1250 property. The applicable percentage, which in most cases is 100 percent, is multiplied by the amount of Additional Depreciation to determine the amount of gain that must be recognized as ordinary income in the year of the disposition, limited to gain realized on the disposition.

5.10.3 **Exception: When Replacement Property Is Section 1250 Property.** In an exchange involving possible IRC § 1250 recapture, no gain need be recognized to the extent of the reinvestment of the property into other IRC § 1250 property. IRC § 1250(d)(4); Treas Reg § 1.250-3(d)(1). Therefore, IRC § 1250 recapture will not be a problem in most exchanges, except for exchanges into unimproved real estate; and even then, recognized gain is reduced or eliminated when § 1250 property is received along with non-§ 1250 property. See attached chart for the tax consequences of three different scenarios. When § 1250(d)(4)(A) applies so that § 1250 gain is not currently recognized, the gain will be deferred. Treas Reg § 1.1250-3(d)(5). The Additional Depreciation not recognized will be allocated to the replacement § 1250 property so that on the final disposition of the § 1250 Replacement Property, the Additional Depreciation that was deferred will be recognized and taxed as ordinary income. Additionally, any depreciation deductions of § 1250 property that are not recaptured under § 1250 at the time of the exchange, will be subject to tax at a rate of 25 percent at the time of final disposition of the Replacement Property. See IRC § 1(h)(1)(D) (although no specific guidance as to how to treat § 1(h)(1)(D) depreciation recapture in § 1031 exchanges, it seems clear that § 1031 overrides § 1(h)(1)(D) and there will not be current recognition of gain, and the unrecaptured depreciation
should be allocated to the Replacement Property to be recaptured upon final disposition of the property).

5.10.4 **Low Risk of Recognition Under Section 1250.** There is a low risk that exchanging § 1250 property for non-§ 1250 property will result in current recognition of ordinary income because most § 1250 property has no Additional Depreciation. Section 1250 property acquired after 1986 will never have Additional Depreciation because after 1986, straight-line depreciation is the only method to depreciate all nonresidential real property and all residential rental property. IRC § 168(b)(3); Gerald J. Robinson, Federal Income Taxation of Real Estate ¶ 6.04[3] (5th ed 1995). Additionally, most property acquired before 1987 will be fully depreciated by 2005, which also means that there is no additional depreciation in this property. See id. (During 1981 to 1986, the period when accelerated depreciation was allowed on § 1250 property, the minimum recovery periods ranged from 15 to 19 years. If the taxpayer used the minimum recovery period, property acquired in 1986 would have been fully depreciated in 2005.).
The following table shows the recognized gain treated as ordinary income, on three transactions in which §1250 depreciable real property is exchanged for varying amounts of non-§1250 property. Gain will be recognized and taxable as ordinary income to the extent that excess depreciation deductions exceed the fair market value of §1250 property received in the transaction.

<table>
<thead>
<tr>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relinquished Property</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amount Realized</td>
<td>1,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Gain Realized</td>
<td>900,000</td>
<td>900,000</td>
</tr>
<tr>
<td>Replacement Property</td>
<td></td>
<td></td>
</tr>
<tr>
<td>§ 1250 Property</td>
<td>-</td>
<td>500,000</td>
</tr>
<tr>
<td>Non-§ 1250 Property</td>
<td>1,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Boot*</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1,000,000</td>
<td>1,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Tax Under § 1031</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Boot Income</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>b. Gain Realized</td>
<td>900,000</td>
<td>900,000</td>
</tr>
<tr>
<td>Recognized Gain (lesser of a or b)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Tax Under § 1250(d)(4)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Recognized Gain under § 1031 (above)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>b. Adjusted for Insufficient Property Gain Otherwise Recognized Under § 1250(a)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>i. Additional Depreciation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accelerated depreciation</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>Less straight line depreciation</td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td>300,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(ii) Gain Realized (above)</td>
<td>900,000</td>
<td></td>
</tr>
<tr>
<td>Gain under §1250(a) (lesser of (i) or (ii))</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Less FMV of §1250 Property Acquired (above)</td>
<td>-</td>
<td>500,000</td>
</tr>
<tr>
<td>§1250 Ordinary Income (not to exceed greater of a. or b.)**</td>
<td>300,000</td>
<td>-</td>
</tr>
</tbody>
</table>

* For illustrative purposes of this table, "boot" is treated as a separate category from non-§1250 property; however, non-§1250 property actually includes boot.

** Assuming that the applicable percentage is 100 percent.

5.11 **Section 1245 Recapture.** Section 1245 recapture applies to any sale of depreciable personal property notwithstanding the provisions of Section 1031. The recapture amount is the depreciation claimed on the property or the gain realized, whichever is less. No recapture is required, however, to the extent that the Replacement Property is also IRC § 1245 property and has a fair market value greater than the fair market value of the Relinquished Property.
5.12 **Computation of Realized and Recognized Gain or Loss.**

<table>
<thead>
<tr>
<th>Relinquished Property Seller: Accommodator Buyer: Buyer</th>
<th>Replacement Property Seller: Seller Buyer: Accommodator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Closing Statements</td>
<td></td>
</tr>
<tr>
<td>Closing Date: December 15</td>
<td></td>
</tr>
<tr>
<td>Sales price / purchase price</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Earnest money deposit</td>
<td>35,000</td>
</tr>
<tr>
<td>Loan principal</td>
<td>650,000</td>
</tr>
<tr>
<td>Interest @ 9% from 11/1</td>
<td>7,313</td>
</tr>
<tr>
<td>Prepayment penalty</td>
<td>13,000</td>
</tr>
<tr>
<td>Loan fee</td>
<td></td>
</tr>
<tr>
<td>Gift to Exchanger's daughter</td>
<td>8,500</td>
</tr>
<tr>
<td>Payment of real property taxes</td>
<td>26,000</td>
</tr>
<tr>
<td>Tax prorate</td>
<td>11,917</td>
</tr>
<tr>
<td>Phase I environmental assessment</td>
<td>18,000</td>
</tr>
<tr>
<td>Appraisal fee</td>
<td>4,400</td>
</tr>
<tr>
<td>Escrow fee and recording costs</td>
<td>800</td>
</tr>
<tr>
<td>Title insurance</td>
<td>1,400</td>
</tr>
<tr>
<td>Exchange Accommodator fee</td>
<td>500</td>
</tr>
<tr>
<td>Prorate of rents</td>
<td>5,000</td>
</tr>
<tr>
<td>Deposits allocated</td>
<td>24,000</td>
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<tr>
<td>Brokerage commission</td>
<td>30,000</td>
</tr>
<tr>
<td>Legal fees</td>
<td>1,500</td>
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<tr>
<td>Cash proceeds to Seller / Buyer</td>
<td>256,904</td>
</tr>
<tr>
<td>Additional cash deposit to close</td>
<td>8,796</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,035,917</strong></td>
</tr>
</tbody>
</table>

**1,035,917**  **1,035,917**  **1,588,200**  **1,588,200**
Gain Realized

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of Replacement Property (detail below)</td>
<td>1,507,600</td>
</tr>
<tr>
<td>Cash received (detail below)</td>
<td>176,163</td>
</tr>
<tr>
<td>Fair market value of noncash boot received</td>
<td></td>
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<tr>
<td>Mortgage against Relinquished Property (detail below)</td>
<td>650,000</td>
</tr>
<tr>
<td>Total consideration received</td>
<td>2,333,763 (2,333,763)</td>
</tr>
<tr>
<td>Basis of Relinquished Property (detail below)</td>
<td>250,000</td>
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<tr>
<td>Cash given (detail below)</td>
<td>102,213</td>
</tr>
<tr>
<td>Adjusted basis of noncash boot given</td>
<td></td>
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<tr>
<td>Mortgage against Replacement Property (detail below)</td>
<td>1,265,000</td>
</tr>
<tr>
<td>Total consideration given</td>
<td>1,617,213 (1,617,213)</td>
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<tr>
<td>Gain realized</td>
<td>716,550</td>
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Gain Recognized

**Cash boot**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received (detail below)</td>
<td>176,163</td>
</tr>
<tr>
<td>Cash given (detail below)</td>
<td>(102,213)</td>
</tr>
<tr>
<td>Net cash and boot received (not below zero)</td>
<td>73,950 (73,950)</td>
</tr>
</tbody>
</table>

**Mortgage relief**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage on Relinquished Property (detail below)</td>
<td>650,000</td>
</tr>
<tr>
<td>Mortgage on Replacement Property (detail below)</td>
<td>(1,265,000)</td>
</tr>
<tr>
<td>Net mortgage relief (if less than zero, enter zero)</td>
<td>-</td>
</tr>
<tr>
<td>Gain recognized (not greater than realized gain)</td>
<td>73,950</td>
</tr>
</tbody>
</table>

Note: Cash received prior to closing, such as the receipt of $35,000 as an earnest money deposit, cannot be offset by cash given. Cash received can be offset by cash given only if the amounts are received as part of a closing in which cash is also given.
### Basis of Replacement Property

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted basis of Relinquished Property</td>
<td>250,000</td>
</tr>
<tr>
<td>(detail below)</td>
<td></td>
</tr>
<tr>
<td>Cash given (detail below)</td>
<td>102,213</td>
</tr>
<tr>
<td>Mortgage on Replacement Property</td>
<td>1,265,000</td>
</tr>
<tr>
<td>Subtotal</td>
<td>1,617,213</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash received (detail below)</td>
<td>176,163</td>
</tr>
<tr>
<td>Mortgage on Relinquished Property (detail below)</td>
<td>650,000</td>
</tr>
<tr>
<td>Subtotal</td>
<td>826,163</td>
</tr>
<tr>
<td>(826,163)</td>
<td></td>
</tr>
<tr>
<td>Gain recognized</td>
<td>73,950</td>
</tr>
<tr>
<td>Basis of Replacement Property</td>
<td>865,000</td>
</tr>
</tbody>
</table>

### Proofs

#### Proof 1

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of Replacement Property (see detail below)</td>
<td>1,507,600</td>
</tr>
<tr>
<td>Less gain realized</td>
<td>(716,550)</td>
</tr>
<tr>
<td>Gain recognized</td>
<td>73,950</td>
</tr>
<tr>
<td>Basis of Replacement Property</td>
<td>865,000</td>
</tr>
</tbody>
</table>

#### Proof 2

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales price of Relinquished Property</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Sales Expenses</td>
<td>(33,450)</td>
</tr>
<tr>
<td>Basis of Relinquished Property (detail below)</td>
<td>(250,000)</td>
</tr>
<tr>
<td>Realized gain</td>
<td>716,550</td>
</tr>
</tbody>
</table>
Detailed Schedules

Detail: Basis of Relinquished Property

- Cost of Relinquished Property: 350,000
- Depreciation on Relinquished Property: 100,000
- Adjusted Basis of Relinquished Property: 250,000

Detail: Value of Replacement Property

- Purchase price of Replacement Property: 1,500,000
- Phase I environmental assessment: 1,500
- Appraisal fee: 4,400
- Escrow and recording costs: 1,100
- Portion of legal fees to purchase Replacement Property (not tax advice): 600
- Value of Replacement Property: 1,507,600

Detail: Mortgages Against Relinquished Property

- First Mortgage: 650,000
- Second Mortgage
- Other
- Mortgages against Relinquished Property: 650,000
### Structuring 1031 Exchanges

#### Ronald A. Shellan

**Detail: Mortgages Against Replacement Property**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Mortgage</td>
<td>1,265,000</td>
</tr>
<tr>
<td>Second Mortgage</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
</tr>
<tr>
<td>Mortgages against Replacement Property</td>
<td>1,265,000</td>
</tr>
</tbody>
</table>

**Detail: Cash Received**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnest money received in sale of Relinquished Property</td>
<td>35,000</td>
<td></td>
</tr>
<tr>
<td>Interest proration on sale of Relinquished Property</td>
<td>7,313</td>
<td>Deductible</td>
</tr>
<tr>
<td>Prepayment penalty on sale of Relinquished Property</td>
<td>13,000</td>
<td>Deductible</td>
</tr>
<tr>
<td>Other</td>
<td>8,500</td>
<td>Taxable gift</td>
</tr>
<tr>
<td>Real property taxes on Relinquished Property</td>
<td>26,000</td>
<td>Deductible</td>
</tr>
<tr>
<td>Rent proration on sale of Relinquished Property</td>
<td>5,000</td>
<td>Reduces Income</td>
</tr>
<tr>
<td>Portion of legal fee to sell Relinquished Property</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allocated to tax advice (not acquisition advice)</td>
<td>750</td>
<td></td>
</tr>
<tr>
<td>Loan fee to acquire Replacement Property</td>
<td>30,000</td>
<td>Amortizable</td>
</tr>
<tr>
<td>Tax proration to purchase Replacement Property</td>
<td>18,000</td>
<td>Deductible</td>
</tr>
<tr>
<td>Purchase deposits on Replacement Property</td>
<td>32,000</td>
<td></td>
</tr>
<tr>
<td>Portion of legal fee to purchase Replacement Property</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allocated to tax advice (not acquisition advice)</td>
<td>600</td>
<td></td>
</tr>
<tr>
<td>Cash received</td>
<td>176,163</td>
<td></td>
</tr>
</tbody>
</table>

**Detail: Cash Given**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax proration on sale of Relinquished Property</td>
<td>11,917</td>
<td>Reduces deduction</td>
</tr>
<tr>
<td>Sale of deposits on Relinquished Property</td>
<td>24,000</td>
<td></td>
</tr>
<tr>
<td>Earnest money to purchase Replacement Property</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td>Rent proration on purchase of Replacement Property</td>
<td>7,500</td>
<td>Income</td>
</tr>
<tr>
<td>Additional cash required to close purchase of Replacement Property</td>
<td>8,796</td>
<td></td>
</tr>
<tr>
<td>Cash given</td>
<td>102,213</td>
<td></td>
</tr>
</tbody>
</table>
Detail: Sales expenses for Relinquished Property

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Escrow fee and recording costs</td>
<td>800</td>
</tr>
<tr>
<td>Title insurance</td>
<td>1,400</td>
</tr>
<tr>
<td>Exchange Accommodator fee</td>
<td>500</td>
</tr>
<tr>
<td>Legal fees</td>
<td>750</td>
</tr>
<tr>
<td>Brokerage commission</td>
<td>30,000</td>
</tr>
<tr>
<td>Sales expenses</td>
<td>33,450</td>
</tr>
</tbody>
</table>

6. BASIS OF REPLACEMENT PROPERTY

The basis of Replacement Property is a carryover of the basis of the Relinquished Property. The gain in a tax-free exchange is deferred only because the gain will ultimately be recognized when the Exchanger sells the Replacement Property. See example in Article 5.11

6.1 Allocation of Basis. The basis of properties received is allocated to all Replacement Properties, whether or not the Replacement Property is of like kind.

6.2 Example. An Exchanger exchanges real estate Relinquished Property with a fair market value of $12,500 and a basis of $10,000 for real estate Replacement Property with a fair market value of $9,000, an automobile worth $2,000, and $1,500 cash. The gain realized in the transaction is $2,500 ($12,500 fair market value of the Relinquished Property less its basis of $10,000). The boot received is $3,500, composed of the $1,500 in cash and the $2,000 automobile. The gain recognized is $2,500, which is the lesser of the boot received ($3,500) or the gain realized ($2,500). The basis of the Replacement Properties is $11,000, which is the old basis of the Relinquished Property of $10,000, plus the gain recognized of $2,500, less the cash received of $1,500. The basis of $11,000 is allocated to the automobile and the real estate based on their fair market values. The automobile would have a basis of $2,000, and the real estate would have a basis of $11,000. Treas Reg § 1.1031(d)-1(c).

6.3 Depreciation of Replacement Property. The Exchanger cannot continue to use the Exchanger's old depreciation method (which may be quite accelerated) on the Replacement Property. The Exchanger must use the depreciation method for which the property qualifies on the date it is acquired. Priv Ltr Rul 8929047 (Apr. 25, 1989). Under Notice 2000-4, 2000-3 IRB 313, if the Relinquished Property is subject to MACRS depreciation under Sections 167 and 168 and the Replacement Property is subject to MACRS depreciation, the carryover basis of the Replacement Property should be treated in the same manner as the Relinquished Property, with any increase in basis being treated as newly purchased MACRS property.
7. **THREE-PARTY EXCHANGES**

This section discusses three-party exchanges. It also discusses a number of issues common to all multiparty exchanges, including general judicial tolerance to highly structured exchange transactions, direct deeding, and assignments of earnest money agreements.

7.1 **Structuring Three-Party Exchanges.** Rarely do two people exchange their properties directly. There are three typical ways that a three-party exchange is structured:

7.1.1 **Seller sells Relinquished Property to Buyer.** In this structure, the Exchanger exchanges the Relinquished Property with the Seller for the Replacement Property, which is owned by the Seller. As part of a single escrow, the Seller sells the Relinquished Property for cash.

![Figure 1 Three-Party Exchange Through Seller](image)

7.1.2 **Buyer acquires Replacement Property from Seller.** In this format, the Exchanger exchanges the Relinquished Property with the Buyer for the Replacement Property. The Buyer, as part of a single escrow, purchases the Replacement Property from the Seller for cash.
7.1.3 **Use of an Accommodator.** If an Accommodator is used, neither the Buyer nor the Seller is involved in taking title to or conveying property other than his own.

7.2 **Judicial Latitude in Structuring Exchanges.** There are many examples of tricky structuring that must be negotiated in order to complete exchanges, particularly reverse exchanges and build-to-suit exchanges. It is fortunate that the general attitude of the courts is that "[t]axpayers have been allowed wide latitude in structuring [tax-free exchange] transactions." Swaim v. United States, 651 F2d 1066, 1069 (5th Cir Unit A July 1981). See also Maxwell v. U.S., 62 AFTR2d (P-H) ¶ 88-5101 (SD Fla 1988); Biggs v. C.I.R., 632 F2d 1171 (5th Cir 1980). The courts have allowed significant involvement by the Exchanger without finding that the Accommodator was the agent of the Exchanger. See Fred L. Fredericks, 65 TCM (RIA) ¶ 94,027 (1994) (Accommodator not held as agent even though it was a wholly owned subsidiary of the Exchanger); 124 Front Street, Inc. v. C.I.R., 65 TC 6 (1975) (Exchanger

7.3 **Direct Deeding.** In a multiparty exchange, instead of transferring the Relinquished Property from the Exchanger to the Accommodator and then to the ultimate Buyer, or the Replacement Property from the Seller to the Accommodator and then to the Exchanger, the parties can employ direct deeding. The Exchanger can directly convey the Relinquished Property to the Buyer, and the Seller can directly convey the Replacement Property to the Exchanger. Rev Proc 90-34, 1990-1 CB 552.

![Figure 4 Example of Direct Deeding](image)

7.4 **Intent to Consummate Exchange.** Although an intent to effect a transaction as a tax-free exchange will not cause a transaction not otherwise qualifying as an exchange to qualify as a tax-free exchange, it is a condition precedent to a successful tax-free exchange. Typically, an intent to consummate an exchange is established through a well-drafted exchange agreement. In a simultaneous exchange or deferred exchange, the intent to consummate an exchange transaction must arise prior to the Relinquished Property's being conveyed by the Exchanger. In a reverse exchange, the intent must be manifest prior to acquisition of the Replacement Property. See generally Alderson v. C.I.R., 317 F2d 790 (9th Cir 1963); Coupe v. C.I.R., 52 TC 394 (1969).

7.5 **Contractual Interdependence.** Contractual interdependence may simply be a requirement that bolsters the concept in the documentation regarding the "intent" to consummate an exchange. Yet the courts and various commentators refer to it as a separate requirement. In Biggs v. C.I.R., 632 F2d 1171 (5th Cir 1980), the court referred to the existence of an "integrated exchange plan." In Garcia v. C.I.R., 80 TC 491 (1983), acq., 1984-1 CB 1, the court also emphasized the need to have an "integrated plan" to complete the exchange whereby Relinquished Property will be transferred only if Replacement Property can be acquired and conveyed to the Exchanger.
7.6 **Assignment of Earnest Money.** In most multiparty exchanges, the Exchanger will negotiate the sale of the Relinquished Property and the acquisition of the Replacement Property. The earnest money agreements are typically assigned to the Accommodator as part of the closing of the sale or purchase. This technique is generally used with a professional Accommodator or another party to the transaction who is acting as an Accommodator.

7.6.1 The Exchanger can initially intend to sell the Relinquished Property or purchase the Replacement Property and later decide to consummate an exchange. Brauer v. C.I.R., 74 TC 1134 (1980); Alderson v. C.I.R., 317 F2d 790 (9th Cir 1963); Coupe v. C.I.R., 52 TC 394 (1969). Therefore, the earnest money agreement need not mention the existence of an exchange. It is advisable, however, that all earnest money agreements involving exchange property include a "cooperation clause" providing that the other party to the transaction will cooperate with the Exchanger in structuring the transaction as a tax-free exchange. Cooperation may include an assignment of the earnest money agreement to an Accommodator if there is no delay or additional cost or liability.

7.6.2 Typically, the assignment is signed by the Exchanger, the Accommodator, and the Seller or Buyer. Execution of the assignment by the Seller or Buyer meets the requirement that the Buyer or the Seller be "notified in writing of the assignment" before the property is transferred. Treas Reg § 1.1031(k)-1(g)(4)(v).

7.6.3 The assignment of the earnest money agreement should deal with other important issues. It should make it clear that the assignment is effective only on closing so that the Accommodator is not brought into the exchange until the last possible moment. The assignment should also make it clear that all warranty and other rights that are in the earnest money agreement between the Exchanger and the Buyer or Seller will continue and that litigation to enforce those rights will omit the Accommodator as a party. The assignment may also make it clear that title will pass via direct deeding.

8. **DEFERRED ("STARKER") EXCHANGES**

8.1 **Defined.** A deferred exchange is an exchange whereby the Exchanger conveys Relinquished Property to an Accommodator and at a later point in time, in an otherwise-qualifying transaction, the Exchanger receives Replacement Property. A forward-deferred exchange can be structured with or without an Accommodator.

8.1.1 **No Accommodator.** The first deferred exchange approved by the courts was Starker v. United States, 602 F2d 1341 (9th Cir 1979). The original Starker exchange was structured without an Accommodator. In the First Leg, the Relinquished Property is transferred to the Buyer, in
consideration of which the Exchanger receives a promise (exchange agreement) to acquire and transfer Replacement Property to the Exchanger. In the Second Leg, the Buyer acquires the Replacement Property and transfers it to the Exchanger, completing the exchange.

8.1.2 **With an Accommodator.** Most deferred exchanges use an Accommodator in order to complete the transaction more quickly and easily.
8.2 Identification Requirement.

8.2.1 Identification period. In a deferred exchange, the Replacement Property must be properly identified within the Identification Period. The Identification Period starts on the day the Exchanger transfers the Relinquished Property and ends at midnight on the 45th day thereafter ("Identification Period"). Treas Reg § 1.1031(k)-1(b)(2)(i). If the Exchanger transfers more than one Relinquished Property in a single exchange transaction, the Identification Period starts when the first property is transferred. Treas Reg § 1.1031(k)-1(b)(2)(iii). The Identification Period is not extended by weekends or holidays. If the identification is not timely made, the exchange will be taxable. Terry D. Smith v. C.I.R., 71 TCM (RIA) ¶ 97,109 (1997); David Dobrich v. C.I.R., 84 AFTR2d 99-6131 (9th Cir 1999), aff'g 1997 TCM 477 (Oct. 20, 1997).

8.2.2 Manner of identification. The requirements are as follows:

8.2.2.1 Written document. The Replacement Property must be designated in a written document.

8.2.2.2 Execution. The document must be signed by the Exchanger. There is no authority to support execution by someone holding a power of attorney.

8.2.2.3 Delivery. The document must be delivered by hand, mail, facsimile, etc., to another party involved in the exchange, including the Seller, Accommodator, escrow agent, or title company, before the end of the Identification Period.

8.2.2.4 Description. The Replacement Property must be unambiguously described, such as by a legal description, a street address, or the name of a particular building (e.g., Mayfair Building, if the town does not have two buildings of the same name). Treas Reg § 1.1031(k)-1(c)(2), (3). In Michael Hillyer v. C.I.R., 69 TCM (RIA) ¶ 96, 214, at 1565 (1996), the Exchanger designated "property zoned M-2 located south and east of Route 41 in Galesburg Township, Knox County, Illinois." The court noted that many properties satisfied this description, but did not hold that this problem had caused the exchange to fail. This opinion may be considered to be dictum because the court held that the transaction had failed for a variety of other reasons.

8.2.2.5 Tenancy in common interests. When identifying a Replacement Property where only an undivided interest is to be acquired, no one quite knows what constitutes a proper identification. Traditionally, the identification is something like an undivided
20 percent interest in the Replacement Property. But if the amount actually acquired is only 15%, is this a problem? The regulations provide a 75 percent safe harbor if less than the entire property is acquired, but this is when acquiring only one and a half acres (75 percent) of a 2 acre parcel, not an undivided interest in the whole. Treas Reg § 1.1031(k)-1(d)(2)

Example 4. Worse yet, if 21% is acquired, the Exchangor did not acquire a lesser percentage of the whole that was identified. Many have analogized that the "safe harbor" in the regulations would apply to tenancy in common interests, especially is less than the whole is acquired. Thus, 75% of 20% interest that was identified, or a 15% interest in the Replacement Property should work. But identifying 21% is within a 25% limit, but it is a greater percent of the whole and might be slightly more risky. Another approach identified in a January, 2005 ABA Taxation Section meeting in San Diego is to identify whatever percentage interest in the Replacement Property $800,000 in cash (assuming that is the amount the Accommodator is holding) can acquire. This ignores the effect of debt which could allow (depending on the level of debt) to acquire a greater or lesser interest in the Replacement Property.

8.2.2.6 Improvement exchanges. If the property is to be improved, the identification must also include "as much detail . . . regarding construction of the improvements as is practicable at the time the identification is made." Treas Reg § 1.1031(k)-1(e)(2). Improvement Exchanges are more fully discussed in Article 9.

8.2.3 Multiple Replacement Properties. The Exchanger's designation must meet one of the following requirements, or the exchange will be fully taxed. Treas Reg § 1.1031(k)-1(c)(4).

8.2.3.1 Three alternative designation rules. There are three alternative designation rules. The Exchanger must meet only one of the following three rules:

8.2.3.1.1 Three-property rule. The Exchanger may identify three properties without regard to the fair market values.

8.2.3.1.2 200 percent rule. The Exchanger may identify any number of properties provided that their aggregate fair market value does not exceed 200 percent of the fair market value of the Relinquished Property.

8.2.3.1.3 95 percent rule. The Exchanger may designate any number of Replacement Properties, provided that
during the Exchange Period the Exchanger actually receives identified Replacement Properties that have a fair market value equal to 95 percent of the aggregate fair market value of all identified Replacement Property.

8.2.3.2 Received during Identification Period. Any Replacement Property that is actually received by the Exchanger during the Identification Period will be treated as being properly identified under the identification requirement. In TAM 200602034, the taxpayer failed the 200-percent rule, the three-property rule and the 95 percent rule. However, the taxpayer was allowed to exchange tax-free the property actually received during the Identification Period.

8.2.3.3 What is property? When satisfying the three-property rule discussed above, it is important to consider whether a particular property constitutes one or more properties. There is not much doubt that if several parcels are acquired that are contiguous to each other and are owned by the same owner, they would be considered to be a single parcel of property for purposes of the three-property rule. It appears possible, although no authoritative guidance is available, that if the properties are contiguous to each other, but are owned by two different sellers, the parcels would be considered a single parcel of property for purposes of the three-property rule. If the properties are not contiguous to each other, it is unlikely that they would be treated as a single parcel of property, unless it was an unusual circumstance. For example, a condominium and the parking space for the condominium would probably be considered a single parcel of property, although no guidance is available. Likewise, a farm that was farmed as an economic unit but that had a parcel that was not contiguous to the bulk of the farm might be considered to be a single parcel, but this may be pushing the issue, and one might want to treat the issue conservatively. See Terrence Floyd Cuff, Identification of Multiple Replacement Properties in a Deferred Exchange, 25 J Real Est Tax'n (1998). In Section 4 of Rev Proc 2002-22, the IRS stated for ruling purposes, non-contiguous properties could be considered to be a single property if they were part of a "single business unit." See also discussion regarding whether a transaction constitutes one or two exchanges at Article 4.5.3.

8.2.3.4 Incidental property ignored. Incidental property that is part of the main property identified, such as a spare tire in a car, or personal property, such as furniture and laundry machines in an apartment building, is ignored so long as the value of the
incidental property is less than 15 percent of the total value. The truck and spare tire are treated as one property. Such incidental property could still be taxed as boot.

8.2.3.5 Prior law. Prior to the adoption of existing regulations, there was no limit as to the number of properties that could be designated. In Raymond St. Laurent v. C.I.R., 69 TCM (RIA) ¶ 96,150 (1996), the tax court allowed the Exchanger to identify 20 separate properties and to acquire only 2 of those properties. The court also rejected arguments that contingencies were required to name multiple properties.

8.2.4 Revocation of identification. All designations are counted unless they have been revoked prior to the end of the Identification Period. Any revocation must be signed by the Exchanger and delivered before the end of the Identification Period. Treas Reg § 1.1031(k)-1(c)(6).

8.2.5 Backdated identification. In David Dobrich v. C.I.R., 73 TCM (RIA) ¶ 98,039 (1998), the Exchanger was hit with a $774,307 civil fraud in addition to $1,032,409 in tax for backdating a 45-day designation.

8.3 Receipt Requirement. The Replacement Property, which has been properly designated, must be received within the Exchange Period.

8.3.1 Exchange Period. In a deferred exchange, the Replacement Property must be received by the Exchanger by the end of the Exchange Period. The Exchange Period starts on the date on which the Exchanger transfers the Relinquished Property and ends on the earlier of the 180th day thereafter or the due date (including extensions) of the Exchanger's tax return ("Exchange Period"). The Exchange Period is not extended for weekends or holidays. It is not extended by a "good faith effort" to acquire the Replacement Property in a timely manner. David A. Knight v. C.I.R., 73 TCM (RIA) ¶ 98,107 (1998). The Exchange Period will not be extended because the Accommodation was taken over by a receiver. Priv Ltr Rul 200211016 (Dec. 10, 2000). The extension will be valid only if the taxpayer actually files for an extension. In Orville E. Christensen v. C.I.R., 69 TCM (RIA) ¶ 96,254 (1996), the Tax Court held that an exchange was fully taxable when Replacement Property was received after the tax return due date even though the Exchanger qualified for an automatic four-month extension. See also Raymond St. Laurent v. C.I.R., 69 TCM (RIA) ¶ 96,150 (1996).

8.3.2 Multiple Relinquished Properties. If the Exchanger transfers more than one Relinquished Property in a single exchange, the Exchange Period starts when the first property is transferred. Treas Reg § 1.1031(k)-1(b)(2)(ii). If an exchange plan involves the sale of more than one Relinquished Property, it may be possible to avoid this rule.
by structuring the transactions as separate exchanges. See discussion in Article 4.5.

8.3.3 **Receipt of Replacement Property different from property identified.** If the Replacement Property received is different from the property identified, the exchange will fail.

8.3.3.1 **Nature and character.** The nature and character of the property received must be the same as the property identified. For example, if two acres and a barn are identified, but only the barn and the real estate immediately surrounding it are acquired, the exchange will be taxable. Treas Reg § 1.1031(k)-1(d)(2) Example 3.

8.3.3.2 **75 percent safe harbor.** The regulations appear to provide a 75 percent safe harbor if less than the entire property is acquired. If two acres of unimproved property are designated, but the Exchanger acquires only one and a half acres (75 percent) of the whole, the identification will be successful. Treas Reg § 1.1031(k)-1(d)(2) Example 4.

8.3.3.3 **Improvements not identified.** If the identification of the Replacement Property did not include improvements, but the Replacement Property was improved, the exchange will fail because the Exchanger received property other than the Replacement Property that was identified. Treas Reg § 1.1031(k)-1(e)(2). Improvement Exchanges are more fully discussed in Article 4.

8.3.3.4 **Improvements not completed.** The Replacement Property will qualify if it is only partially constructed real estate on the date it is received by the Exchanger. Personal property will not be treated as like kind unless the improvements have been completed as of the date it is conveyed to the Exchanger. Treas Reg § 1.1031(k)-1(e)(5) Examples (ii), (iii).

9. **REVERSE-DEFERRED EXCHANGES**

9.1 **General.** A reverse exchange is an exchange in which the Replacement Property is acquired before the Relinquished Property is sold. In contrast, in a deferred-forward exchange, the Relinquished Property is exchanged and sold first and the Replacement Property is acquired within 180 days of the sale of the Relinquished Property. In most reverse exchanges an Accommodator will hold either the Relinquished Property or the Replacement Property. This is known as "parking" the property. A reverse exchange should be attempted only if there is an absolute need to acquire the Replacement Property before the Relinquished Property is sold.
9.1.1 **Lack of authority.** Except for the safe harbor provided by Rev Proc 2000-37, there are no such regulations for a reverse exchange (see Treas Reg § 1.1031(k)-1(a)) or much in the way of favorable court guidance. Thus, unless structured within the safe harbor of Rev Proc 2000-37, there is a much higher risk in embarking on a reverse exchange. There are, however, a few cases that support reverse exchanges. They are *Biggs v. C.I.R.*, 69 TC 905 (1978), aff’d, 81-1 USTC (CCH) ¶ 9114 (5th Cir 1980), *J. H. Baird Pub'l'g Co. v. C.I.R.*, 39 TC 608 (1962), and *In re Exchanged Titles*, 159 BR 303 (Bankr CD Cal 1993), all of which are discussed in more detail below.

9.1.2 **IRS basis for attacking.** Unless structured within the safe harbor of Rev Proc 2000-37, the IRS will generally attack a reverse exchange by taking the position that the Accommodator in the transaction was the agent for the Exchanger.

9.1.2.1 In *DeCleene v. Commissioner*, 115 TC No. 34 (Nov. 17, 2000), Exchanger purchased the Replacement Property and did not acquire it through an Accommodator. He later transferred it to an Accommodator to hold the property for a period of three months while it was being improved. The Tax Court held that the Exchanger did not have a majority of the benefits and burdens of ownership. Therefore, the Accommodator was in reality the agent of the Exchanger and the Exchanger in effect was attempting to treat improvements to property already owned by the Exchanger as Replacement Property. It held that this was in violation of the rule in *Bloomington Coca-Cola Bottling Co. v. C.I.R.*, 189 F2d 14 (7th Cir 1951). Note the very powerful language the court used:

"[Accommodator] did not acquire any of the benefits and burdens of ownership of the [Replacement Property] during the 3-month period it held title to that property. [Accommodator] acquired no equity interest in the [Replacement Property]. [Accommodator] made no economic outlay to acquire the property. [Accommodator] was not at risk to any extent with respect to the [Replacement Property] because the obligation and security interest it gave back on its purported acquisition of the property were nonrecourse. [Accommodator] merely obligated itself to reconvey to petitioner prior to yearend the [Replacement Property] with a substantially completed building on it that had been built to his specifications and that pursuant to prearrangement he was obligated to take and pay for.

"The parties treated [Accommodator's] holding of title to the [Replacement Property] as having no economic significance. The transaction was not even used as a financing device. No interest
accrued or was paid on the nonrecourse note and mortgage, which assured that petitioner would get back the [Replacement Property] after it had been improved. [Accommodator] had no exposure to real estate taxes that accrued with respect to the property while [Accommodator] held the title; all such taxes were to be paid by petitioner. No account was to be taken under the terms of the reacquisition agreement of any value that had been added to the property by reason of the building constructed in the interim. The construction was financed by petitioner through the bank he was accustomed to dealing with. Petitioner through his guaranty and reacquisition obligation was at all times at risk with respect to the [Replacement Property]. [Accommodator] had no risk or exposure with respect to the additional outlay of funds required to finance construction of the building. [Accommodator] had no potential for or exposure to any economic gain or loss on its acquisition and disposition of title to the [Replacement Property]."
Accommodator borrowed all of the funds from a bank or from the Exchanger. The funds borrowed by the Exchanger were recourse. The Exchanger guaranteed the bank loan. The Replacement Property was leased from the Accommodator to the Exchanger on a triple-net basis for a period of one year with a possible one-year extension. The Exchanger had an option to purchase the parked Replacement Property for its fair market value, which was deemed to be its cost if the purchase was consummated within 18 months. There was also some sort of stop loss agreement that limited the liability of the Accommodator to "Z" percent that was picked up by the Exchanger. Under the facts, the Accommodator was perhaps going to have some opportunity for gain if the option was not exercised within 18 months. It had no actual funds invested to purchase the property. It did have liability under the recourse loan that it might actually have to pay if the Exchanger did not exercise the option (in which case the loan would be satisfied as part of the consideration to purchase the replacement property). It is frankly very curious how the IRS approved this ruling, as the facts appear to be quite weak. The analysis is weak as well. For example, it attempted to distinguish DeCleene v. Commission, 115 TC No.34 (Nov. 17, 2000), because it did not have an integrated plan to complete an exchange. However, DeCleene v. Commission decision was based on an analysis that found that the majority of the benefits and burdens of ownership of the parked property were with the Exchanger and not the Accommodator.

9.1.2.4 See also FAA 20050203F (Jan 14, 2005) where the IRS shot down a reverse exchange because the Accommodator did not have a majority of the benefits and burdens of ownership of the parked property during the parking period. This advisory was issued on a transaction entered into prior to Rev Proc 2000-37.

9.1.3 Creating risk and benefits in the Accommodator. For a reverse exchange not using the safe harbor of Rev Proc 2000-37, the Accommodator must be considered a "principal" in the transaction. The Accommodator must have some of the risks and benefits of ownership. It should be noted that as a practical matter, Accommodators are unwilling to accept any of the material risks of ownership and Exchangers are unwilling to allow the Accommodator to have any of the benefits of ownership. What are some types of risks and benefits that can be given to the Accommodator?

9.1.3.1 Title acquisition by the Accommodator brings with it risks for personal injury and environmental claims.
9.1.3.2 The Accommodator can be personally liable on mortgages.

9.1.3.3 The Accommodator can assume the loss if the value of the parked property declines.

9.1.3.4 The Accommodator can have the benefit if the parked property increases in value.

9.2 **Three Types of Reverse Exchanges.** There are three basic types of reverse exchanges.

9.2.1 **True reverse exchange.**

9.2.1.1 **Definition.** A true reverse exchange is an exchange in which the Exchanger actually acquires the Replacement Property first and later sells the Relinquished Property. No Accommodator is used in a true reverse exchange.

9.2.1.2 **Legal authority.** The best case supporting the concept of a reverse exchange is Starker v. United States, 602 F2d 1341 (9th Cir 1979). In Starker, with respect to a deferred exchange, the court accepted the principle that the receipt of the Replacement Property need not occur simultaneously with the disposition of the Relinquished Property. Virtually no case law, however, supports a true reverse exchange. For this reason, a "true reverse" is almost never attempted. For the most part, case law is against the use of true reverse exchanges:

9.2.1.2.1 **Bennie D. Rutherford,** 47 TCM (P-H) ¶ 78,505 (1978), involved a transfer of 12 heifers to the Exchanger in 1973 in return for the Exchanger's agreement to transfer 12 heifers in 1974, 1975, and 1976. The transaction was held to be tax-free.

9.2.1.2.2 **Bezdjian v. C.I.R.,** 845 F2d 217 (9th Cir 1988), the Exchanger attempted to exchange rental property for a gas station. Eventually, the Exchanger acquired the gas station and sold the rental property to another party three weeks later. There was no prearranged agreement attempting to treat the transaction as an exchange. The transaction was held to be taxable.

9.2.1.2.3 **Edward C. Lee,** 55 TCM (P-H) ¶ 86,294 (1986), the Exchanger sold property to different purchasers and directed that the proceeds be used to pay the indebtedness on farm property purchased the year...
before. Again, the transaction was held to be taxable.

9.2.1.2.4 Smith v. C.I.R., 537 F2d 972 (8th Cir 1976), held that a cash sale of Relinquished Property followed by a transfer of the Replacement Property to the Exchanger was taxable.

9.2.1.2.5 Julius Dibsy v. C.I.R., 68 TCM (RIA) ¶ 95,477 (1995), involved an exchange of two liquor stores. The Exchanger purchased the Replacement Property and operated it for six months before selling the Relinquished Property. The transaction was held to be taxable.

9.2.1.2.6 In C. Bean Lumber Transport v. United States, 83 AFTR2d 99-2013 (WD Ark 1999), a reverse trade-in involving trucks was not allowed. The purchase of the replacement truck was not treated as being exchanged for a relinquished truck.

9.2.1.2.7 In Priv Ltr Rul 9823045 (June 25, 1998), the IRS allowed a reverse exchange. The Exchanger was a power company and acquired a replacement easement for power transmission lines prior to selling its existing relinquished easement. The transaction was done with one other company and had contractual interdependence because the Exchanger was obligated to transfer the old easement to the other party to the exchange after the new easement was acquired and the power lines were tested and in place.
9.2.2 Park Replacement Property.

9.2.2.1 General. In a reverse exchange in which the Replacement Property is parked, the Exchanger causes the Accommodator to acquire the Replacement Property and the Accommodator holds the Replacement Property until the Relinquished Property is ready to be sold. When the Relinquished Property is ready to be sold, the Exchanger transfers the Relinquished Property to the Accommodator, who simultaneously transfers the Replacement Property to the Exchanger.

Figure 7 Reverse Exchange in Which Replacement Property Is Parked

9.2.2.2 Simultaneous exchange. This type of exchange is really a simultaneous exchange, but it is thought of as a reverse because the Exchanger, through the Accommodator, acquires the Replacement Property before the Relinquished Property is conveyed.

9.2.2.3 Time limits. If the exchange is structured using Rev Proc 2000-37, there are time limits which must be observed (see 9.3.1.4 and 9.3.1.5). Otherwise, there are no time limits. After the Accommodator acquires the Replacement Property, the Exchanger can theoretically wait an unlimited time to sell the Relinquished Property and complete the exchange.
9.2.2.4 Legal authority.

9.2.2.4.1 Rev Proc 2000-37 (see 9.3).

9.2.2.4.2 Biggs v. C.I.R. The case most practitioners rely on for support in structuring a reverse exchange is Biggs v. C.I.R., 69 TC 905 (1978), aff'd, 81-1 USTC (CCH) ¶ 9114 (5th Cir 1980). In Biggs, the Exchanger's attorney's corporation served as the Accommodator and purchased the Replacement Property with the Exchanger's funds and held it for two months. Later, the Exchanger conveyed the Relinquished Property directly to a Buyer and simultaneously received the Replacement Property from the Accommodator. The court held that the transaction qualified as a tax-free exchange.

9.2.2.4.3 J. H. Baird Publ'g Co. v. C.I.R., 39 TC 608 (1962). This case combines an improvement exchange with a reverse exchange. The Accommodator acquired the Replacement Property and commenced to construct improvements on it. During construction, the Accommodator exchanged the Relinquished Property for the Replacement Property. The Court held that the transaction qualified as a simultaneous exchange.

9.2.3 Park Relinquished Property.

9.2.3.1 General. In a reverse exchange in which the Relinquished Property is parked, the Exchanger causes the Accommodator to acquire the Replacement Property and the Accommodator immediately exchanges the Relinquished Property for the Replacement Property. The Accommodator holds the Relinquished Property (as opposed to the Replacement Property) until it is sold.
9.2.3.2 **Simultaneous exchange.** Like a reverse exchange, in which the Replacement Property is parked, this type of exchange is also really a simultaneous exchange. It is thought of as a reverse, however, because the Exchanger, through the Accommodator, acquires the Replacement Property before the Relinquished Property is sold.

9.2.3.3 **Time limits.** If the exchange is structured using Rev Proc 2000-37, there are time limits which must be observed (see 9.3.1.4 and 9.3.1.5). Otherwise, there are no time limits. After the Accommodator acquires the Relinquished Property, the Accommodator can theoretically wait an unlimited time to sell the Relinquished Property.

9.2.3.4 **Legal authority.** Rev Proc 2000-37 explicitly allows reverse exchanges in which the Relinquished Property is parked. The only other authority for a reverse exchange in which the Relinquished Property is parked comes from In re Exchanged Titles, Inc., 159 BR 303 (Bankr CD Cal 1993). The Exchanger lent funds to the Accommodator to purchase the Replacement Property, and the Accommodator immediately transferred it to the Exchanger in exchange for the Relinquished Property. The Exchanger collected rent, paid taxes and mortgage payments, maintained the Relinquished Property, and even refinanced the Relinquished Property while it was in the hands of the Accommodator. Before the Relinquished Property was sold and the loan to the Accommodator to purchase the Replacement Property was paid off, the Accommodator filed an involuntary
Chapter 7 bankruptcy petition. The bankruptcy trustee claimed the Relinquished Property as an asset of the bankruptcy estate. The court held that the Accommodator held only the pure legal title to the Relinquished Property, not the equitable title, and that to accomplish a reverse exchange, only equitable title is required. This authority is quite weak because it appears to be inconsistent with general tax principles. The court may have determined that the Accommodator need not be the equitable owner (the owner for tax purposes) of the Relinquished Property so that the Exchanger could recover the Relinquished Property from the bankruptcy trustee.

9.3 **Rev Proc 2000-37.** On September 15, 2000, the Internal Revenue Service issued Rev Proc 2000-37. The procedure provides a safe harbor for Exchangers in structuring a reverse tax-free exchange. The new revenue procedure embodies a liberal approach but may force Exchangers who are not sure whether they can sell their Relinquished Property within Rev Proc 2000-37's restrictive timelines to choose between the new safe harbor or a traditional (but riskier) reverse exchange.

9.3.1 **Qualifying Arrangement.** Rev Proc 2000-37 provides a safe harbor to an Exchanger who wishes to complete a reverse exchange. If the following six requirements are met, the IRS will not challenge (thus creating a "safe harbor") the characterization of property as Relinquished Property or Replacement Property in a tax-free exchange:

9.3.1.1 **Ownership.** The property must be owned by an "exchange accommodation titleholder" who is not the Exchanger or a disqualified person as defined in Treas Reg § 1.1031(k)-1(k). In general, a disqualified person is a person who is not related to the Exchanger. If the property is replacement property, it cannot have been owned by the Exchangor within the last 180 days. Rev Proc 2004-51. As discussed below, the exchange accommodation titleholder can also be a qualified intermediary under Treas Reg § 1.1031(k)-1(g)(4). For simplicity, we will refer to the title-holding entity, which will often be the qualified intermediary, as the Accommodator. The Accommodator must either hold a deed to the parked property or be a purchaser under a real estate contract. The revenue procedure also requires that the Accommodator either be a taxpaying entity or, if it is a partnership or an S-corporation, have 90 percent of its interests owned by a taxpaying entity. Rev Proc 2000-37 makes it clear that it is permissible for the Accommodator to own the property through a single-member limited liability company, which is a disregarded entity for tax purposes under Treas Reg § 301.7701-3(b)(1).
9.3.1.2 Intent. The Exchanger must have a bona fide intent that the property held by the Accommodator be used as either Relinquished Property or Replacement Property in a tax-free exchange. This requirement is the same as the requirement found for a traditional forward exchange. Treas Reg § 1.1031(k)-1(j)(2)(iv).

9.3.1.3 Required Contract Provisions. The Accommodator and the Exchanger must enter into an agreement providing that the Accommodator is "holding the property for the benefit of the Exchanger in order to facilitate an exchange under section 1031" and Rev Proc 2000-37. The agreement must also provide that the Accommodator will be treated as the owner of the parked property for federal income tax purposes and that both parties will report the transaction in a manner consistent with the agreement. This agreement must be entered into no later than five business days after the parked property is transferred to the Accommodator.

Accordingly, Accommodators must file tax returns which report lease income and deduct interest expenses, depreciation and other costs of operating the parked property. Accommodators who are alarmed at the increased bookkeeping requirements may be able to avoid being forced to claim depreciation by providing in the lease agreement that the taxpayer-tenant has the obligation to restore the value of the property at the expiration of the lease term. Terre Haute Electric Co. v. Comm., 21 AFTR 118, 96 F2d 383, 38-1 USTC (CCH) ¶ 9228 (7th Cir 1938); Hibernia Nat. Bank v. U.S., 54 AFTR2d 84-5868 (CCH), 740 F2d 382 (5th Cir 1984).

9.3.1.4 Identification Requirement. Within 45 days after the Accommodator acquires title to the parked Replacement Property, the Relinquished Property must be identified. The "identification must be made in a manner consistent with the principles described in section 1.1031(k)-1(c)." It is not clear whether this references to the "principles" of the regulations refers only to issues such as signing and delivery of the designation, or whether it also refer to the number of replacement properties that can be designated. If so, one of three tests would have to be met: i) no mean that not more than three relinquished properties can be designated, or ii) more than three relinquished properties can be designated if their value does not exceed 200 percent of the value of the Replacement Property, or iii) more than three relinquished properties can be designated if 95 percent of the value of all of the relinquished properties designated are actually used as Relinquished Property in the tax-free exchange. In Ltr Rul 200718028, Exchanger had
the Accommodator acquire the Replacement Property, but failed within the 45-day period to identify the Relinquished Property. The IRS excused the failure because the Relinquished Property was actually sold within the 45-day period (even though the Relinquished Property was not otherwise identified).

9.3.1.5 **Receipt Requirement.** Within 180 days after the Accommodator acquires title to the parked property, the property must be transferred to the Exchanger as Replacement Property or to a buyer as Relinquished Property in a tax-free exchange. The identification requirement and receipt requirement for reverse exchanges were first suggested by the American Bar Association in 1993. See ABA Section of Taxation, Report on the Application of Section 1031 to Reverse Exchanges, 21 J Real Est Tax'n 44 (1993).

9.3.1.5.1 The revenue procedure provides that if the property is not transferred to the Exchanger as Replacement Property, it cannot be transferred to a disqualified person. Therefore, the revenue procedure cannot be used in a related-party exchange under Section 1031(f) if the purchaser of the Relinquished Property is a related party.

9.3.1.5.2 The receipt requirement is worded in such a way that all the parked property must be transferred to the Exchanger. It provides that no later than 180 days after receipt by the Accommodator, "the property is [either] transferred . . . to the Exchanger as Replacement Property; or . . . transferred [to a buyer] as Relinquished Property." The language appears to preclude bifurcating a single reverse exchange into a safe-harbor reverse exchange and a traditional reverse exchange. The Exchanger, for example, cannot use 50 percent of the Replacement Property within the 180-day replacement period as Replacement Property for Relinquished Property Blackacre, while using the remaining 50 percent of the Replacement Property outside of the 180-day replacement period as Replacement Property for Relinquished Property Whiteacre.

9.3.1.5.3 It also appears that the language of the revenue procedure prevents a single parcel of property from being used as Replacement Property for two Exchangers. For example, a single Accommodator cannot hold Replacement Property and then transfer
50 percent to Exchanger X as Replacement Property and the remaining 50 percent to Exchanger Y as Replacement Property. This problem could be solved if Exchanger X and Exchanger Y each had a separate Accommodator and each Accommodator purchased only an undivided one-half interest in the parked Replacement Property.

9.3.1.5.4 The revenue procedure does not specifically provide that two Exchangers who co-owned the Relinquished Property and were both parties to the same exchange agreement (as would be the case with most husband-and-wife transactions) would be treated as the "Exchanger," but it is doubtful that the IRS intended to preclude this very common situation.

9.3.1.5.5 It should also be pointed out that if a reverse exchange is converted into a forward exchange, the identification and replacement requirements must be adhered to. For example, an Exchanger may wish to complete improvements to the Replacement Property held by the Accommodator after the Relinquished Property is sold. If so, the Exchanger must also comply with the forward-exchange requirements for identification of the Replacement Property within 45 days and receipt of the Replacement Property within 180 days after the Relinquished Property is conveyed by the Exchanger.

9.3.1.5.6 There is no effect on the regular Exchange Period if the exchange is structured as a reverse exchange under Rev Proc 2000-37. For example, Relinquished Property identified in a reverse exchange can be exchanged in part for Replacement Property held pursuant to Rev Proc 2000-37, and for other Replacement Property acquired up to the last day of the 180-day Exchange Period. CCA 200836024.

9.3.1.6 **Total Holding Period.** The combined period that the Accommodator holds any parked property (Relinquished Property or Replacement Property) cannot exceed 180 days. This requirement is somewhat problematic. Traditionally, a reverse exchange was often used to extend the 180-day period for completing improvements to Replacement Property, thus
avoiding taxable boot to the Exchanger. This strategy will not be available for an Exchanger who elects to take advantage of Rev Proc 2000-37's safe harbor.

9.3.2 **Permissible Agreements.** In addition to laying out the six requirements necessary to fall within the safe harbor, Rev Proc 2000-37 approves seven different types of legal relationships regardless of whether such arrangements, such as leases, purchase agreements, puts, and calls, include "arm's length" terms.

9.3.2.1 **Title Holder as Qualified Intermediary.** The Accommodator who holds title to the parked property may act as a qualified intermediary under Treas Reg § 1.1031(k)-1(g)(4). Thus, the title-holding Accommodator can also act as the exchange Accommodator if the title-holding Accommodator can meet the requirements of a qualified intermediary.

9.3.2.2 **Loans.** The taxpayer may loan funds to the accommodator or guarantee a loan to the accommodator. The revenue procedure allows all of the permissible agreements to contain terms which are not arm's length terms. Thus, no interest need be charged on the loan to keep it within the revenue procedure's safe harbor. However, failing to charge interest may cause the loan to be treated under the imputed interest rules under IRC § 7872.

9.3.2.3 **Guaranty Arrangements.** The Exchanger may guarantee the obligations of the Accommodator to purchase the parked property. The Exchanger may also indemnify the Accommodator against costs and expenses.

9.3.2.4 **Leasing Arrangements.** The parked property can be leased to the Exchanger. Leasing the property from the Accommodator to the Exchanger is very common in reverse exchanges. Under Rev Proc 2000-37, Exchangers need not be concerned about being charged market lease rates. For example, the lease amount might be set an amount equal to the mortgage payments against the parked property plus all other costs of holding the parked property.

9.3.2.5 **Exchanger as Contractor.** The Exchanger can manage the parked property or act as a contractor or supervisor to improve the parked property. These activities are also routinely done in traditional reverse exchanges that involve improvements to the Replacement Property. The benefit of the new Rev Proc 2000-37 is that these activities are now approved. But an Exchanger should not act as a contractor and receive a profit because that might be seen as a violation of the G6 rules. The
G6 rules (from Treas Reg § 1.1031(k)-1(g)(6)) provide that an Exchanger cannot withdraw funds held by an Accommodator until the exchange is completed.

9.3.2.6 **Purchase Agreements, Puts, and Calls.** The Exchanger and the Accommodator may enter into purchase agreements, puts, and calls with respect to the parked property as long as they are for a period of not more than 185 days (5 days past the 180-day replacement period) from the Accommodator's acquisition of the parked property.

9.3.2.6.1 Purchase agreements, puts, and calls can be at a fixed or formula price, thus freeing tax lawyers from attempting to fashion market-rate provisions in such agreements.

9.3.2.6.2 An Exchanger who wishes to take advantage of Rev Proc 2000-37 but is not sure that the sale of his Relinquished Property can close within the 180-day replacement period cannot automatically convert to a traditional reverse exchange. Such a conversion cannot be accomplished because the applicable legal documents must provide that the right to force the Accommodator to transfer the parked property to the Exchanger must cease after 185 days! Further, the leases and options may not have been structured using arm's-length terms that are not required under Rev Proc 2000-37.

9.3.2.6.3 If the Exchanger realizes that he will not be able to sell the Relinquished Property within the 180-day replacement period, he could seek to extend the date of the call or option agreement to a period beyond the 185-day deadline. Obviously, the Accommodator would have to consent to such an extension.

9.3.2.7 **Arranging for Parking Relinquished Property.** In a parking arrangement where the Relinquished Property is parked, it has always been very difficult to structure the documentation so that if the Relinquished Property is ultimately sold for more than the amount envisioned by the Exchanger, the Exchanger could recover the excess. This problem generally occurred only if the amount owed by the Accommodator on various loans secured by the parked Relinquished Property was less than the sales proceeds from the sale of the Relinquished Property. If such an outcome is a possibility, this structure was usually not
recommended. If the agreements provided that the Exchanger could recover the excess proceeds from the Accommodator, it would be easy for the IRS to argue that the Exchanger and not the Accommodator had most of the benefits and burdens of ownership with respect to the parked Relinquished Property. Rev Proc 2000-37 now makes it clear that such arrangements will not cause the exchange to be taxable. Of course, unless such excess cash was used to purchase additional Replacement Property, the cash would be distributed to the Exchanger in the form of taxable boot.

9.3.3 **Conversion to Traditional Reverse Exchange.** The revenue procedure make it clear that an Exchanger can choose to either use Rev Proc 2000-37 or structure a reverse exchange using the traditional method with its inherent tax risks. If the Exchanger is sure that a particular Relinquished Property can be sold to a buyer within the 180-day period, Rev Proc 2000-37 provides a risk-free approach to structuring the exchange. But many Exchangers are unsure which of several possible relinquished properties will eventually be sold and, even if a particular Replacement Property is under contract to sell, whether in fact the transaction will close within the 180-day replacement period. In this situation, the Exchanger may want to structure the transaction under Rev Proc 2000-37, with the possibility of converting the transaction to a traditional reverse exchange. If conversion is a possibility, the entire transaction must be structured using the more conservative arm's-length terms in leases, purchase agreements, puts, and calls so that the majority of benefits and burdens of the parked property reside with the Accommodator, and the Exchanger must also obtain the consent of the Accommodator to extend the period to acquire the parked property beyond 185 days.

9.4 **Typical Structural Elements.**

9.4.1 **Loan.** Typically the Exchanger will lend to the Accommodator the funds to purchase the Replacement Property. This structure was approved by the Tax Court in *124 Front Street, Inc.*, 65 TC 6 (1970); *Biggs v. Comm.*, 69 TC 905 (1978), affd 632 F2d 1171 (5th Cir 1980). A typical Accommodator will require that the loan be nonrecourse because the Accommodator does not want to be personally liable to repay the loan. The loan should provide for interest to be paid at a market rate.

9.4.1.1 **IRS attack.** If the loan is nonrecourse and the Accommodator does not use any of its own funds to acquire the Replacement Property, the IRS's argument that benefits and burdens of ownership are with the Exchanger is strengthened. An exchange under Rev Proc 2000-37 is not subject to such attack.
as it specifically provides that loan terms do not need to be at arm's length.

9.4.1.2 **True equipment leases.** Under some circumstances, especially with large equipment acquisitions, such as aircraft, leasing companies are willing to acquire the equipment with their own funds. Structuring such a transaction will greatly strengthen the transaction from attack by the IRS.

9.4.1.3 **Bank financing.** If the Exchanger does not have its own funds, the loan is structured as either a direct loan from a bank to the Accommodator, which is guaranteed by the Exchanger, or a loan from a bank to the Exchanger, who in turn lends the funds to the Accommodator.

9.4.1.4 **Can loan be secured against Relinquished Property?** In order to purchase and improve the Replacement Property, Exchangers often want the Accommodator to secure the loan against the Relinquished Property. It has always been a concern that when the Relinquished Property is sold, the loan against the Relinquished Property will be treated as debt against the Relinquished Property and that the new debt against the Replacement Property will have to be equal to or greater than the debt against the Relinquished Property, including any debt whose proceeds were used to pay for the acquisition of and improvements to the Replacement Property. It appears that such a debt will not be treated as debt for purposes of the debt replacement of debt rules because the debt is in effect contingent debt.

Section 1031 and the regulations thereunder do not deal with assumption of contingent liabilities, but there is analogous authority under Section 752 and its regulations that deal with the topic in connection with a partner's share of recourse liabilities. Howard J. Levine, *Taxfree Exchanges Under Section 1031*, 567-2nd Tax Mgmt Portf (BNA) § II.D.4.b(2), (3), at A-19 to A-20 (1997). A partner's share of liabilities increases his or her outside basis in the partnership. The key issue is whether the partner bears the risk of economic loss. Treas Reg § 1.752-2(a). A constructive liquidation is used to determine whether the partner would be required to pay the obligation of the partnership. Treas Reg § 1.752-2(b). Whether and to what extent the partner is obligated to pay is determined under all the facts and circumstances, including guaranties of partnership obligations. Treas Reg § 1.752-2(b)(3). This treatment is also distinguishable from an Exchanger's normal circumstance because the nature of a partnership is that partners are only secondarily liable for
partnership obligations, if at all. Therefore, a personal guaranty would be relevant to determine the extent to which the partners would be liable in the event of default by the partnership.

The more instructive aspect of Section 752 and the attendant regulations is contained in Section 1.752-2(b)(4), which states, "A payment obligation is disregarded if, taking into account all the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligation will ever be discharged." The section goes on to say, "If a payment obligation would arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs." Treas Reg § 1.752-2(b)(4). This appears to be applicable to scenarios in which the partnership's obligations are contingent and the partners therefore unlikely to be called on to fulfill the obligation. One example might be a loan that the partnership guaranteed. Although not directly applicable to Section 1031, this regulation suggests that a liability that is unlikely to be discharged should be disregarded, at least until some event triggers liability. Levine, supra, 567-2nd Tax Mgmt Portf § IID.4.b(2), (3), at A-19 to A-20.

When the Relinquished Property is sold, the sale proceeds should be thought of as including all the proceeds used to pay off the loan. These proceeds are then arguendo deposited with the Accommodator, who uses the proceeds to pay off the Accommodator's loan to purchase and improve the Replacement Property.

9.4.2 **Security for loan.** The loan of funds to acquire the Replacement Property is typically secured by a security interest in the Replacement Property if the Replacement Property is parked with the Accommodator, or in the Relinquished Property if the Relinquished Property is parked with the Accommodator. If the Accommodator has sufficient financial strength, security is not strictly necessary.

9.4.2.1 **Obligation secured.** The security instrument can secure not only the obligation to pay back the loan, but also the obligations of the Accommodator under the exchange agreement.

9.4.2.2 **Bank financing.** If the funds to acquire the Replacement Property originate from a bank or other financial institution, it is likely that the Exchanger will assign its security interest to the bank to secure its obligations under its guaranty or its loan with the bank.
9.4.3 **Option.** The documentation should provide that the parked property can be purchased from the Accommodator by the Exchanger if the Exchanger decides not to sell the parked property.

9.4.3.1 **Option price.** The option price is generally the unpaid balance of the loan.

9.4.3.2 **IRS attack.** It would be better if the option price were a true market price because a market price gives the Accommodator more attributes of ownership than an option price. An Accommodator can never make a profit as a result of its ownership of the parked property with an option price. In *Biggs v. C.I.R.*, 632 F2d 1171 (5th Cir 1980), the court approved a provision in the exchange agreement allowing the Accommodator to terminate the agreement at any time. Transactions under Rev Proc 2000-37 do not need to have a market-rate option price.

9.4.3.3 **Foreclosure alternative.** An alternative to providing for an option in the exchange documents is to secure the loan to purchase the Replacement Property with a trust deed on the parked property. Instead of relying on an option that is subject to IRS attack, the trust deed can be foreclosed. As a practical matter, the Accommodator will be willing to provide a deed in lieu of foreclosure. The problem with this approach, however, is that the Accommodator may not cooperate or the value of the parked property may exceed the loan obligations, in which case the Accommodator may sell the parked property, pay off the loans secured by the parked property, and keep any excess funds.

9.4.4 **Lease.** Typically, the Accommodator leases the parked property to the Exchanger. It can be argued by the IRS that a lease indicates that the Exchanger has beneficial ownership of the parked property. The IRS could also treat a lease transaction as a sale-leaseback pursuant to *Century Electric Co. v. C.I.R.*, 192 F2d 155 (8th Cir 1951), and Rev Rul 60-43, 1960-1 CB 687. A conservative Exchanger will avoid a lease, but most reverse exchanges are structured with a lease-back transaction to the Exchanger.

9.4.4.1 **Term.** The lease term is generally for a term of six months to a year to allow the Exchanger plenty of time to sell the Relinquished Property. The lease theoretically can be for any period of time, but most Accommodators do not want to hold the parked property indefinitely.
9.4.4.2 **Triple net.** The lease is generally a triple-net lease requiring the Exchanger to pay all maintenance, taxes, and insurance on the parked property.

9.4.4.3 **Payments.** The lease payment should be at market rate, but the lease payment is almost always set at a few dollars above (e.g., $100 a month) the amount of the monthly payment due on the loan and on any underlying mortgage.

9.4.4.3.1 **IRS attack.** If the lease payment is set at a true market rate, it is more likely that the lease will be viewed as a true lease. If the payment is the same as the payment due on the loan, there is a greater chance that the transaction will be attacked. If the lease income is significantly higher than the monthly loan payment (e.g., much more than $100 a month), it is easier to argue that the Accommodator has some of the benefits of owning the parked property. The lease amount for an exchange under Rev Proc 2000-37 do not need to be at a market rate. The lease payment, for example, could be explicitly equal to the mortgage payments due on the parked property.

9.4.4.3.2 **Timing.** Generally, a lease payment is made in advance, while a loan payment is made in arrears. In order to simplify the payment and receipt of funds so that they are not a month apart, the lease payment can be made in arrears.

9.4.4.4 **Warranties.** Generally, the acquisition agreement to purchase the Replacement Property and the lease contemplate that the warranties and representations are assigned by the Accommodator to the Exchanger without recourse. These agreements also provide that if any action is to be brought on any representation and warranty, the action is brought by the Exchanger directly against the Seller of the Replacement Property and not against the Accommodator.

9.4.4.5 **Indemnification and insurance.** The Accommodator typically wants no personal liability. The Accommodator is therefore indemnified from all claims in the lease. The lease will also provide that the Exchanger must provide insurance to protect the Accommodator's interest in the leased Replacement Property.
9.4.5 **Lease alternatives.** The Accommodator does not need to lease the property to the Exchanger. The Accommodator can operate the Replacement Property (assuming that it is an office building or apartment building that generates lease income) and use any lease proceeds to pay operating expenses and debt service on the property.

9.4.5.1 **Management.** Typically, an outside management company will manage the property. The Exchanger can manage the property, but such an arrangement should be avoided because it makes the transaction appear as if the Exchanger were the true economic owner of the property.

9.4.5.2 **Surplus income.** If the lease income is greater than the expenses and debt service on the property, then the Accommodator must keep the excess income.

9.4.5.3 **Deficiency.** Under the exchange agreement, if the lease income is not sufficient to pay all expenses and debt service on the property, the Exchanger generally must lend the Accommodator sufficient funds to pay all such expenses.

9.5 **After the Relinquished Property Is Sold.** After the Exchanger finds a Buyer for the Relinquished Property, the following steps are taken:

9.5.1 **Sale agreement.** If the Replacement Property is parked, the agreement to sell the Relinquished Property is assigned from the Exchanger to the Accommodator. This step is not required if the sale agreement relating to the sale of the Relinquished Property is executed by the Accommodator as the Seller or if the Relinquished Property is parked.

9.5.2 **Conveyance of properties.** The Relinquished Property is conveyed either to the Accommodator or directly (see Rev Proc 90-34, 1990-1 CB 552) to the Buyer. Simultaneously, the Replacement Property is conveyed by the Accommodator to the Exchanger.

9.5.3 **Debt repaid.** The Accommodator uses all the proceeds from the sale of the Relinquished Property to pay down or pay off the loan due to the Exchanger.

9.5.3.1 **Loan less than sales proceeds.** If the loan cannot be paid off in full, the nonrecourse provision of the loan means that the unpaid balance of the loan amount will never be paid.

9.5.3.2 **Loan greater than sales proceeds.** If for some reason the Replacement Property is sold for more than the loan amount, the extra cash can be used as part of a forward-deferred exchange or as cash boot to the Exchanger. Such an eventuality must be described in the exchange agreement.
9.5.3.2.1  **Forward-deferred exchange.** The extra funds can be used by the Exchanger as part of a forward-deferred exchange. The 45-day identification requirement and the 180-day receipt requirement must be fully complied with. Therefore, if the Relinquished Property is parked, it will be quite difficult to comply with both requirements because the Relinquished Property could be held by the Accommodator for an indefinite period of time.

9.5.3.2.2  **Cash boot.** The extra cash can be distributed to the Exchanger. It would be treated as taxable boot to the Exchanger.

9.5.4  **Other actions.** The lease and the exchange agreement are canceled, and the security interest in the Replacement Property is extinguished.

9.6  **Comparison of Parking Relinquished Versus Replacement Property.**

9.6.1  **Requirements of commercial lender.** Many commercial lenders balk at having the Accommodator execute the promissory note and trust deed to purchase the Replacement Property, especially because most Accommodators insist that those documents be nonrecourse as to the Accommodator. This is true even if the Exchanger is willing to guarantee the loans. Thus, practical requirements of the lender often require that the Relinquished Property be parked.

9.6.2  **Deferred exchange time limits.** If the Relinquished Property has a greater value than the Replacement Property, it is often necessary for the Exchanger to acquire a second Replacement Property. In this situation it is often advantageous to park the Replacement Property, because the Identification Period and the Exchange Period do not start until the Relinquished Property is transferred by the Exchanger.

9.6.3  **Alternative Relinquished Properties.** If the Exchanger is unsure which Relinquished Property will be sold, or which will sell first, it is best to park the Replacement Property. The Exchanger will then be able to defer the date by which he must select the Replacement Property until a buyer is found for one of the potential Replacement Properties.

9.6.4  **Relinquished Property sale proceeds exceed loan to Exchanger.** If the Relinquished Property is parked, the ultimate sales price is often unknown. If the Relinquished Property sells for an amount greater than the loan obligations of the Accommodator to purchase the Replacement Property, the Exchanger wants to keep such excess funds and as a practical matter the documents must reflect this requirement. But giving the funds back to the Exchanger is inconsistent with the concept that the Accommodator is
the "owner" of the Relinquished Property, because the Accommodator would not have the right to obtain appreciation in the value of the Relinquished Property. Thus, it is often cleaner to park the Replacement Property. If the exchange is structured under Rev Proc 2000-37, this is not an issue as the agreement can explicitly provide that the sales proceeds of the Relinquished Property are held for the benefit of the Exchanger.

9.7 Use of limited liability company ("LLC") in a reverse exchange.

9.7.1 Structure. The Accommodator can organize a single-member LLC to act as its agent to hold the real estate. This entity is ignored for tax purposes. Treas Reg § 301.7761-3(b)(1). The Accommodator acts as the Accommodator, not as the LLC, and the LLC is only a title-holding entity. At the conclusion of the exchange, the parked Replacement Property is transferred to the Exchanger by simply transferring the Accommodator's ownership interest in the single-member LLC to the Exchanger. Such a transfer in effect transfers the Replacement Property to the Exchanger because it now becomes the Exchanger's single-member LLC.

9.7.2 Advantages. The advantages to the Exchanger include the following:

9.7.2.1 No need to record a deed to transfer the property to the Exchanger, thus avoiding paying transfer taxes.

9.7.2.2 No need to prepare special provisions to a construction contract in an improvement exchange to have the contract assumed by the Exchanger. The contract would be entered into between the LLC and the contractor and would continue after the LLC was transferred from the Accommodator to the Exchanger. Presumably, the contractor would require the Exchanger to guarantee the construction contract at all times.

9.7.2.3 No need to have complicated exchange provisions in the construction loan with the bank. The loan documentation can simply approve the change in ownership of the borrower from the Accommodator to the Exchanger. The actual borrower, the LLC, would remain the same during the entire construction period.

9.7.2.4 Title insurance issued to the LLC will continue to insure its interest.

9.8 Depreciation of the Parked Property. Neither the Exchanger nor the Accommodator can claim depreciation on the parked property. In Estate of Bowers v. C.I.R., 94 TC 582 (1990), the Exchanger was denied reverse-exchange treatment because the Exchanger deducted the operating expenses for the Replacement Property for the period when it was held by the Accommodator. Claiming depreciation demonstrated to the Tax Court that the Exchanger treated...
the property as if the Exchanger, not the Accommodator, owned the property. The Accommodator probably cannot claim depreciation on the parked property because it is holding the parked property for sale.

9.9 **Title Insurance.** In a reverse or improvement exchange where title to the Replacement Property is held by the Accommodator, it is important that the Exchanger have title insurance protection. Typically, a title policy will be issued in favor of the Accommodator, but there is no protection to the Exchanger unless one of the following further steps is taken. Note, however, that none of the following steps will protect the Exchanger against liens or encumbrances permitted or suffered by the Accommodator while the Accommodator is holding title to the Replacement Property.

9.9.1 **Additional named insured.** At the time the policy is issued, the Exchanger is listed as an additional named insured on the policy. There is often no additional cost for this listing.

9.9.2 **Purchaser's policy of title insurance.** At the time the policy is issued to the Accommodator, the title insurance company simultaneously issues a purchaser's policy of title insurance in the name of the Exchanger. The theory behind a purchaser's policy is that under the exchange agreement or other legal document, the Accommodator has a legal obligation to convey title to the Replacement Property to the Exchanger. A purchaser's policy arose for a real estate contract where the seller was under an obligation to provide future title to the purchaser. There is no technical need to record the exchange agreement or other agreement that is the promise to convey future legal title prior to the title insurer agreeing to issue a policy. Some title companies, however, still insist that the agreement to convey title be recorded before they will issue a purchaser's policy of title insurance. The cost for the policy is generally nominal as it is being issued simultaneously with an owner's policy in favor of the Accommodator.

9.9.3 **Warranty deed.** Have the Accommodator convey title to the Exchanger by a warranty deed. This should be negotiated with the Accommodator and reduced to writing in the Exchange Agreement, Option Agreement, or Purchase and Sale Agreement. Many Accommodators are unwilling to issue a warranty deed because there may be liens against the Replacement Property of which they may not be aware, such as a construction lien. But, the Accommodator's liability under a warranty deed can be limited to what the title insurance company will defend. Set forth below is language that limits the warranties in a deed that accomplishes this task:

Grantors covenant that Grantors are seized of an indefeasible estate in the real property described above in fee simple, that Grantors have good right to convey the property, that the property is free from encumbrances except for matters of record,
and that Grantors warrant and will defend the title to the property against all persons who may lawfully claim the same by, through, or under Grantors, provided that the foregoing covenants are limited to the extent of coverage available to Grantors under any applicable standard or extended policies of title insurance, it being the intention of Grantors to preserve any existing title insurance coverage.

9.9.4 **Single-member LLC.** A fourth alternative can be used if the property-holding entity is a single-member limited liability company and the Exchanger is a single entity. Under these circumstances, the Replacement Property can be conveyed by simply transferring the ownership of the single-member limited liability company. A single-member limited liability company is ignored for tax purposes, and the transfer is considered the same as a transfer of the property by a deed. Treas Reg § 301.7701-3(b)(1). The change in ownership of the single-member limited liability company does not affect the original title insurance policy on the Replacement Property, which would continue to protect the Exchanger.

10. **IMPROVEMENT (BUILD-TO-SUIT) EXCHANGES**

10.1 **General.**

10.1.1 **Definition.** An improvement exchange is an exchange in which the Accommodator (who could be a professional corporate Accommodator, Seller, contractor, or developer) improves the Replacement Property before it is conveyed to the Exchanger. There are three basic types of improvement exchanges:

10.1.1.1 **Deferred exchange.** In a forward-deferred exchange, the Accommodator acquires the Replacement Property and constructs improvement on it during the 180-day Exchange Period.

10.1.1.2 **Reverse exchange parking Replacement Property.** In a reverse exchange in which the Replacement Property is parked, the Accommodator can take whatever time is necessary to construct improvements on the Replacement Property. When the improvements are completed, the Exchanger can continue to park the Replacement Property while the Exchanger finds a purchaser for the Relinquished Property, or the Replacement Property can be exchanged for the Relinquished Property, which is parked while the Exchanger locates a purchaser for the Relinquished Property.
10.1.1.3 **Seller completes improvements.** A very simple form of improvement exchange is to arrange for the Seller to complete improvements to the exchange property before it is transferred to the Exchanger. This approach is ideal because there is no requirement that an Accommodator be used in the transaction. The purchase price is simply increased by the cost of the repairs or improvements. The Seller is often concerned that if the transaction does not close, the Seller will be stuck with the cost of the improvements. This problem can be solved by increasing the amount of the earnest money to cover the cost of repairs, but the Exchanger may be nervous about increasing the earnest money without assurances that the transaction will close. For large improvement transactions, unless the Seller is motivated, it is quite difficult to arrange the financial risks in the transaction so that both the Seller and the Exchanger will be willing to consummate the transaction.

10.1.2 **Benefits of an improvement exchange.** An improvement exchange allows the Exchanger to use tax-free dollars to build or repair Replacement Property. There are substantially higher transaction costs associated with completing an improvement exchange, however, including higher fees by most professional Accommodators, and higher legal and accounting fees.

10.1.3 **Holdback credits do not work.** An approach instinctively utilized by many realtors and escrow companies to handle minor repairs to Replacement Property is to have repairs performed at the Seller's or Accommodator's expense after the Replacement Property is conveyed to the Exchanger. This approach does not work because the Exchanger is not receiving like-kind property when the Exchanger receives postclosing repairs. Treas Reg § 1.1031(k)-1(e)(4) specifically provides that "additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of a like kind."

10.2 **IRS Basis for Attacking.** As is the case with a reverse exchange, the IRS will generally attack an improvement exchange by taking the position that the Accommodator in the transaction was the agent for the Exchanger. In general, the IRS can argue that the benefits and burdens of ownership in many improvement exchanges lie with the Exchanger despite the form of the transaction. Under tax law, if the Exchanger possesses the benefits and burdens of ownership, then there cannot be a simultaneous later transfer of the Relinquished Property for the Replacement Property.

10.3 **Identification of Replacement Property.** For a forward-deferred improvement exchange, the Replacement Property must be identified. There is no identification requirement for a reverse exchange.
10.3.1 **Improvements identified.** The identification will meet all requirements if the normal identification of the real property is made and if "as much detail is provided regarding construction of the improvements as is practicable at the time the identification is made." Treas Reg § 1.1031(k)-1(e)(2).

10.3.2 **Plans and specifications.** If possible, the identification should include a full set of plans and specifications of the property to be constructed. If there are no plans and specifications in existence, it appears that whatever vague plans are in existence will satisfy the identification requirement.

10.3.3 **200 percent rule.** For purposes of the rule that requires that the Exchanger identify three possible Replacement Properties or any number of Replacement Properties as long as their aggregate value does not exceed 200 percent of the value of the Relinquished Property, the "value" is the value of the Replacement Property as of the date it is expected to be received by the Exchanger. Treas Reg § 1.1031(k)-1(e)(2)(ii).

10.3.4 **Property not completed.** The Replacement Property will qualify as like-kind property even if it is only partially constructed (e.g., 20 percent complete) as of the date the Replacement Property is conveyed to the Exchanger, provided the Replacement Property is real estate. For some reason, the IRS takes the position that personal property will not be treated as like kind unless it is 100 percent complete as of the date it is conveyed to the Exchanger. Treas Reg § 1.1031(k)-1(e)(5) Examples (ii), (iii).

10.4 **Exchange Period Issues.** For a forward-deferred exchange, the Replacement Property must be conveyed to the Exchanger within the 180-day Exchange Period. There is no Exchange-Period requirement for a reverse exchange if the Replacement Property is parked with the Accommodator.

10.4.1 **Consume cash.** Generally, the only problem that the 180-day period presents to most Exchangers is that the cash the Accommodator is holding from the sale of the Relinquished Property must be invested by the Accommodator in the Replacement Property. Otherwise, the Accommodator must release the cash to the Exchanger as taxable boot. Cash cannot be consumed by simply prepaying construction expenses or having construction materials delivered to the jobsite. Prepaid expenses or materials delivered to the jobsite are not considered to be of like kind to real estate.

10.4.2 **Sufficient Replacement Property debt.** In order to avoid taxable boot to the Exchanger, the debt on the Replacement Property at the time it is acquired by the Exchanger must be equal to or greater than the debt on the Relinquished Property. If the project is only partially completed, the debt on the Replacement Property may not exceed the debt on the Relinquished Property. Any debt deficiency will be taxable as boot unless the
Exchanger contributes cash to acquire the Replacement Property to the extent of the debt deficiency.

10.5 **Construction Financing.** Typically, construction financing is provided by a loan from the Exchanger to the Accommodator.

10.5.1 **Bank financing.** If the Exchanger does not have its own funds, the loan is structured either as a direct loan from the bank to the Accommodator, which is guaranteed by the Exchanger, or as a loan from the bank to the Exchanger, who in turn lends the funds to the Accommodator.

10.5.2 **Promissory note.** The note should bear a market rate of interest. The note will typically be nonrecourse, especially if the Accommodator is a professional Accommodator and not a motivated Seller or developer.

10.5.2.1 Priv Ltr Rul 9149018 (Sept. 4, 1991) approved an Exchanger's acting as both a lender and an exchanging party in a tax-free exchange transaction and concluded that the Accommodator had sufficient risks and benefits of ownership to avoid being treated as the Exchanger's agent.

10.5.2.2 In J. H. Baird Publ'g Co. v. C.I.R., 39 TC 608 (1962), the tax court approved overseeing improvements by a contractor to land to be acquired. The contractor acquired a building site and constructed a building to the specifications of the Exchanger.

10.5.2.3 In 124 Front Street, Inc. v. C.I.R., 65 TC 6 (1975), the tax court approved advancing money toward the purchase of property to be acquired in an exchange.

10.5.3 **Trust deed.** The note from the Accommodator to the Exchanger is secured by a mortgage or trust deed, which can also secure the obligations of the Accommodator under the exchange agreement. If financing is supplied by a bank, which is reloaned by the Exchanger to the Accommodator, the Exchanger will generally be required to pledge the mortgage or trust deed to the bank to secure its loan to the Exchanger.

10.6 **Construction Contract and Exchange Agreement.** Typically, the Accommodator will enter into a construction contract with a contractor to build the improvements. The exchange agreement will provide that the Accommodator will convey the Replacement Property to the Exchanger on the last day of the Exchange Period.

10.6.1 **Developer as Accommodator.** If the developer is acting as an Accommodator, the exchange agreement will generally include a construction contract that specifies plans and specifications and provides that the Replacement Property will be conveyed to the Accommodator by the last day of the Exchange Period.
10.6.2 **Reluctance of professional Accommodator.** Professional Accommodator firms often refuse, or are extremely reluctant, to serve during construction. If they do agree to serve, they generally charge very stiff fees and require full insurance and indemnification.

10.7 **Use of LLC to Act as Accommodator to Avoid Environmental Liability.**

10.7.1 **Generally.** The Accommodator can be a single-member LLC whose parent normally acts as an Accommodator. The LLC is ignored for tax purposes. Treas Reg § 301.7701-3(b)(1). A separate LLC can be created for each Exchanger. The separate LLC will help avoid, but will not eliminate, environmental and other liability. The trick is to provide in the operating agreement that the Accommodator does not operate the LLC's real property.

10.7.2 **Local Recipients.** In some jurisdictions, an Accommodator may have to be licensed as a Contractor. Oregon passed an exemption in 2003. Enrolled House Bill 3218, 514.

10.7.3 **Avoiding Piercing LLC Liability Veil.** The Accommodator must agree to fund the LLC with some funds so that it will not be treated as a shell entity that would be ignored by the courts. An agreement to pay an agreed-on amount to the LLC on demand will probably suffice. The Accommodator would generally enter into a management agreement with the LLC to handle funds, provide bookkeeping services, provide the 45-day and 180-day notices, prepare and negotiate the exchange documents, but not operate the real property. All formalities should be strictly observed. If the LLC is not treated as a separate entity for state law purposes by the Accommodator and the Exchanger, then do not expect the Accommodator's creditors to treat the LLC as a separate legal entity.

10.8 **Improvements to Exchanger's Own Property.**

10.8.1 **Generally.** An Exchanger cannot obtain tax-free exchange treatment with respect to improvements on the Exchanger's own property.

10.8.1.1 In *Bloomington Coca-Cola Bottling Co. v. C.I.R.*, 189 F2d 14 (7th Cir 1951), the Exchanger was treated as having had a taxable transaction when the Exchanger conveyed an old plant facility and cash to a contractor in consideration for the construction of a new plant on the Exchanger's own land. The court held that the Exchanger had merely exchanged the old plant facility for the services of the contractor in constructing a new facility. See also Priv Ltr Rul 9031015 (May 4, 1990).

10.8.1.2 Rev Rul 67-255, 1967-2 CB 270, held that for IRC § 1033(g) purposes, the investment of proceeds of a condemnation in
construction of a building on property previously owned by the Exchanger was not regarded as like kind.

10.8.2 **Improvements to leased property owned by the Exchanger.** In two liberal letter rulings, Exchangers were permitted to lease property to avoid the rule that improvements to the Exchanger's own property cannot qualify as Replacement Property in a tax-free exchange. (Letter rulings cannot be relied on or quoted as support for any legal position.)

10.8.2.1 **Priv Ltr Rul 200329021 (July 18, 2003).** The essence of this private letter ruling is that the Exchanger structured an exchange in which it exchanged the Relinquished Property for a sub-leasehold interest (for a longer than 30-year term when extensions were included) and improvements. The lessor of the sublease was the Exchanger's parent corporation. The exchange was structured as a deferred improvement exchange under Rev Proc 2000-37. The related party rules under IRC § 1031(f) did not bother the Internal Revenue Service: "However, since both Taxpayer and parent continue to be invested in exchange properties, both will remain so invested for a period of not less than two years following the exchange, and neither is otherwise cashing out its interests, gain recognition is not triggered under § 1031(f)(4)." Another very interesting aspect of the transaction was that planning costs paid by the parent corporation to independent third parties with respect to constructing the improvements were reimbursed to the parent corporation as part of the exchange transaction. The payment was not treated as boot. Pursuant to Treas Reg §§ 1.1031(k)-1(g)(4)(iii)(B), 1.1031(k)-1(g)(6), the Exchanger cannot receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held by the Accommodator, yet in this case the Exchanger's parent received exchange proceeds to reimburse it for expenses paid to construct the Replacement Property prior to the date that the Accommodator acquired the Replacement Property.

10.8.2.2 **Priv Ltr Rul 200251008 (Dec. 19, 2002).** Although the facts are complicated, the essence of this ruling is that a safe-harbor exchange under Rev Proc 2000-37, 2000-40 IRB 308, was approved where the Replacement Property consisted of a leasehold interest owned by a party related to the Exchanger plus improvements constructed thereon. The sub-leasehold interest owned by the related party was leased at fair market rents for more than 30 years to the Accommodator who built improvements on it. The sub-leasehold plus the improvements built by the Accommodator constituted the Replacement Property. Curiously, the IRS did not think that the related party
rules were a problem: "[S]ince both Taxpayer and the related parties continue to be invested in the exchange properties, and are not otherwise cashing out their interests, § 1031(f)(1) is not a concern for this transaction unless and until Taxpayer or the related parties dispose of their interests in the exchanged property within two years after the last transfer that was part of the exchange." Caution is urged in strictly following this private letter ruling since the IRS's related party analysis is contrary to the express provisions of § 1031(f)(1) as the Exchanger did cash out his interest in the Relinquished Property. To avoid this problem, should only the improvements to leasehold be considered to be the Replacement Property?

10.8.2.3 Rev Proc 2004-51. Note that in 2004 Rev Proc 2000-37 was amended by Rev Proc 2004-51 to provide that the Replacement Property cannot have been owned by the Exchangor within 180 days of the date that the Replacement Property was held by the Accommodator. In a lease transaction, the Replacement Property is not held by the Accommodator. Rev Proc 2004-51 provides that the IRS is "continuing to study parking transactions, including transactions in which a person related to the taxpayer transfers a leasehold in land to an accommodation party and the accommodations party makes improvements to the land and transfers the leasehold with the improvements to the taxpayer in exchange for other real estate." Thus, the IRS is studying this issue and the leasing technique described above can still be used. However, there still is some risk that an IRS agent or court would not agree with this interpretation.

10.8.2.4 Priv Ltr Rul 8304022 (Oct. 22, 1982). In this private letter ruling, the Exchanger leased property to an Accommodator for 35 years. The Accommodator built a parking garage on the property. The IRS ruled that the exchange of other property owned by the Exchanger for the Accommodator's fee interest in the parking garage and the Accommodator's lessee's interest in the 35-year lease qualified as a tax-free exchange.

10.8.2.5 Priv Ltr Rul 9243038 (July 27, 1992). In this ruling, the Exchanger leased property to a developer for 90 years, and the developer constructed improvements on the property. Later, the transaction was restructured because of the developer's economic difficulties. The ruling stated that the exchange of real estate owned by the Exchanger for the developer's 90-year lease and improvements to the leased property was a tax-free exchange. It was noted that when the leasehold interest was acquired by the Exchanger, the lease would terminate by
operation of merger. The ruling found that there was no improper intent to acquire the leasehold interest.

10.8.3 **Sale and exchange back.** Priv Ltr Rul 7823035 (Mar 9, 1978) and Priv Ltr Rul 9149018 both approved the exchange of Relinquished Property for Replacement Property because the Accommodator was a developer who had previously purchased the Replacement Property from the Exchanger for the express purpose of constructing improvements on it.

10.9 **Title Insurance.** See discussion at Article 9.9.

11. **ACCOMMODATORS**

In recent years, the use of Accommodators has increased dramatically. In fact, a whole industry has grown up of corporations whose only job is to serve as a principal in a tax-free exchange.

11.1 **Advantages of an Accommodator.**

11.1.1 **Knowledge.** Many Accommodators are very knowledgeable in handling exchanges. They often provide forms and advice.

11.1.2 **Modest fees.** Many Accommodators charge only a modest fee for their services. The fees are generally subject to negotiation.

11.1.3 **Avoids environmental risks.** If either the Buyer or the Seller takes title to an extra property, even for an instant, he can be held liable for environmental claims.

11.2 **Disadvantages of an Accommodator.**

11.2.1 **Lack of capital.** Accommodators are generally corporations that have very little capital. They can become insolvent or file for bankruptcy. In a bankruptcy, the cash or real estate held by the Accommodator may be at risk for bankruptcy claims for up to 90 days after the Replacement Property is transferred by the Accommodator to the Exchanger.

11.2.1.1 In *In re San Diego Realty Exchange, Inc.*, 132 BR 424 (Bankr SD Cal 1991), the Exchanger lost Replacement Property that he had received from an Accommodator when the Accommodator filed for bankruptcy within 90 days. Note the following:

The Regulations force most taxpayers to use professional intermediaries or Accommodators to hold the exchange balance during the pendency of a deferred exchange. These intermediaries serve as limited-purpose depository institutions. These depositories, however, are not subject to
any regulation or regulatory supervision. They are much like the high-flying state banks formed in the 1800s.

Parties to exchanges often deposit vast sums of money with affiliates of small escrow companies, title companies, or law firms that are little more than shell corporations. Exchange intermediaries are posted to guard the honey pot for up to 180 days—with little or no supervision. This situation would tempt even a guardian with the integrity of Pooh Bear. One can imagine that Jesse James would have loved to be an intermediary.

A small intermediary may borrow from exchange balances to cover his lack of success at the track, losses at the roulette table, investments that have turned sour, or indulgences to an expensive paramour. Even an affiliate of a large title insurance company or financial institution may be bankrupted by litigation over failed exchanges, by embezzlement, or by environmental liabilities. The taxpayer potentially stands in the position of an unsecured creditor when an intermediary becomes bankrupt or insolvent. Even completed exchanges may be attacked as preferences under the Bankruptcy Act. Terrence Floyd Cuff, Several Examples of Real Estate and the Deferred Exchange Regulations, 12 Tax Mgmt Real Est J 199 (Aug. 1996).

11.2.1.2 Generally, if the Accommodator is affiliated with another corporation, such as a title insurance company, the parent corporation may be willing to guarantee the obligations of its Accommodator corporation. Such guaranties will not cause "constructive receipt" of the funds held by the Accommodator in deferred exchanges. Treas Reg § 1.1031(k)-1(g). Such a guaranty is the best form of security if the guarantor parent corporation is solvent, but other forms of security are available as well.

11.2.2 Absolute necessity to seek legal counsel. Accommodators do not provide legal services, even if there are lawyers on staff. Many of the exchange agreements drafted by Accommodators are poorly drafted and fail to satisfy the deferred-exchange safe-harbor rules. For the nominal fee Accommodators charge, they should not be expected to take the time to deal with the many legal issues found in all but the simplest tax-free exchanges. Accountants also generally have no experience in drafting exchange agreements. It is strongly recommended that legal counsel familiar with tax-free exchanges be consulted on virtually every tax-free exchange.
11.3 **Qualified Accommodator Not an "Agent."** In a simultaneous exchange, an Accommodator that is a Qualified Intermediary will not be considered an agent of the Exchanger. Treas Reg § 1.1031(b)-2(a).

11.4 **Attorney Conflict-of-Interest Rules if Serving Dual Role as Attorney and Accommodator.** Note that an attorney representing his Accommodator corporation in Oregon may violate DR 5-101 (conflict of interest) if attempting to provide legal advice to the client. OSB Informal Op No 89-38.

11.5 **Qualified Intermediary (Accommodator).** An Accommodator will be treated as a Qualified Intermediary and thus will not be considered the agent of the Exchanger if the Qualified Intermediary is not the Exchanger or a disqualified person. Treas Reg § 1.1031(k)-1(g)(4). The regulations impose the following requirements:

11.5.1 The Accommodator is not the Exchanger or a disqualified person;

11.5.2 The agreement between the Accommodator and the Exchanger provides that the Exchanger cannot receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held by the Qualified Intermediary;

11.5.3 The Accommodator enters into a written agreement with the Exchanger to acquire the Relinquished Property from the Exchanger and acquire and transfer the Replacement Property to the Exchanger; and

11.5.4 The Accommodator directly contracts to sell the Relinquished Property, or the agreement to sell the Relinquished Property is assigned by the Exchanger to the Accommodator. Treas Reg § 1.1031(k)-1(g)(4).

11.6 **Exchange Agreement Requirement.** The safe harbor is not available unless the Exchanger enters into a written exchange agreement and the Accommodator, "as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer." Treas Reg § 1.1031(k)-1(g)(4)(iii)(B).

11.7 **No Pledge Agreements Required.** Pursuant to Treas Reg §§ 1.1031(k)-1(g)(4)(iii)(B), 1.1031(k)-1(g)(6), the agreement with the Qualified Intermediary must provide that the Exchanger cannot receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held by the Qualified Intermediary.

11.8 **Assignments.** The safe-harbor rules also require that if there is an assignment of the Exchanger's right to sell the Relinquished Property or purchase the Replacement Property, the buyer or the seller is "notified in writing of the assignment" before the property is transferred. Treas Reg § 1.1031(k)-1(g)(4)(v). Failure to do so can cause the transaction to be taxable. Tech Adv Mem 200130001 (Mar. 1, 2001).
11.9 **Closing Items Including Legal Fees and Earnest Money Deposits.** If the Exchanger receives prorated rents or has other expenses paid relating to the acquisition of the Replacement Property or the disposition of the Relinquished Property that are typically found on a closing statement, the receipt of those funds will be ignored for purposes of the safe-harbor rules. Treas Reg § 1.1031(k)-1(g)(7). Payments relating to a failed acquisition of Relinquished Property will probably not qualify. Also, legal fees may be determined not to be found on a "typical" closing statement and thus should probably not be paid until the G6 contingencies have been satisfied. Likewise, payment of Accommodator fees should not be made by the Accommodator to the Exchanger until a G6 event has occurred.

11.10 **Disqualified Person.** A disqualified person may not serve as a qualified intermediary or Accommodator under the safe-harbor provisions. Treas Reg §§ 1.1031(k)-1(g)(4)(iii)(A), 1.1031(k)-1(k). A disqualified person is a person who:

11.10.1 Is related to the Exchanger under IRC § 267(b) or IRC § 707(b) (determined by substituting 10 percent for 50 percent). Such relationships include spouse, ancestors, lineal descendants, siblings, and related corporations or trusts.

11.10.2 Within the last two years has been the Exchanger's employee, attorney (Priv Ltr Rul 9232030 (May 12, 1992)), accountant, investment banker, broker, or real estate agent. Excluded are:

11.10.2.1 Services for the Exchanger with respect to exchanges of property;

11.10.2.2 Routine financial, title insurance, escrow, or trust services for the Exchanger. See, for example, Priv Ltr Rul 9826033 (June 26, 1998), in which a qualified intermediary was not disqualified for making loans to the taxpayer; and

11.10.2.3 Banks are able to act as Accommodators even if they had a financial relationship with the Exchanger in the last two years. Treas Reg § 1.1031(k)-1(k)(4)(ii).

An attorney serving as an Accommodator in Oregon may violate DR 5-101 (conflict of interest). OSB Informal Op No 89-38.

11.11 **Terminating an Accommodator.** The regulations provide that the right to fire the Accommodator under state law is to be ignored in determining whether the Accommodator is a Qualified Intermediary. If an Accommodator is fired, can the transaction still qualify as an exchange under the safe-harbor rules? There is no answer. If it is necessary to terminate the new Accommodator, the new Accommodator should execute an exchange agreement that requires the new Accommodator to acquire the Relinquished Property, sell the Relinquished
Property, acquire the Replacement Property, and transfer the Replacement Property to the Exchanger.

12. **PARTNERSHIP EXCHANGES**

12.1 **General Concepts**

12.1.1 **Partnership Basics.**

12.1.1.1 What is a partnership? The Internal Revenue Code defines a partnership as an enterprise by which "any business, financial operation, or venture is carried on." IRC § 761(a).

12.1.1.2 For income tax purposes, a limited liability company, unless it elects to be treated as a corporation, is treated as a partnership.

12.1.1.3 A partnership (even a tenancy in common relationship that is determined to in fact be a partnership) files an IRS Form 1065 income tax return.

12.1.1.4 Partnership Taxation. A partnership is never subject to tax at the partnership level. All income and losses are recognized by the partners.

12.1.1.5 Recognizing a partnership. Recognizing what is and what is not a partnership is not always easy.

12.1.1.5.1 A tenancy in common relationship can easily be a disguised partnership.

12.1.1.5.2 Some relationships that appear to be a partnership might be something else such as an agency relationship.

12.1.1.5.3 Finally, even a loan might really be a partnership. For example, if the lender’s payments are subject to cash flow, there is little or no security, and interest is a percentage of profits of the venture, the loan would probably be classified as a partnership arrangement for tax purposes.

12.1.2 **Exchange by partnership.** A partnership can of course enter into a tax-free exchange. As long as the partnership as an entity transfers the Relinquished Property and receives the Replacement Property within all requirements of the law, the exchange will be tax-free.

12.1.2.1 Because of the dual nature of a partnership (an entity versus an aggregation of individuals), Exchangers are often confused as to
the precise nature of the transaction that they wish to enter into. For example, in Tech Adv Mem 199907029 (Sept. 30, 1998), four individuals, A, B, C, and D, owned an apartment building. They had filed partnership returns for 20 years. The apartment complex was destroyed and the property was sold. Partner C sold his interest for cash. Partners A, B, and D, using separate exchange agreements, purchased a Replacement Property together. The IRS ruled that since A, B, and D constituted more than a 50 percent interest in the partnership, the partnership continued and the exchange was successful. This was despite the fact that instead of one exchange agreement, there were three exchange agreements, one for each of the three exchanging partners. The cash boot received by partner C was taxable to the partnership, and thus, partners A, B, and D also had to pay tax on the cash received by partner C.

12.1.2.2 If a partnership sells Relinquished Property, it must acquire the Replacement Property. In Sandoval v. Commission, TCM 2000-189 (June 27, 2000), the court held that where the Exchangers held the Relinquished Property as tenants in common, but acquired the Replacement Property in a partnership, the transaction did not qualify as a like-kind exchange.

12.1.3 Exchange of partnership interests. Although a partnership can exchange its interest in any property as part of a tax-free exchange, a partnership interest cannot be exchanged tax-free by a partner in an exchange. Beginning April 25, 1991, partnership interests are not qualified property and cannot be exchanged tax-free. Treas Reg § 1.1031(a)(2)(D). Thus, a general or limited partner in a real estate partnership, or a member in a limited liability company, cannot exchange his or her interest in the partnership for real estate.

12.1.4 Exchanges involving multiple partnerships. Once in a while a situation will arise in which A, B and C are partners in two or more partnerships involving separate real estate. If A and B wish to separate themselves, they can merge all of their partnership interests into a single partnership (which can be elected to be treated as a distribution / contribution). Thereafter, the partnership can distribute properties with a value equal to B's equity to B. Under IRC § 704(c)(2), provided that the properties are of a like-kind, and provided that the redemption is made within 180 days of the organization of the merged partnership, or the day the tax return is due, the transfer will be treated exactly like a tax-free exchange. To prevent A's partnership from terminating, someone such as A's spouse will have to become a partner in the continuing partnership.
12.2 **Exchange followed by transfer to partnership (swap and contribute).**

12.2.1 **Magneson holding.** The tax court allowed an exchange followed by an immediate transfer of the Replacement Property to a partnership (in which the Exchanger was a general partner) under the theory that there was a continuity of investment and the contribution was merely a change of form of ownership. *Magneson v. C.I.R.,* 753 F2d 1490 (9th Cir 1985). The court framed the issue as follows: "whether property acquired in a like-kind exchange with the intention of contributing it to a partnership . . . is held for investment within the meaning of . . . section 1031(a)." The court held that it was not held for investment because the transfer was a "continuation of the Magnesons' investment unliquidated but in a modified form."

12.2.2 **IRS attack.** Despite the Magneson ruling, there are three theories that the IRS can use to attack an exchange followed by a transfer of the Replacement Property to a partnership:

12.2.2.1 The **partnership was really the buyer** of the Replacement Property. In this event, the Exchanger never actually received the Replacement Property and thus did not complete a tax-free exchange. The Exchanger was the partnership's agent in acquiring the Replacement Property, was acting in his capacity as a partner, or was part of a step-transaction, and thus the fact that the Replacement Property was held momentarily by the Exchanger should be ignored. The step-transaction doctrine was used by the court in *True v. U.S.,* 190 F 3rd 1165 (10th Cir 1999) to deny IRC § 1031 exchange treatment involving a property purchase followed by a contribution to a partnership.

12.2.2.2 The Exchanger did **not hold** the Replacement Property for investment or in his trade or business as is required by IRC § 1031. It is clear that by transferring the property to the partnership, the Exchanger held the Replacement Property only for the purpose of immediately transferring it to the partnership, and the fact that the partnership will hold it for investment is irrelevant because the partnership is a legal taxable entity.

12.2.2.3 A final basis for attacking the transfer is that it involves an exchange of real property for a partnership interest, in violation of IRC § 1031(a)(1)(iv).

12.2.3 **Distinguishing Magneson.** Magneson is contrary to Rev Rul 75-292, 1975-2 CB 333, and cases such as *Regals Realty Co. v. C.I.R.,* 127 F2d 931 (2d Cir 1942), which have held that transfers to or from a corporation immediately following an exchange are taxable.
12.2.3.1 The court in Magneson held that a corporation is different from a partnership because IRC § 1031 specifically did not at the time allow an exchange for stock, but under case law did allow an exchange for a partnership interest. But exchanges for partnership interests were specifically disallowed by Congress for exchanges closing after April 25, 1991.

12.2.3.2 The court in Magneson treated the partnership as an aggregate of individuals and not as an entity. But Oregon and many other states have adopted the partnership statutes based on the Revised Uniform Partnership Act. The National Conference of Commissioners on Uniform State Laws commentary on the new partnership act states that it "embraces the entity theory of the partnership." Section 201 Comments.

12.2.3.3 The court in Magneson also examined the rights of a partner under California law to possess and materially participate in the management of partnership property. Those rights were expansive for the Magnesons. The rights may vary in other partnership agreements in other jurisdictions and may well not exist in a limited partnership or LLC.

12.2.3.4 The court in Magneson attempted to limit its opinion in such a way that it might well cause transfers to LLCs or limited partnerships to be treated as taxable exchanges because much of the case discussed how holding property in partnership form was similar to outright ownership under California law. The court noted the following:

"Our holding in this case is limited to those situations in which the taxpayer exchanges property for like-kind property with the intent of contributing the acquired property to a partnership for a general partnership interest. Further, the taxpayer must show, as the Magnesons have here, that the purpose of the partnership is to hold the property for investment, and that the total assets of the partnership are predominantly of like kind to the taxpayer's original investment."

12.2.4 **Lease alternative.** An attractive alternative for the Exchanger, rather than immediately conveying the Replacement Property to the partnership, is to lease the property to the partnership on a long-term lease. The lease can often be structured so that it is almost economically the same as owning a partnership interest. For example, assume that instead of forming a partnership with a partner to each own half of the property, Exchanger and partner each acquire the property and lease the property on a triple-net lease to a partnership. The partnership can then operate the property indefinitely. In some arrangements, the Exchanger has an option to
convey the Replacement Property to the lessee in exchange for a partnership interest in the lessee.

12.3 **Exchange where individual partners want to separately exchange or cash out of partnership:**

12.3.1 **Partnership exchanges and then liquidates (swap and drop).** Another approach is to have the partnership complete the exchange and then liquidate. It could complete the exchange and purchase two Replacement Properties and then distribute one property to partner A and the other property to partner B. The IRS attack on this approach is that the Replacement Property was not held by the partnership for investment. Alternatively, the partnership could purchase a single Replacement Property and later refinance and use the refinance proceeds to redeem the interest of the cashed out partner. The risk here would be that if the refinance and exchange were part of a single unified plan, the IRS could treat the refinance proceeds as boot. See 5.7.4. To prevent the partnership from terminating, a new partner would have to be brought in prior to completing the transaction.

12.3.2 **Partnership liquidates and then exchanges (drop and swap).** One approach is to liquidate the partnership and convey the Relinquished Property on the day of closing. Assuming the AB Partnership was comprised of A and B, A and B should also sign documents to terminate the partnership agreement, if there is one, and declare that the partnership has been liquidated. A can then complete the transaction as an exchange and B can complete the transaction as a sale. What could be simpler? Another variation to this approach is when there are three or more partners, A, B and C, and only A wants to exchange. In this event, A is removed as a partner by transferring an interest in the partnership property to A in redemption of his partnership interest.

12.3.2.1 There are various basis that the IRS can use to attack the proposed form of transaction:

12.3.2.1.1 **Is property held for sale?** First, the transaction can be attacked by the IRS because A's 50 percent interest in the Relinquished Property in his hand is "property held primarily for sale" by A and is not property "held either for productive use in a trade or business or for investment." See IRC § 1031(a)(2)(A)(a)(1). The argument is that the property is in A's hands only for a moment, for purposes of selling it via a tax-free exchange. This argument treats the partnership as an entity. It can, of course, be argued under the aggregate theory that the liquidation of the partnership is a mere...
change in the form of holding the property, and A should be credited as owning the property through A's ownership in the partnership. There are no cases on point. In the case of Miles H. Mason, 57 TCM (P-H) ¶ 88,273 (1988), the tax court approved a partnership liquidation immediately followed by an exchange. But this case relies on the fact that the transaction could have been analyzed as an exchange of an interest in a partnership—an approach that Congress has since specifically prohibited. In the corporate area, the authorities are split. An IRC § 333 liquidation (since repealed) followed by an exchange was not allowed in Rev Rul 77-337, 1977-2 CB 305. In Bolker v. C.I.R., 81 TC 782 (1983), aff’d, 760 F2d 1039 (9th Cir 1985), however, a corporate liquidation followed by an exchange was allowed. See also Tech Adv Mem 9645005 (July 23, 1996); Tech Adv Mem 9818003 (May 1, 1998).

12.3.2.1.2 **Transaction treated as partnership sale followed by liquidation (step-transaction).** The IRS can also argue that what really occurred was a sale by the partnership followed by a liquidation. If the sale occurred by the partnership, the gain on the taxable sale would be allocated to all the partners, not just the partner who wanted taxable treatment. In the corporate setting, a corporate liquidation followed by a sale was treated as a corporate sale followed by a liquidation. C.I.R. v. Court Holding Co., 324 US 331, 65 S Ct 707, 89 L Ed 981 (1945). Evidence of this fact would exist if the earnest money agreement to sell the partnership was in the name of the partnership. The only known application of this concept to the partnership area is found in Tech Adv Mem 9645005 (July 23, 1996), which treated an IRC § 1033 condemnation rollover as a partnership transaction. A contrary result, however, was reached in Priv Ltr Rul 9022037 (Mar. 5, 1990), where a partnership liquidated, then signed a purchase agreement and sold its assets under an IRS approved IRC §1033 condemnation. See also Priv Ltr Rul 8527090 (Apr. 15, 1985), and Priv Ltr Rul 8041061 (July 17, 1980). In Priv Ltr Rul 200651030 (Dec 22, 2006), the IRS approved an interesting scenario which is similar to the Court Holding Co. scenario. First, trust executing a
purchase a sale agreement to sell real estate. The trust then liquidated into an LLC of the trust beneficiaries. The LLC was allowed to complete the exchange despite the fact that it held the property for sale pursuant to the purchase and sale agreement. This was allowed because the LLC was held to be functionally the equivalent and an extension of the prior trust.

12.3.2.1.3 Transaction treated as prohibited exchange of partnership interest for property. A third basis for attacking the transaction is that it really is an exchange of A's interest in the partnership for Replacement Property, a transaction specifically prohibited by IRC § 1031(a)(2)(D).

12.3.2.2 Liquidate Partnership Prior to Closing. If liquidating the partnership on the date of closing has problems, why not liquidate the partnership months in advance of the exchange? Under this approach, the partnership is liquidated and A and B hold the property as tenants in common. A can then complete his exchange, while B sells for cash. Another alternative for a three-person partnership is for partner A, who wants to complete an exchange, to withdraw from the partnership and receive a one-third interest in the partnership's property in complete redemption of his interest in the partnership. Months later, the exchange is completed. There are two problems with this approach.

12.3.2.2.1 Problems of immediate liquidation not eliminated. If the IRS could prove that the partnership was liquidated for the purpose of completing an exchange by A, it could probably disallow the exchange. It is advisable to delay the exchange of the Relinquished Property for as long as possible after the liquidation of the partnership. The passage of time only makes it harder for the IRS to prove that the motivation of the partners in liquidating the partnership was to avoid income taxes. If it can, the following bases for attacking the transaction as discussed above, are still available:

a. The property is held by the former partner for sale, not investment, and the exchange is thus taxable.

b. The transaction will be treated as a sale by the
partnership, taxable to all the partners, followed by a liquidation of the partnership.

c. The transaction will be treated as a prohibited exchange of an interest in the partnership for property.

12.3.2.2.2 Tenancy in common will be treated as a partnership. An additional basis the IRS can use to attack an arrangement whereby the partnership is liquidated and each partner holds the former partnership property for some period of time prior to an exchange is to argue that the tenancy in common arrangement is in fact as partnership. If the arrangement is a partnership, then there a fully taxable exchange of a partnership interest. For a fuller discussion of this issue, see 12.4.

12.3.3 Special allocation of boot to retiring partner. One frequently suggested approach to terminating one partner out of a partnership of three or more partners is to structure the transaction so that the partnership will receive some cash in the exchange and use that cash to redeem the retiring partner's interest. The cash received will cause the partnership to have boot income in an amount equal to the cash boot. The boot income might be specially allocated to the retiring partner. But it is doubtful whether the allocation will be respected as having "substantial economic effect" for tax purposes because the allocation and the subsequent use of the cash boot to redeem the retiring partner's interest in the partnership will not (except in very rare cases) zero out the retiring partner's capital account as required under Treas Reg § 1.704-1(b)(2). See Terence Floyd Cuff, Planning for Partnership Exchanges Under Section 1031, 68 Taxes 339 (1990).

Note also Tech Adv Mem 199907029 (Sept. 30, 1998), where a partnership composed of A, B, C, and D sold Relinquished Property and partners A, B, and C acquired Replacement Property in individual names and D received cash. The IRS held that the partnership had been reconstituted and continued in the names of A, B, and C and that the cash received by D constituted boot income, which was allocated to all the partners.

Example: Assume that there are three equal partners, A, B, and C, in the ABC Partnership. ABC owns property worth $9 that has a basis of $6. Each partner's basis (and capital account) in ABC is $2. ABC wishes to sell its property. A and B want to exchange into Replacement Property. C desires to take his cash and withdraw from the partnership. The partnership (through an exchange Accommodator) can use $6 of the cash proceeds and purchase Replacement Property. The remaining $3 of cash proceeds and all of the gain ($3) can be specially allocated to C. C's basis
capital account after the transaction will be $2 (his original basis capital account balance in ABC of $2, increased by $3 in gain and decreased by $3 for the distribution of cash). Since C's capital account is not zeroed out, the transaction will not have substantial economic effect and the special allocation of gain only to C will not be respected for tax purposes.

12.3.4 Installment note solution. A solution to this dilemma may be to restructure the transaction so that C does not receive cash, but receives an installment note. The note can be distributed to C without causing a disposition under Section 453B. See Treas Reg § 1.453-9(c)(2).

Example: Assume that there are three equal partners, A, B, and C, in the ABC Partnership. ABC owns property worth $9 that has a basis of $6. Each partner's basis (and capital account) in ABC is $2. ABC wishes to sell its property. A and B want to exchange into Replacement Property. C desires to take his cash and withdraw from the partnership. The partnership (through an exchange Accommodator) can use $6 of the cash proceeds and purchase Replacement Property. The remaining $3 is not paid to the partnership in cash. Rather, the partnership accepts the purchaser's promissory note which is structured as an installment note. Thus, the note must be payable at least in part in two taxable years. IRC §453(b)(1). So generally the note is structured so that most of it is paid the day after closing, with a small amount due (but more than a mere nominal amount) due the following January 2nd. If an accommodator is involved in the transaction, the note could be due from the accommodator instead of the buyer. The partnership then distributes the $3 note to C, who accepts the $3 note in full satisfaction of his partnership interest. The partnership books up its assets so that C's capital account is increased to $3, representing the increased value of his interest in the partnership's assets. C's basis in his capital account balance after the transaction will be $0 (his original basis in his capital account balance in ABC of $2, increased by $1 for the book-up, and decreased by $3 for the distribution of the promissory note). Since there is no special allocation of recognized gain, and since C's capital account is zeroed out, the transaction will meet all Section 704(b) requirements. An added twist: C's basis in the note will be $2, a carryover of his basis in ABC. Normally, someone receiving $3 of boot income in an exchange would have to recognize the entire boot as gain. Now when C receives payment of the note, he will recognize only $1 of gain.

12.3.5 Divide partnership into two partnerships and then exchange. Another approach, if there are four or more partners, two or more of which want to exchange and two or more of which want to cash out is to divide the partnership into two partnerships under IRC Section 708(b)(2)(B). The risk in this approach is that the division following by the sale would be collapsed under the step-transaction doctrine to simply be a single sale by
the original partnership that received taxable boot. The boot will then be allocated to all of the partners and not just the partners who cashed out.

12.3.6 **Partnership exchanges and acquires two Replacement Properties in separate economic pools.** This approach can be used where all of the partners want to exchange, but want to acquire separate Replacement Properties. The solution is to have the partnership acquire both Replacement Properties and amend the partnership so that the management and the economic benefits for each properties are separated between the partner groups. For example, partnership AB could sell its Relinquished Property and acquire two Replacement Properties, Whiteacre and Blackacre. Substantially all of the income, cash flow and profit relating to Whiteacre can be specially allocated to A, while the income, cash flow and profit relating to Blackacre can be specially allocated to B. A 90 / 10 allocation would be safe. It is questionable whether a 99/1 allocation would be respected. While a theoretically neat solution, the practical problems in structuring such an arrangement could be substantial.

12.3.7 **Partner Buy-Out.** Another solution is to buy out the partner’s interest who does not want to participate in the exchange. If C in the ABC partnership does not want to complete an exchange, than C’s interest can be redeemed in a separate transaction prior to the completion of the exchange. The primary disadvantage of this approach is that A and B must contribute the required cash to complete the transaction.

12.4 **Tenancy in common arrangements.**

12.4.1 **Will tenancy-in-common relationship be treated as a partnership?**
What is the difference between a tenancy in common arrangement and a partnership? The following details that a tenancy in common arrangement will be treated as a partnership if the tenants in common operate the tenancy in common as a trade or business. For real estate, this includes providing services in addition to customary services such as providing trash collection, utilities, and maintenance of common areas.

12.4.1.1 Definition of "partnership". The definition of what constitutes a partnership is very broad:

12.4.1.1.1 The Internal Revenue Code defines a partnership as an enterprise by which "any business, financial operation, or venture is carried on." IRC § 761(a). The courts and the IRS have generally looked at a number of different factors:


12.4.1.1.2 The former regulations in this area provided that mere co-ownership of property does not constitute a partnership, nor is a joint undertaking merely to share expenses. But a tenancy in common can be a partnership if the tenants actively carry on a trade or business. Treas Reg §§ 1.761-1(a), 301.7701-3(a).

12.4.1.1.3 The Supreme Court in C.I.R. v. Culbertson, 337 US 733, 742-43, 69 S Ct 1210, 93 L Ed 1659 (1949), weighed in with the following:

"[C]onsidering all the facts--the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent--the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."
12.4.1.1.4 In *Luna v. C.I.R.*, 42 TC 1067, 1078 (1964), the court looked at various factors that must be considered in determining whether a venture is going to be treated as a partnership for tax purposes:

"whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented to [the IRS] or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise."

12.4.1.2 Court decisions on whether tenancy in common treated as partnership. With one exception, the authorities found that a partnership was in existence when the entity had a common name, common bank account, and common records and had filed a partnership tax return.

12.4.1.2.1 The following authorities treated a tenancy-in-common relationship as a partnership:

a. *Demirjian v. C.I.R.*, 54 TC 1691 (1970), aff'd, 457 F2d 1 (3d Cir 1972). In this case, owners of a rental building collected income, paid operating expenses, maintained a joint checking account, and filed a partnership tax return. The tax court held that they were partners.

b. *Madison Gas & Electric Company*, 633 F2d 512 (CA-7, 1980), held that sharing expenses and divided the jointly produced property among the owners created a partnership

c. *Rothenberg v. C.I.R.*, 48 TC 369 (1967). Very similar fact pattern to *Demirjian*. The court held that the partners were in the active trade or business of conducting a rental business, as opposed to holding property for investment.

d. *M.H.S. Company, Inc.*, 45 TCM (P-H) ¶ 76, 165 (1976), aff'd, 41 AFTR2d 78-1398, 575 F2d 1177 (6th Cir 1978). Although the property was acquired as tenants in common, the court held that under Tennessee law, the
parties intended to develop a shopping center as joint venturers. Thus, the
Section 1033 exchange was held to be taxable.

12.4.1.2.2 The following authorities did not treat a tenancy-in-
common relationship as a partnership:

a. Lulu Lung Powell, 36 TCM (P-H) ¶ 67,032 (1967). The tax court
held that six brothers and sisters who inherited interests in 12 parcels of rental real
estate were not partners. The parties collected rent through agents and did
does of the same kind as did the persons in Demirjian and Rothenberg,
including filing partnership tax returns. Perhaps the difference is that they
inherited the property, rather than voluntarily entered into the relationship with
each other?

b. Rev Rul 75-374, 1975-2 CB 261. The IRS held that co-owners
were not partners if they provided "customary services" such as providing trash
collection, utilities, and maintenance of common areas. See also
Priv Ltr Rul 8048064 (Sept. 5, 1980); Priv Ltr Rul 8117040 (Jan. 27, 1981);
Priv Ltr Rul 7826012 (Mar. 28, 1978); Priv Ltr Rul 200019014 (Feb. 10, 2000).

12.4.2 Steps to effectively liquidate partnership. Even if a partnership can
technically be liquidated, it is important that it is effectively liquidated in
fact and that the resulting tenancy in common arrangement be respected.
In Chase v. C.I.R., 92 TC 874 (1989), the partners attempted to liquidate
the partnership, but failed because the deed was not recorded and the bank
accounts continued to hold all the partnership income and to pay all the
partnership expenses. Assuming that it is determined that the partnership
can technically be liquidated, here are steps that should be taken to
liquidate the partnership in fact:

12.4.2.1 Execute and record a deed to transfer all partnership real
property to the former partners.

12.4.2.2 Execute an agreement to terminate the partnership and to
terminate any partnership agreement.

12.4.2.3 Assign all leases to the former partners as tenants in common,
direct that lease payments be made to each former partner and
not to the partnership, and, unless using a property manager,
take steps to ensure that each lease payment be deposited in
each former partner's separate bank account.

12.4.2.4 Renegotiate all leases so that former partners are not providing
any services under the lease (providing non-customary services
is an incident of operating a partnership).

12.4.2.5 Transfer all other partnership assets to the former partners, close
all partnership bank accounts, contact all partnership creditors,
and, unless using a property manager, request that payments be made by separate check to each partner.

12.4.2.6 Unless using a property manager, pay obligations such as the payment of property taxes and mortgage payments (by each former partner individually).

12.4.2.7 Put any earnest money agreement to sell the property in the names of the former partners and not in the name of the partnership.

12.4.2.8 Timely file a final partnership tax return, and check the appropriate boxes to indicate that the return is the final return.

12.4.2.9 File a protective election under Section 761(a), which allows a partnership to "elect out" of partnership status and requires that the property owners be co-owners, that each partner have the right to take or dispose of his interest in the retained property, that the property be held for investment purposes, and that there be no active trade or business. See separate discussion in Article 12.4.3 below.

12.4.2.10 Execute a tenancy-in-common agreement among all the former partners to affirm how the property will be managed. It should be drafted in such a way that it affirmatively does not create a partnership relationship between the parties. See separate discussion in Article 12.4.4 below.

12.4.2.11 If using a property manager, renegotiate the arrangement so that the property manager is not providing any non-customary services to tenants.

12.4.3 **Electing Out of Partnership Status.** If a partnership elects to be excluded from treatment as a partnership under IRC § 761(a), an exchange of such a "partnership" interest will be treated as an exchange of the underlying interests owned by the partnership. Treas Reg § 1.1031(k)-1(g)(8). It is not necessary to terminate the partnership as long as all requirements have been satisfied. Note, however, that the IRS took the position in FSA 200216005 and FSA 199923017 that a limited partnership, general partnership, or limited liability company cannot elect out of partnership status. See also Sheldon, Limited Partnerships Can't Elect Out of Subchapter K, Jun 2002 J of Tax’n. The election is often difficult because it is available only if the following criteria can be met:

12.4.3.1 The partnership is for investment purposes only and not for the active conduct of a trade or business;
12.4.3.2 The property owners are co-owners (a partnership or LLC cannot hold title);

12.4.3.3 Each owner reserves the right to separately take or dispose of his or her share of any property acquired or retained; and

12.4.3.4 There is no active trade or business.

12.4.4 Common tenancy-in-common agreement may cause partnership treatment. Certain common provisions found in tenancy-in-common agreements may prevent the parties from being treated as a tenancy in common or from electing out of partnership status. Such provisions include:

12.4.4.1 Prohibition on right to partition property. Yet waiving right to partition was not fatal in Priv Ltr Rul 8048064 (Sept. 5, 1980).

12.4.4.2 Right of first refusal agreements. Allowed in Gen Couns Mem 37016 and Priv Ltr Rul 8048064.

12.4.4.3 Agreement to act pursuant to holders of majority of tenancy-in-common interests. When the co-owners gave away this right in a tenancy-in-common agreement, the IRS held that the parties were partners. Priv Ltr Rul 8002111 (Oct. 22, 1979). Majority decision regarding sale of property did not cause partnership treatment in Priv Ltr Rul 8048064. The Court in Bergford v. Commission, 12 F3rd 166 (9th Cir. 1993) in holding that a tenancy-in-common arrangement focused completely on the fact that an outside manager was making all management decisions and had an interest in future profits, but failed to comment on the fact that decisions were made by a vote of the co-owners.

12.4.5 Promoter created tenancy in common arrangements.

12.4.5.1 Promoters are creating tenancy in common arrangements using a triple-net lease structure. The steps are as follows:

12.4.5.1.1 The promoter purchases the property that may be leased to various lessees.

12.4.5.1.2 For some promoters, a triple net lease structure is used as follows:

a. Assign the leases to a newly organized LLC hereafter referred to as the Master Lessee LLC.
b. The promoter enters into a Master Lease with Master Lessee LLC. This lease is a triple-net lease.

c. The promoter sells the property to various tenants in common subject to the Master Lease.

12.4.5.2 Advantages to real estate purchasers:

12.4.5.2.1 Exchanger with limited funds are able to purchase an interest in a larger, quality property rather than being required to purchase a free-standing property.

12.4.5.2.2 Exchanger is able through the use of a triple-net lease to obtain motivated management for the property. The only activity the Exchanger must do is deposit the check each month.

12.4.5.2.3 The Exchanger is able through the triple-net lease lock in a return and does not need to worry about problems losing cash flow because of vacancies.

12.4.5.2.4 Promoter is often willing, although may not be legally obligated, to repurchase interests in property for a Exchanger who decides to find another investment.

12.4.5.2.5 Often a choice when other properties fall out when faced with the 45-day and 180-day deadlines.

12.4.5.3 Risks and disadvantages:

12.4.5.3.1 Returns are often less than for comparable properties because promoter is receiving a return. In fact, the promoter over time can often increase rents significantly to subtenants over time and increase its equity because rents to owners under the master lease are fixed or rising very slowly.

12.4.5.3.2 The arrangement is relatively complex. In the event some action needs to be taken, such as a sale or refinance, it is more difficult because of the many parties involved.

12.4.5.3.3 Due diligence must be carefully performed on the underlying property. If the subleases are not there, the Master Lessee may default. Guarantees by the individual promoters can mitigate this risk.
12.4.5.3.4 Tenancy in common interests may not be as marketable as other interests. This is a new area and we do not yet have a lot of experience. Many promoters indicate they are willing to repurchase the interests at a slight discount, but often are not legally bound to do so.

12.4.6 **IRS Ruling Requirement.** In Rev Proc 2002-22, 2002-14 IRB 733, the IRS has provided definitive guidance to Exchangers and their legal counsel in structuring such transactions. Rev Proc 2002-22 now provides guidance on when a tenancy-in-common arrangement is considered to be a partnership. Rev Proc 2002-22 technically provides parameters only for Exchangers who want to obtain a ruling on whether a tenancy-in-common arrangement is in fact a partnership. As a practical matter, however, the revenue procedure is the standard as to how to safely structure a tenancy-in-common interest so that it will not be deemed to be a partnership. The revenue procedure's 15 requirements are discussed below:

12.4.6.1 **Tenancy-in-Common Ownership.** Each co-owner must hold title to the property as a tenancy-in-common under local law. Ownership through disregarded entities, such as single-member limited liability companies, is specifically allowed.

Some may see certain sinister requirements in this rule. For example, will owning interests in real estate as tenants by the entireties or joint tenancy work? What about owning unusual interests in property such as a lessee's leasehold interests in a long-term lease or interests in ownership entities such as Illinois Land Trusts? Or even an undivided beneficial interest in a revocable living trust? Although it does not appear that the IRS intended to preclude such interests, they clearly do not meet the "letter" of the revenue procedure's requirements.

Section 4 of the revenue procedure also provides some guidance on what constitutes a parcel of real property for purposes of the ruling. Each parcel constituting the property must be viewed together as a single business unit. It also provides that the IRS will generally consider contiguous parcels as a single business unit. It goes on to provide that noncontiguous parcels will also qualify as a single property "where there is a close connection between the business use of one parcel and the business use of another parcel." The revenue procedure gives an example of an office building and a parking garage that services the office building. Though the parcels are not contiguous, the revenue procedure provides that they will be considered to be a single parcel.
Note that sometimes actual co-ownership may be impossible because of demands of lenders or because of land-use laws. It may be possible (albeit outside of the Rev Proc) to have a single entity hold bare legal title to the property for all of the tenancy in common as an agent. See CIR v. Bollinger, 485 U.S. 340 (1988) which appears to approve of such an arrangement in a different legal context. Rev Rul 2004-86, 2004-33 IRB 191 approved holding property through a Delaware Statutory Trust, but this Revenue Ruling is too narrowly drawn to be of much assistance for most tenancy in common transactions.

12.4.6.2 Number of Co-Owners. The number of co-owners cannot exceed 35 persons. For this purpose, husband and wife are treated as a single person, as well as all persons who acquire interests from co-owners by inheritance. Tenancy-in-common arrangements exceeding 35 persons are rare.

12.4.6.3 No Treatment of Co-Ownership as an Entity. The revenue procedure prevents the owners from acting like an entity. They cannot file a partnership or corporate tax return, conduct business under a common name, refer to themselves as partners, shareholders, or members of a business entity, or otherwise hold themselves out as conducting business as an entity.

For the most part, these requirements will not present difficulties to Exchangers. The requirement to not conduct business under a common name, however, will be problematic. Virtually every strip mall, office building, and apartment building in the country has a name, and using the name would appear to violate the revenue procedure. This problem can be avoided if the co-owners lease the property to a single user, who may or may not sublease the property to other subtenants under that lease ("Master Lease"). A common Master Lease arrangement is to lease the property to the sponsor who created the tenancy-in-common interest on a long-term lease (often 20 years or more). The lease rents often increase slowly over time, allowing the tenant ("Master Lessee") to create income on the spread. As will be discussed below, a number of requirements of the revenue procedure promote using a Master Lease.

The revenue procedure also provides that a ruling will not be considered if the property was held in an entity immediately prior to holding the property in tenancy-in-common ownership. This requirement is designed to prevent ruling requests for partnerships that want to liquidate in order to allow individual partners to exchange their interests tax-free under the provisions of IRC § 1031 (so-called drop-and-swap transactions).
12.4.6.4 **Co-Ownership Agreement.** The revenue procedure specifically allows co-ownership agreements. This is good news because some practitioners believed that even the existence of a tenancy-in-common agreement might be deemed by the IRS to be evidence of the existence of a partnership. Such tenancy-in-common agreements may run with the land. The terms of such agreements, such as voting, granting rights of first offer, and restrictions on the right of partition, are discussed separately later.

12.4.6.5 **Voting.** Voting is allowed in a tenancy-in-common agreement. The revenue procedure implies that, at a minimum, co-owners holding no more than 50 percent of the undivided interests in the property must approve any specific action. Most important decisions, however, require unanimous approval: selling, leasing, borrowing funds secured by a blanket lien, hiring a manager, or approving or even renewing a management contract.

From a business point of view, requiring unanimous approval does not make good sense. For example, a single intransigent co-owner, no matter how small his interest, could block an action approved by every other co-owner. An intransigent co-owner can be placed in a position so that he can legally blackmail the other co-owners. As was the case in which co-owners had to avoid operating under a common name, a Master Lease will allow the co-owners to avoid the unanimous requirement with respect to leasing and engaging a manager. The Master Lessee will make all leasing decisions regarding leases by entering into subleases. The Master Lessee can also manage the property or hire a manager to manage it.

Another issue is whether the co-owners in the tenancy-in-common agreement can agree to take an action such as refinancing the property. Clearly, the unanimous voting requirement would be defeated if the parties agreed in the tenancy-in-common agreement to refinance or sell the property in five years. Yet, if the parties agreed, for example, in the tenancy-in-common agreement to obtain a permanent loan from XYZ Mortgage Company when the construction loan was due, it appears that such an action would be sufficiently contemporaneous to be acceptable under the revenue procedure.

Once a co-owner has consented to an action, he can grant a power of attorney to allow another person to execute specific documents to carry out that action. But, the revenue procedure prohibits global powers of attorney.
One of the most troublesome issues in complying with the guidelines is the unanimous vote requirement in order to lease property. A Master Lease avoids the problem. Also, leasing guidelines and a form of lease unanimously approved by the co-owners. Finally, some TIC agreements use an implied consent concept whereby if no one objects to the lease (say in 3 days) than the lease will be approved. This concept was approved in Priv Ltr Rul 200327003.

12.4.6.6 **Restrictions on Alienation.** In general, there can be no restrictions on the right to transfer, partition, or encumber a co-owner's interest in the property. But certain restrictions are allowed. First, restrictions on alienation contained in loan documents are allowed. Second, the revenue procedure allows agreements to restrict the right of partition by requiring that the tenancy-in-common interest first be offered to the other co-owners, the sponsor, or the lessee at fair market value at the time of the offer. Query: Since no loans can exist between co-owners, must the purchase price be paid for in cash even if the seller is no longer a co-owner at the instant of the sale? Third, the tenancy-in-common agreement can include a right of first offer in favor of the other co-owners, the sponsor, or a lessee. Again, the offer price must be at fair market value.

Note that a right of first offer is allowed with respect to selling a tenancy-in-common interest, but a right of first refusal is not specifically allowed. It seems that the IRS should not care whether a right of first refusal or a right of first offer were used.

12.4.6.7 **Sharing Proceeds and Liabilities Upon Sale of Property.** If the property is sold, the tenancy-in-common agreement must provide that any debt secured by a blanket lien must first be satisfied. The remaining proceeds thereafter must be distributed to the co-owners in accordance with their percentage interest in the property.

The foregoing requirement would arguably prohibit a sale in which the buyer assumed the secured debt since the lien must first be satisfied. The IRS can have no conceivable reason to object to a sale involving assumption of the underlying debt. Perhaps solace can be taken by Exchangers that the requirements of the revenue procedure will have been complied with at all times except the final action in selling the property.

12.4.6.8 **Proportionate Sharing of Profits and Losses.** Each of the co-owners must share all profits and losses in proportion to their undivided interests in the property. This provision is perfectly
logical and will not pose a problem to Exchangers structuring tenancy-in-common transactions.

The revenue procedure also requires that no co-owner, sponsor, or lessee may advance money to pay expenses for a period longer than 31 days. What is the logic behind this requirement? It is not at all clear. Perhaps the IRS wanted to discourage long-term advances, which are in effect debts owed by one co-owner to another. Such debts are disallowed in Section 6.14 of the revenue procedure. One commentator has opined that if a co-owner did not pay his share of expenses, the only remedy available would be to "sell the property or purchase the interest of the defaulting co-owner." Richard M. Lipton, New Rules Likely to Increase Use of Tenancy-in-Common Ownership in Like-Kind Exchanges, 96 J Tax'n _____ (May 2002). The author believes this approach to be overly conservative. The revenue procedure does not preclude traditional remedies such as bringing a legal action to specifically perform the obligations under the agreement.

12.4.6.9 **Proportionate Sharing of Debt.** The revenue procedure mandates that co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests. Thus any tenancy-in-common agreement should specifically provide that debt is shared in accordance with each co-owner's ownership percentage. Otherwise, the obligation of the co-owners to the mortgage lender, which is usually joint and several, may not under local law allocate the debt obligation between the parties in proportion to their ownership interests in the property. Note that the revenue procedure does not prevent a co-owner from borrowing against his tenancy-in-common interest in the property, as long as it is not secured by a blanket lien on the property. Such a debt, for example, could theoretically be secured by only the co-owner's tenancy-in-common interest in the property.

12.4.6.10 **Options.** The revenue procedure allows call options to be issued by co-owners. A call option must be based on the fair market value of the property at the time the option is exercised. No minority or marketability discounts are allowed. This is achieved by requiring that the option price be the fair market value of the entire property multiplied by the co-owner's interest in the property. Put options in favor of the co-owners, the sponsor, the lessee, the lender, or their affiliates are not allowed. This will prevent tenancy-in-common sponsors from guaranteeing a floor value of the property being purchased by co-owners. A put option in favor of an outside party is allowable. There is no reason why a put option, even to the
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insiders, could not have been allowed by the revenue procedure as long as it was also at fair market value and as long as the put option and call options could not be exercised during the same period.

12.4.6.11 No Business Activity. As was expected, the revenue procedure requires that the co-owners' activities "must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities)." It cites Rev Rul 75-374, 1975-2 CB 261, and the requirements for unrelated business taxable income found in IRC § 512(b)(3)(A).

For example, the co-owners could not operate property that was a hotel, motel, nursing home, or car wash. See also Priv Ltr Rul 200019014. Here especially, legal counsel will need to scrutinize the proposed operation of the property. Again, the Master Lease can come to the rescue. If the property is leased under a Master Lease, then the co-owners can be insulated against issues as to whether the management activities are customary activities.

There is, however, at least one fly in the ointment. Activities of parties related to the co-owners (disregarded for a co-owner who owns an interest in the property for six months or less) will be imputed to the co-owners. Thus, for example, if the co-owners leased the property under a Master Lease to a nursing home operated through a limited liability company controlled by one of the co-owners, the co-ownership arrangement could be considered by the IRS to be a partnership.

To avoid this problem, properties such as hotels, motels, nursing homes, and car washes should not be the subject of a co-ownership arrangement unless a Master Lease is used and the Master Lessee either is not a co-owner or agrees to convey its interest in the property within six months. A Master Lessee should be very cautious about agreeing to sell its property within a six-month period because the Master Lessee could be forced to sell its interest at a bargain-basement price.

We disagree with the advice that in all situations the transaction should be structured so that the Master Lessee co-owner must agree to sell its interest in the property within six months. See Lipton, supra, 96 J Tax'n at ______. There is need for the Master Lessee to sell his interest in the property if the property's management will require only customary activities.

12.4.6.12 Management and Brokerage Agreements. Co-owners may not enter into management or brokerage agreements unless they
are "renewable" annually. This can be problematic because the co-owners must, as discussed above, unanimously agree "to hire any manager" or agree to the "negotiation of any management contract." If every co-owner did not agree, who would manage the property? The answer to this problem is our old friend the Master Lease.

The revenue procedure also provides that the manager may use a common bank account to operate the property. All net revenues must be disbursed to the co-owners every three months. There is no provision for reserves, but it is doubtful that reserve payments required under mortgages would be disallowed. The manager can also prepare statements showing each co-owner's share of revenue and costs. The manager may also be authorized to obtain or modify insurance, negotiate a lease, or negotiate a new mortgage (even though the co-owners must approve these actions by the required vote percentage). The fees paid to the manager must not be in excess of fair market value and cannot be based on income or profit. This latter requirement is to prevent the manager from in effect being a "manager" partner who receives an allocation of partnership income for services rendered to the partnership.

12.4.6.13 Leasing Agreements. All leases must be bona fide leases for federal tax purposes. Rents must be set at fair market value. See IRC § 856(d)(2)(A). No rent can be determined in whole or in part by net income, profit, cash flow, increases in equity, or similar arrangements. But, rent can include or be based on a percentage of gross sales in receipts. This provision maintains the principle that only the co-owners can share in the fruits of the operation of the property.

12.4.6.14 Loan Agreements. The revenue procedure prohibits any loan from a co-owner, sponsor, manager, or lessee to acquire a tenancy-in-common interest in the property. Note that this provision might be interpreted to prevent a tenancy-in-common agreement to include mandated seller-financing provisions when a co-owner is exercising rights under a right-of-first-offer provision.

12.4.6.15 Payment to Sponsor. Any payment to a sponsor must reflect the fair market value of the services provided and may not be based on income or profit from the property. Again, the principle is enunciated in the revenue procedure that only co-owners may share in the benefits from operating the property.

12.4.6.16 Conclusion. For the most part, the principles set forth in Rev Proc 2002-22 are reasonable. Although the IRS sought and
received significant input from tax practitioners in formulating the revenue procedure (including significant input from the author), the revenue procedure's language in places reflects a lack of actual experience in structuring real estate transactions in the real world. It also reflects a failure to vet the actual language of the revenue procedure with tax practitioners before finalizing it. The most significant problems will be the requirement for unanimous consent to sell, lease, finance, or enter into a management contract with respect to the property. Most transactions will probably be structured under a long-term Master Lease to avoid the requirement for unanimous consent for leasing or entering into a management contract.

The revenue procedure is the standard for structuring tenancy-in-common transactions. Sponsors of tenancy-in-common transactions generally structure all of their transactions so that its requirements are met. In such event, Exchangers can be fully assured that their tax-free exchange transactions will in fact be fully tax-free.

12.5 Reduction of Liabilities. An interesting issue that partnerships must deal with is whether the partnership debt-relief recognition rules under Section 752(b) are overridden by the nonrecognition rules of Section 1031. Rev Rul 2003-56 (May 9, 2003) held that the reduction of liabilities does not need to be treated as boot in a multi-year exchange. Priv Ltr Rul 200019017 (May 12, 2000) held that Section 1031 overrode Section 752(b) (at least if both legs of the exchange are completed during the same tax year).

13. INSTALLMENT SALE AND EXCHANGING

13.1 General Rule. Generally, any cash or installment note received by the Exchanger is taxed fully as boot. See IRC § 453(f)(6). Installment notes, however, are taxed only in the year in which principal payments are received.

Example: An Exchanger exchanges Relinquished Property valued at $1 million, with a basis of $160,000, for Replacement Property valued at $200,000, $200,000 cash, and a $600,000 note. The $800,000 in boot ($200,000 cash and $600,000 note) is fully taxable as and when received. The only deferred gain is $40,000. Prop Treas Reg § 1.453-1(f)(1)(iv) Example (4), 49 Fed Reg 18,866, 18,868 (1984).

13.2 Excess Basis. If the basis of the Relinquished Property exceeds the fair market value of the Replacement Property, then the excess ("Excess Basis") reduces the gain on the taxable boot received.

Example: An Exchanger exchanges Relinquished Property valued at $1 million, with a basis of $400,000 for Replacement Property valued at $200,000, $200,000
cash, and a $600,000 note. The Excess Basis is $200,000 ($400,000 basis in Relinquished Property less $200,000 fair market value of Replacement Property). The gain percentage on the boot received is 75 percent ($800,000 boot received reduced by $200,000 Excess Basis, divided by total boot received of $800,000). There is no deferred gain. Prop Treas Reg § 1.453-1(f)(1)(iv) Examples (1), (2), 49 Fed Reg 18,866, 18,867 (1984).

13.3 Net Qualifying Indebtedness and Excess Basis. Net Qualifying Indebtedness is the excess of indebtedness for which the Exchanger is released in an exchange, less any cash payments made by the Exchanger to acquire the Replacement Property. In an exchange, Net Qualifying Indebtedness does not have to be treated as boot received in the year of sale to the extent that it is less than the Excess Basis.

Example: An Exchanger exchanges Relinquished Property valued at $1 million, with a basis of $400,000 and subject to a $200,000 mortgage, for Replacement Property valued at $200,000, $200,000 relief of indebtedness on the Relinquished Property, and a $600,000 note. The Excess Basis is $200,000 ($400,000 basis in Relinquished Property less $200,000 fair market value of Replacement Property). The gain percentage on the boot received is 75 percent ($800,000 boot received reduced by $200,000 Excess Basis, divided by total boot received of $800,000). The $200,000 relief of indebtedness on the Relinquished Property does not have to be treated as boot received by the Exchanger in the year of sale. There is no deferred gain. Prop Treas Reg § 1.453-1(f)(1)(iv) Example (3), 49 Fed Reg 18,866, 18,867 (1984).

13.4 Basis Strip. Instead of combining an installment sale and a tax-free exchange in one transaction, superior results (with greater risk) can be achieved by bifurcating the transaction as a separate sale transaction and a separate exchange transaction. By treating the transaction as two separate transactions, more basis is available to reduce recognized gain. The transaction is subject to attack by the IRS's treating it as one transaction with the "sale" proceeds fully taxable as boot.

13.4.1 Example. An Exchanger exchanges Relinquished Property valued at $1 million, with a basis of $160,000, for Replacement Property valued at $200,000 and an $800,000 note. The transaction is structured as a sale of 80 percent of the Relinquished Property for an $800,000 note and an exchange of 20 percent of the Relinquished Property for Replacement Property valued at $200,000. If the bifurcated structure is upheld, instead of the $800,000 note being fully taxable as boot, the $800,000 note will have $128,000 of basis (80 percent of $160,000). The gain percentage will be 74 percent ($800,000 less basis of $128,000, divided by $800,000).

13.4.2 Transaction treated as two transactions or one? See discussion "Two Exchanges or One?" at Article 4.5
13.5 **Installment Sales and Deferred Exchanges.**

13.5.1 **Accommodator sells note.** If an Accommodator receives a promissory note from a Buyer, the Accommodator can sell the note for cash. The Exchanger will be able to treat the transaction as part of a fully tax-free exchange. Such a sale of the note will be a taxable disposition to the Accommodator. IRC § 453B(a).

13.5.2 **Accommodator uses note to acquire Replacement Property.** The Accommodator can also use the note and trust deed acquired on the sale of the Relinquished Property to purchase the Replacement Property. The Seller of the Replacement Property will not be able to treat the note payable to the Accommodator as part of an installment note because the note will not be "evidence of indebtedness of the person acquiring the property"--the Accommodator; rather, the note will be treated as evidence of indebtedness of the Buyer of the Relinquished Property. IRC § 453(f)(3). The Exchanger will be able to treat the transaction as part of a fully tax-free exchange because the Accommodator, rather than the Exchanger, disposed of the note for IRC § 453B purposes.

13.5.3 **Exchanger loans funds to Buyer to purchase Relinquished Property.** The Exchanger can either directly or indirectly fund the Buyer's purchase of the Relinquished Property. If the Exchanger is willing to sell the Relinquished Property on the installment basis, but also wants to complete the transaction as a tax-free exchange, the Exchanger can loan the funds to the Buyer of the Relinquished Property in cash. The cash can be transferred on closing to the Accommodator to be used to purchase the Exchanger's Replacement Property. If the Exchanger directly loaned the funds to the Buyer, the IRS might argue that the transaction is indistinguishable from the Accommodator distributing the Buyer's installment note to the Exchanger which would be taxable as boot when the principal payments were made under the note under Treas Reg § 1.103(k)-1(j)(2)(v). Surprisingly, however, the IRS approved such a transaction as a tax-free exchange in Priv Ltr Rul 9826033 (Mar. 27, 1998). To avoid the IRS from arguing that the installment sale rules should apply, it is recommended that the loan be structured through an entity related to the Exchanger rather than actually having the Exchanger make the loan. The actual lender of course should not act as the agent of the Exchanger.

13.5.4 **No disposition if Accommodator transfers note to Exchanger.** Alternatively, at the end of the exchange, or even if the exchange fails and no Replacement Property is acquired and conveyed to the Exchanger, the Accommodator can transfer the note to the Exchanger and it will be treated as an installment note in the hands of the Exchanger. The conveyance of the note to the Exchanger is not treated as a disposition.

13.5.5 **Cash boot received in year two.** If the First Leg of a deferred exchange closes in year one, but some cash remains after the Accommodator (or the other party to the exchange) purchases the Replacement Property, the distribution of the cash to the Exchanger in year two is taxed as a boot distribution to the Exchanger in year two.

Treas Reg § 1.1031(k)-1(j)(2)(vi) Examples 1, 2, 57. The court in *Orville E. Christensen v. C.I.R.* 69 TCM (RIA) ¶ 96,254 (1996), held with respect to a case arising before the regulations were adopted that proceeds received in year two of an exchange were taxable to the Exchanger in year two. See also *Smalley v. Comm.* 116 TC No. 29 (2001).

13.5.6 **Deferred exchange fails.** If the First Leg of a deferred exchange closes in year one but no Replacement Property is designated during the Identification Period, which ends in year two (or no Replacement Property is acquired during the Exchange Period, which ends in year two), the distribution of cash in year two from the sale of the Relinquished Property to the Exchanger by the Accommodator (or the other party to the exchange) is taxed as a boot distribution to the Exchanger in year two.


13.5.7 **Other requirements.** The transactions described in 4 through 6 above will qualify for installment sale treatment only if the following requirements are met:

13.5.7.1 The Accommodator must be a Qualified Intermediary;

13.5.7.2 Under the terms of the exchange agreement, the Exchanger cannot pledge, borrow, or otherwise obtain the benefits of the cash during the period it is held by the Accommodator;

13.5.7.3 The Exchanger must have a bona fide intent to effect a deferred exchange; and

13.5.7.4 Under the terms of the exchange agreement, the cash held by the Accommodator cannot be distributed to the Exchanger until the end of the 45-day Identification Period if no Replacement Property is identified, or at the end of the 180-day Exchange Period, whichever is earlier.

13.6 **Completing Exchange When Seller Wants Installment Note.**

It is not uncommon for any Exchanger who is attempting to complete a tax-free exchange to find that the perfect Replacement Property is owned by a Seller that
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insists on being paid on an installment basis. For example, let's assume that the Exchanger sold Relinquished Property for cash of $1 million. He wants to purchase Replacement Property for $1,200,000. The Seller is willing to accept only a down payment of $300,000 and the remaining $900,000 in installments over ten years. How can the Exchanger structure the transaction so that he will not be taxed on the remaining $700,000 in cash held by the Accommodator, which cannot be spent to acquire the Replacement Property?

13.6.1 **Letter of credit solution.** One possible approach is to have the Accommodator give its $900,000 note to the Seller and have the note secured only by a letter of credit from a bank. The Replacement Property is then conveyed to the Exchanger free and clear of any mortgage in favor of the Seller. This approach should make everyone happy. The Seller is happy because it has the installment sale it wanted, and it is fully secured by the letter of credit. The Exchanger is happy because it is able to complete its tax-free exchange. Finally, the Accommodator is happy because it can turn over all the money to the bank to secure its letter of credit, and it can arrange for the bank to actually make the payments and draw on the funds for this purpose.

13.6.2 **Drawbacks to letter of credit solution.** But this solution has significant drawbacks. First, banks charge a lot for a letter of credit—often 1 to 2 percent. Second, documenting this kind of transaction can take a lot of lawyer time. The Exchanger, Seller, bank, and Accommodator will each want to hire separate counsel to make sure the transaction works. Finally, there is an interest arbitrage problem. The money must be invested in a very secure way to meet the bank's requirements under its letter of credit. The interest earned on the funds might be only 4 percent. The Seller wanted to earn 8 percent on the installment note. There is no easy way to solve this problem. The Seller must accept an interest rate of 4 percent, or the Exchanger must deposit enough money with the bank to allow the letter of credit to pay 8 percent, or the purchase price to the Seller must be reduced so that the cash deposited with the bank to secure the letter of credit is sufficient to pay the principal plus interest at 8 percent per annum.

14. **EXCHANGES INVOLVING FOREIGNERS AND FOREIGN PROPERTY**

14.1 **Foreign Property.** Property located outside the United States is not of like kind to property within the United States. Treas Reg § 1.1031(h). Priv Ltr Rul 9038030 (June 25, 1990) provides that the Virgin Islands are property within the United States for purposes of this rule. See also Priv Ltr Rul 20004017 (Oct. 10, 2000). The requirements of IRC § 932(a) must also be met. Foreign property can be exchanged for foreign property. Personal property is deemed foreign if it is predominantly used outside of the United States.
14.2 **FIRPTA.** FIRPTA is an acronym for Foreign Investment in Real Property Tax Act of 1980. It requires that a person who buys real estate from a foreign Exchanger withhold 10 percent of the total sales price.

14.2.1 **Simultaneous exchanges without boot.** A foreign Exchanger is able to avoid the withholding requirement in a simultaneous exchange by complying with the requirements of Treas Reg § 1.1445-2(d)(2). The regulation requires that the foreign Exchanger notify the transferee (Accommodator) that the transfer is a nonrecognition transaction and that the transferee provide the IRS with notice of the transaction within 20 days of receiving the foreign Exchanger's property, but this exemption applies only if no boot is received by the foreign Exchanger. If any boot is received, then the full withholding amount on the entire proceeds must be made by the transferee.

14.2.2 **Deferred exchanges or exchanges with boot.** It appears that for deferred exchanges, the notice will not currently provide relief because the Accommodator will not know until the second phase of the exchange is completed whether the Exchanger will receive boot in the transaction. The ABA Taxation Section is proposing that a revenue procedure be adopted so that the notice allowed by Treas Reg § 1.1445-2(d)(2) can be deferred until the closing of the second phase of the deferred exchange.

For deferred exchanges or exchanges involving boot, the Accommodator can be relieved of its FIRPTA withholding obligation if it is presented with a withholding certificate. A withholding certificate under IRC § 1445(b)(4) can be obtained by applying to the IRS, pursuant to Rev Proc 88-23, 1988-1 CB 787. The certificate means that the transferee is not required to withhold under FIRPTA. The certificates are generally available for nonrecognition transactions, but there can be substantial delays in obtaining a withholding certificate from the IRS.

14.2.3 **Growth factor or interest.** Growth factor or interest received by a foreign Exchanger in a tax-free exchange should not be subject to FIRPTA withholding because it is treated as interest income, not as capital gain or boot. Treas Reg § 1.1031(k)-1(h)(2).

14.2.4 **Cal-FIRPTA.** California and several other states have their own FIRPTA-like statutes that provide for withholding on the sale of property. An exemption for an exchange is available by completing California Forms 597-A and 597-B.

14.3 **State Taxation of Exchanges.**

14.3.1 **General.** Most states with an income tax follow the provisions of IRC § 1031. In structuring any exchange, check state law provisions.
14.3.2 **Replacement real property located outside of state.** Many states have provisions that if the like-kind property is real estate and the Relinquished Property is located in-state and the Replacement Property is located in another state, the transaction will be taxable for state law purposes. The states correctly believe that unless they tax such a transaction, the states will not be able to levy a tax when the foreign Replacement Property is ultimately sold.

14.3.3 **Oregon.** Beginning on October 6, 2001, subject to filing a deferral election, Oregon conformed its tax-free exchange laws to federal income tax laws.

14.3.3.1 The 2000 Oregon legislature passed HB 2206. It provides that Oregon will not tax the exchange of Oregon relinquished property in a tax-free exchange if the replacement property is not in Oregon. When the replacement property is ultimately sold, however, an Oregon tax will be due on the gain that would have been recognized on the sale of the original relinquished property. If the replacement property sells for less than it was purchased for, the gain will be reduced. The Oregon Department of Revenue is authorized to require taxpayers who defer gain in this manner to file an annual report with the Oregon Department of Revenue. Use Oregon Form 24. This will allow the Oregon Department of Revenue to better track taxpayers who have invested in out-of-state property as part of a tax-free exchange.

14.3.3.2 For CPAs and other tax technophiles who read this, the actual wording of the statute is a little more complicated. It actually provides that Oregon will tax the sale of the replacement property when it is sold. The gain will be the difference between the basis of the replacement property and the lesser of (i) the fair market value of the replacement property on the date on which the taxpayer acquired it and (ii) the fair market value of the replacement property on the date on which the replacement property is sold. If this difference produces a loss, the taxpayer can deduct the loss on his Oregon return.

14.3.3.3 Example: Joe Taxpayer exchanges Oregon relinquished property in which he has a basis of $300,000 for $500,000. If he does not complete a tax-free exchange, his taxable gain will be $200,000. But Joe purchases Utah replacement property for $700,000. When the Utah replacement property is eventually sold, Joe must recognize the deferred gain of $200,000. If the Utah replacement property is sold for $650,000, then Joe needs to recognize only $150,000 of Oregon gain. The loss (reduction in value from $700,000 to $650,000) on the sale of the Utah
replacement property reduces the gain that Joe must otherwise recognize.

14.3.3.4 Prior to October 6, 2001, under ORS 314.290 Oregon follows the provisions of IRC § 1031 with one major exception. If the Replacement Property is real estate and is located out of the state of Oregon, Oregon taxed the transaction. Oregon would not tax such an exchange, however, if the Exchanger was a resident of the state of Oregon and filed an election to pay tax when the foreign real estate is sold or the Exchanger ceases to be a resident of the state. The Oregon Tax Court Magistrate Division case of Fisher v. Department of Revenue, No. 99033ZC issued on February 12, 2001 declared ORS 314.290 (as it existed prior to October 6, 2001) unconstitutional because it discriminated against nonresidents. The court found such discrimination because residents could exchange tax free for replacement property out of Oregon, but nonresidents could not.

14.3.4 Washington real estate excise tax. The state of Washington levies a real estate excise tax on any transfer of real property. The rate varies by county, but generally the rate is around 1.57 percent of the value of the property transferred. The excise tax applies in a tax-free exchange to both properties. WAC 458-61-370. If the Relinquished Property or the Replacement Property is conveyed directly to or from the Exchanger from or to the buyer or seller, only one excise tax is levied on each transfer. Exchangers have faced the possibility of paying two excise taxes in certain exchanges in which the Accommodator took title to the Replacement Property (as would be the case in an improvement exchange or a reverse exchange). The first excise tax would be due on the acquisition of the Replacement Property by the Accommodator, and the second excise tax would be due on the transfer of the Replacement Property from the Accommodator to the Exchanger. Effective March 4, 1994, however, the excise tax regulations were revised to provide that the second excise tax would not be due if certain technical requirements set forth in the regulations were complied with. WAC 458-61-480. Thus, the Replacement Property when acquired by the Accommodator will be subject to the excise tax, but the later conveyance of the Replacement Property to the Exchanger will escape tax in most instances. Unfortunately, the double-tax problem may not have been solved by certain types of exchanges whereby the Relinquished Property (as opposed to the Replacement Property) was conveyed to the Accommodator and not directly deeded to the buyer. An example is a reverse exchange whereby the Relinquished Property is parked with the Accommodator pending sale to a buyer.
15. RELATED-PARTY EXCHANGES

15.1 Overview.

15.1.1 General Rule. An exchange between related parties will be taxable to both parties if within two years following the exchange either the related party disposes of the Relinquished Property or the Exchanger disposes of the Replacement Property. IRC § 1031(f). This provision was enacted in order to prevent basis shifting whereby related parties complete an exchange of high-basis property for low-basis property in an anticipation of the sale of the low-basis property.

15.1.2 Series of Related Steps. The related-party rules cannot be avoided by entering into a series of steps structured to avoid the purpose of the related-party rules. IRC § 1031(f)(4).

15.1.3 Exceptions to General Rule. There are a number of exceptions to the general rule that related-party exchanges will be taxable unless they were held by both the Exchanger and the related party for two years:

15.1.3.1 A disposition within the two-year period following the death of the Exchanger or the related party. IRC § 1031(f)(2)(A).

15.1.3.2 A disposition within the two-year period as a result of a condemnation or threat of condemnation. IRC § 1031(f)(2)(B).

15.1.3.3 A disposition that did not have as one of its principal purposes the avoidance of federal income taxes ("No Tax Avoidance Exception"). IRC § 1031(f)(2)(C). This exception has expanded over the years and provided quite a number of different ways to avoid the related-party rules. These exceptions are discussed more fully below. But a note of caution: This exception has an additional requirement that the application of the exception must be "established to the satisfaction of the" IRS.

15.1.3.4 The two-year period is suspended if the property is subject to a call option, put option, short sale or similar transaction. IRC §1031(g).

15.2 "Related party" defined.

15.2.1 General Rule. Related parties are defined under IRC § 267(b) or IRC § 707(b). They include siblings, spouse, ancestors, lineal descendants, a corporation 50 percent owned directly or indirectly by the same person, and two corporations that are members of the same controlled group. IRC § 1031(f)(3).
15.2.2 **Who Is Not Related?** Obviously, anyone who is not defined as being related is not related. Examples include the relationship between a married couple and their son or daughter-in-law. Thus, an exchange between the couple and their daughter-in-law is not subject to the related-party rules. Another example is an individual Exchanger and partnership or corporation in which the Exchanger owns 50 percent directly or indirectly and nonrelated persons own the remaining interests in the entity.

15.3 **Examples of Allowable Related-Party Exchanges.**

15.3.1 **Sell Relinquished Property to Related Party and Wait Two Years.** The most commonly invoked exception is for an Exchanger to sell the Relinquished Property to the related party and acquire the Replacement Property from an unrelated party. This exception will work, however, only if the Exchanger does not sell or otherwise dispose of the Replacement Property for two years and the related party also does not sell or otherwise dispose of the Relinquished Property for two years. It is advisable that an agreement be entered between the related party and the Exchanger whereby the related party agrees not to sell or otherwise dispose of the Relinquished Property for two years.

15.3.2 **"True" Exchange With Related Party and Wait Two Years.** In this exception, the Exchanger transfers the Relinquished Property to a related party and acquires the Replacement Property from a related party. Both parties must then wait two years. Under this exception, the Relinquished Property cannot be transferred to an unrelated party and the Replacement Property cannot be acquired from an unrelated party. Again, it is advisable to have the related party agree to not dispose of the Relinquished Property for two years.

**Basis Swap Example.** This exception is a wonderful boon to clever Exchangers because it can allow huge tax savings by use of a "basis swap." Let us assume that an Exchanger owned Relinquished Property with a value of $1 million and a basis of zero and that a partnership it controlled owned Replacement Property with a value of $1 million and a basis of $1 million. If the Exchanger sold the Relinquished Property, it would have a $1 million taxable gain. Now assume that the Exchanger exchanges the Relinquished Property for the related partnership's high-basis Replacement Property. After waiting two years, the partnership can now sell the Relinquished Property for $1 million with no gain or loss! This is because the partnership's basis of $1 million in the Replacement Property is substituted and now becomes a $1 million basis in the Relinquished Property.

15.3.3 **Sell Relinquished Property to Related Party and Purchased Replacement Property from Unrelated Party.** An exchange where the Relinquished Property is conveyed to a Related Party and the Replacement
Property is acquired from a third party was found to be exempt from the related-party rules. The IRS in Priv Ltr Rul 200712013 allowed just such a transaction even when the Related Party stated that it planned to sell the Replacement Property within two years. The IRS indicated that this was not an exchange of high basis property for low-basis property and thus there was no basis swap.

15.3.4 **No Basis Swap.** The No Tax Avoidance Exception has also been applied in related-party exchanges where there is no basis swap. For example, if an Exchanger and her brother inherited Blackacre (consisting of two lots) or acquired it together as tenants in common, their basis would be the same. If they completed an exchange of their undivided interests in Blackacre such that the Exchanger acquired one lot and her brother acquired the other lot, the exchange would be tax-free. In Priv Ltr Rul 200706001 (Oct. 31, 2006), the IRS held that the exchange was tax-free to the Exchanger even though following the exchange the related-party siblings immediately sold the Replacement Property. See also Priv Ltr Rul 199926045 (Apr. 2, 1999).

15.3.5 **The Exchanger and the Related Party Together Do Not Save Tax.** Another exception to the related-party exchange rules is a related-party transaction in which the related party will pay as much tax as the Exchanger will save, or more, by completing a tax-free exchange. This exception is based on the No Tax Avoidance Exception discussed above. The basic reason behind the related-party exchange rules is that the IRS does not want to give the Exchanger the opportunity to save taxes by completing basis swap transactions as described above (unless the parties waited two years). The related-party exchange rule is not needed if the related parties did not save any taxes. For example, if the Exchanger were to complete an exchange by which he acquired the Replacement Property from his sister (deferring $300,000 of taxable income), the exchange would be tax-free as long as the sister had to pay tax on her sale of at least $300,000. No one knows what would happen if the sister had to pay tax on $280,000 of taxable income, but it would probably work. At some point, if the sister's tax liability was substantially less than her brother's savings in taxable income, the IRS could treat the transaction as taxable. This exception will not apply if the sister's $300,000 in taxable income did not generate a tax liability for some reason (e.g., she had a net operating loss carryover that sheltered the gain; see Teruya Bros., Ltd., & Subs. v. Comm'r, 124 TC 45 (2005)).

15.3.6 **No Cash-Out.** The IRS has held that if neither the Exchanger nor the related party cashed out (i.e., neither party received any cash in the exchange transactions), the No Tax Avoidance Exception will apply. In Priv Ltr Rul 200251008 (Sept. 11, 2002), the Exchanger completed an improvement exchange. The Replacement Property was a building constructed on a ground lease from a related party. Even so, since the
related party did not receive any cash in the transaction, it was held that
the related-party rules were not violated and that the exchange was tax-
free.

15.3.7 **No Cash-Out: Exchanger and Related Party Both Exchange.** Another
example of the No Tax Avoidance Exception is a related-party transaction
in which neither the Exchanger nor the related party cashes out of its
investment. *See* Priv Ltr Rul 200616005 (Dec. 22, 2005); Priv Ltr Rul
200440002 (June 14, 2004) (nontaxable transaction when the Exchanger
sold the Relinquished Property in a transaction structured as a tax-free
exchange and purchased the Replacement Property from his sister, and the
sister also completed a tax-free exchange).

15.3.8 **Family Feud.** The No Tax Avoidance Exception has been applied to an
exchange to resolve a family dispute. In Priv Ltr Rul 200012064
(Dec. 21, 1999), the IRS permitted a series of circular tax-free exchanges
between related parties followed by a spin-off of a corporation when the
purpose of the spin-off was not to avoid taxes, but rather to resolve
disagreements between shareholders as to the management of the
corporation.

15.3.9 **Additional Nontaxable Disposition.** The No Tax Avoidance Exception
has also been applied to disposals of the Replacement Property in a tax-
free transaction (e.g., using the property as a capital contribution to a

15.4 **Examples of Prohibited Related-Party Exchanges.**

15.4.1 **Buy Replacement Property From Related Party.** The most common
way that the related-party rules apply is that the Exchanger sells the
Relinquished Property to a buyer, but wants to purchase the Replacement
Property from a related party. This does not work. The two-year
exception cannot apply because both the Exchanger and the related party
must hold the exchange property for two years (which is not possible if the
Relinquished Property has been sold to an unrelated buyer).

15.4.2 **Transfers to Accommodator to Avoid Related-Party Rules.** IRC
§ 1031(f)(4) provides that the exchange is fully taxable if the Exchanger
attempts to complete a series of transactions to avoid the related-party rules.
For example, the related-party rules cannot be avoided by using an
Accommodator and taking the position that the exchange was with only the
Accommodator and not the related party. *See* Rev Rul 2002-83, 2002-2 CB
927.

15.4.3 **Transfers to Third Persons to Avoid Related-Party Rules.** It is also
likely that IRC § 1031(f)(4) will be applied if the related party transfers
the Replacement Property to a person who is not related to the Exchanger.
For example, if a son transfers property to his wife so that the wife can complete an exchange with the son's parents, the transfer to the wife will probably be disregarded and thus will result in a fully taxable exchange.

16. **REPORTING REQUIREMENTS**

The IRS has issued Form 8824, which must be completed by every Exchanger who engages in a like-kind exchange.