The 1031 Exchange Handbook

A complete guide for Legal, Accounting, Financial and Real Estate Professionals

Andrew G. Ogden
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By Andrew G. Ogden
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Preface

In the mid-1980s I began presenting continuing professional education seminars to fellow lawyers, first on general topics relevant to the structuring and taxation of business and real estate transactions, and later focusing on like-kind exchanges under Internal Revenue Code Section 1031. When getting ready to present a seminar, I found that I was always better prepared if I provided the attendees with comprehensive materials covering not only the seminar topics but also related areas that were important to an in-depth understanding of the subject. This seed of this book began with some of the materials I prepared for my continuing education seminars, which have been edited, updated and supplemented with a large quantity of material written especially for this new publication. Finally, the book has been seasoned with the lessons learned from over 25 years experience as a business, real estate and tax lawyer, and as a professional 1031 exchange accommodator.

It is unlikely that any professional working in law, accounting, finance or real estate has not encountered a like-kind exchange at some point in their practice. Driven in part by the significant increase in real estate prices prior to 2009, according to the Internal Revenue Service the number of like-kind exchanges more than doubled between 2001 and 2005. In 2005 alone, the IRS recorded deferred capital gains of approximately $101.3 billion from 429,000 like-kind exchanges. ¹ Although it is likely that the significant decline in real estate values will reduce the volume of like-kind exchanges for some time, past experience suggests that like-kind exchanges will continue to play a significant role in real estate transactions that should increase as real estate prices rebound.

Advising clients about like-kind exchanges present many challenges for a lawyer, accountant, financial or real estate professional. It is a complex area of practice where tax, real estate, contracts, finance, agency, partnerships, estate planning and a number of other legal and business disciplines intersect, with transactions that range from the simple to exceedingly complicated. This book was written specifically for working professionals, with the intent of providing a concise but complete reference source on like-kind exchanges and related topics. However, readers with little or no experience with like-kind exchanges will also find this book to be an understandable introduction to this complex area of practice.

In organizing and writing this book, my first goal was to provide the reader with a usable reference to all topics relevant to understanding like-kind exchanges. It was my second goal to explain the applicability of each topic to the structuring, execution and reporting

of a like-kind exchange. Because like-kind exchanges are not limited to real estate, this book provides a comprehensive explanation of exchanges of both real property and personal property. Finally, for those with limited tax experience, this book also covers the basic principals of capital gains taxation and like-kind exchanges that are applicable to all transactions under Section 1031.

After considering several formats for this book, I chose the outline form because I believe that it provides the most concise format for the organization and presentation of the information. Although at times a traditional book form may lend itself to a more eloquent discussion of a specific topic, the need to cover the wide variety of topics necessary to understand like-kind exchanges requires a more succinct format. In the outline format used in this book, each topic is covered with a summary explanation and a discussion of key authority, with footnotes to provide citations and reference to other authorities for additional explanation and information. The footnotes also provide references to other sources for additional information on topics deemed to be of lesser importance to understanding and structuring like-kind exchanges that, in the interests of conciseness, are covered in less detail than those of more primary importance.

Regarding the citations contained in this book, the Internal Revenue Code\(^2\) is referred to as the “I.R.C.”, the Federal Tax Regulations\(^3\) are referred to as the “Regs.” and other forms of authority use customary citation forms. For an explanation of the various types of guidance issued by the Internal Revenue Service (“I.R.S.”), see the I.R.S. publication "Understanding IRS Guidance – A Brief Primer”.\(^4\)

Finally, in the eBook version of The 1031 Exchange Handbook, hyperlinks (which appear as a [hyperlink](#)) to cross-references within the book, and to outside sources, are provided whenever reasonably possible.\(^5\)

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\(^2\) Internal Revenue Code of 1986, as amended, U.S.C. Title 26, Subtitle A, Chapter 1, Subchapter A et seq.

\(^3\) Treasury Regulations, 26 CFR Ch. I, Part 1, Section 1.0-1 et seq.

\(^4\) See Appendix I: Understanding IRS Guidance - A Brief Primer, infra.

\(^5\) Please note that the I.R.C. materials retrieved via hyperlink are provided as a public service by The Legal Information Institute of Cornell University Law School. The Federal Tax Regulations as set forth in the Code of Federal Regulation are provided by the National Archives and Records Administration.
Chapter One: Overview of Capital Gains Taxation

I. Introduction
Income tax has been imposed on the sale of investments under the Internal Revenue Code since 1913, and at a different rate than ordinary income since 1921. However, the Internal Revenue Code has several provisions that provide for the exclusion of certain capital gains from a taxpayer's income, or the non-recognition of capital gains income. Like-kind exchanges under I.R.C. Section 1031 are one of the non-recognition provisions.

To make matters more complicated, income taxes are imposed by some, but not all, of the 50 states, and those states with an income tax are not uniform in the taxation of capital gains. Further, some of the states that tax capital gains do not follow the non-recognition provisions of I.R.C. Section 1031 or modify its provisions.

Before attempting to understand like-kind exchanges, it is essential to have a working understanding of the basics of both Federal and state taxation of capital gains. For those who may not have a background in taxation, this Chapter is intended as a short primer on the basics of federal and state taxation of capital gains and various tax-deferral mechanisms.

II. Nature and Calculation of Capital Gain
A. Definition of “Capital Gain”
"Capital gain" is the type of income that is realized upon the sale or exchange of a “capital asset”.

B. Calculation of Capital Gain
The capital gain from the sale of a capital asset is the \[
\text{[(total of all money and fair market value of property received) - (adjusted basis of property transferred + selling expenses)]}
\]
Example: Property A was purchased for $100,000, has $15,000 of accumulated depreciation, $10,000 of capital improvements, and is being sold for $200,000 with $10,000 costs of sale.

<table>
<thead>
<tr>
<th>Capital Gains</th>
<th>Sales Price</th>
<th>$200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calculation</td>
<td>(Adjusted Basis)</td>
<td>$95,000</td>
</tr>
<tr>
<td></td>
<td>(Costs of Sale)</td>
<td>$10,000</td>
</tr>
<tr>
<td>Net Capital Gains</td>
<td></td>
<td>$95,000</td>
</tr>
</tbody>
</table>

C. Calculation of Adjusted Basis
The adjusted basis of the property transferred is the \([(\text{acquisition cost} + \text{capital improvements}) - (\text{accumulated depreciation})]^{9}\)

<table>
<thead>
<tr>
<th>Adjusted Basis</th>
<th>Purchase Price</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calculation</td>
<td>(Accumulated Depreciation)</td>
<td>$15,000</td>
</tr>
<tr>
<td></td>
<td>Capital Improvements</td>
<td>$10,000</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td></td>
<td>$95,000</td>
</tr>
</tbody>
</table>

III. Calculation of Tax Due on Capital Gain

A. Long-Term Capital Gain
A “long term capital gain” results from the sale or exchange of a capital asset that was held by the taxpayer for more than one year.\(^{10}\) Long-term capital gain is taxed at a preferential rate compared to “short-term capital gain” (e.g., income from the sale of a capital asset held for less than one year), which is taxed at the ordinary income rate.\(^{11}\)

B. Tax on Capital Gain from Appreciation
In 2003, the tax rate paid by individuals on long-term capital gain was reduced substantially.\(^{12}\) For most individual taxpayers, the current maximum tax rate on the amount of recognized long-term capital gain from appreciation of the capital

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\(^{9}\) See I.R.S. Publication 551 “Basis of Assets” at page 2 (May 2002).

\(^{10}\) I.R.C. Section 1222(3).

\(^{11}\) I.R.C. Section 1222(1); I.R.C. Section 1(h)(1).

\(^{12}\) See Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub.L. 108-27 (“2003 Act”). Prior to 2003, individuals were generally subject to a maximum tax rate of 20% on net long-term capital gain for the tax year over the net long-term capital loss for the year. The 2003 Act reduced the top tax rate on net capital gains from the sale or other disposition of stocks, bonds, and most other investments recognized on or after May 6, 2003 to 5% for taxpayers otherwise in the 10% to 15% tax bracket (0% in 2008, 2009 and 2010) and to 15% for taxpayers in the higher tax brackets. The 2003 Act did not reduce the capital gains rate on any long-term capital gain resulting from the sale or exchange of “Section 1250 Property” (e.g., depreciable real estate), which is still taxed at a maximum 25% rate to the extent of the straight-line depreciation that was allowable with respect to the property. The 2003 Act also eliminated the 2% capital gains tax rate reduction for properties held more than five years for capital gains recognized on or after May 6, 2003.
asset is 15%.\textsuperscript{13}

C. \textbf{Tax on Capital Gain from Depreciation}

Capital gain resulting from reduction of a real property's basis from depreciation is referred to as “Section 1250 Gain” and, if recognized, is taxed at 25% rate.\textsuperscript{14} Note that Section 1250 Gain must be distinguished from the recapture of “Additional Depreciation” which, if recognized, is taxed at ordinary income rates.\textsuperscript{15}

\textbf{Example}: Property A has capital gains of $95,000, comprised of $80,000 of appreciation and $15,000 of accumulated straight-line depreciation.

\begin{tabular}{|c|c|}
\hline
15\% tax rate on appreciation gain & $12,000 \\
25\% tax rate on Section 1250 gain & $3,750 \\
\hline
Total Capital Gains Tax & $15,750 \\
\hline
\end{tabular}

IV. \textbf{State Taxation of Capital Gains}

A. \textbf{General Rule}

At this time 47 states impose some form of taxation on income realized from the sale of capital assets within its jurisdiction. However, there are differences in how each of those states that impose taxes on capital gains. Because of the differences in various states’ provisions regarding the taxation of capital gains, this section is intended as a general overview of state law taxation of capital gains.

B. \textbf{States With No or Limited Taxation of Capital Gains}

1. \textbf{Nevada}

   Does not impose income taxes on either individuals or corporations.

2. \textbf{Alaska}

   No individual income tax, but imposes an income tax on corporations.\textsuperscript{16}

\textsuperscript{13} I.R.C. Section 1(h)(1). See Appendix II: Table of Long-Term Capital Gains Tax Rates.

\textsuperscript{14} I.R.C. Section 1250(1)(A); I.R.C. Section 1(h)(1)(D)(i). See also Appendix II: Table of Long-Term Capital Gains Tax Rates.

\textsuperscript{15} See I.R.C. Section 168(b)(3)(A) & (B); Section 168(e)(2), Section 1250(b)(1), Section 1250(c). Taxpayers who have depreciated a capital asset using an accelerated method will have “Additional Depreciation” to the extent that the depreciation taken exceeds that could be taken using the straight-line method. However, since straight-line is the method of depreciation used for real estate placed in service since 1986, in practice there is usually no recapture of Additional Depreciation.

\textsuperscript{16} Alaska Stat. Section 43.20.011(e).
3. **Colorado**

Colorado imposes income tax on the capital gain realized on the sale of real and personal property located in the state. However, qualified Colorado taxpayers may subtract certain net capital gain income earned from Colorado sources to the extent the gains are included in their federal taxable income for state income tax purposes. The exclusion applies to the sale of real or personal property located in Colorado (or an ownership interest in a Colorado company) if such property was acquired prior to May 9, 1994 or, if acquired after such date, held continuously for at least 5 years prior to the date of sale. However, subtraction of pre-May 9, 1994 property is not available for tax years 2002-2010, and for any tax year beginning on or after January 1, 2001 and during which the state’s fiscal year ends with a qualified surplus, the general rule for the subtraction is expanded to include gains on assets held for at least one year. If the capital gain realized on the sale of Colorado property is not excluded, then it may be deferred by an exchange under I.R.C. Section 1031.  

4. **Florida**

No individual income tax, but imposes an income tax on the adjusted Federal taxable income of corporations.  

5. **New Hampshire**

No individual income tax, but imposes a “business profits tax” on the sale of improved real property which may be deferred in a 1031 exchange.  

6. **South Dakota**

No income tax imposed on individuals, corporations or other associations, but does impose income tax on banks and financial institutions based on Federal taxable income.  

7. **Texas**

No individual income tax, but imposes a franchise tax on corporations and limited liability companies based on federal taxable income including any deferral under I.R.C. Section 1031.  

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18 Fla. Stat. Title XIV, Chapter 220, Section 220.02 et seq.  
19 N.H. Rev. Stat. Chapter Rev 300, Section 301.01 et seq. It should be noted that, in 2008, the New Hampshire Department of Revenue Administration ("DRA") began auditing completed like-kind exchanges to determine if the name of the grantor on the deed conveying title to the Relinquished Property matches the name of the grantee on the deed to the Replacement Property. If the names do not match, then the DRA has been denying deferral of the business profits tax. The application of this policy has not made any exceptions for entities that are disregarded for Federal income tax purposes, such as single member limited liability company that was organized to take title to the Replacement Property.  
20 S.D. Codified Laws Section 10-43-5.  
21 Tex. Tax Code Section 171.001, 171.002(b) & 171.110.
8. **Washington**
No individual income tax, but imposes a gross receipts tax on businesses called the "Business and Occupation Tax".\(^{22}\)

9. **Tennessee**
Individual income tax imposed exclusively on dividend and interest income,\(^{23}\) Excise tax on imposed on corporations based on Federal taxable income.\(^{24}\)

10. **Wyoming**
No income taxes imposed on either individuals or corporations.

V. **"Realization" and "Recognition" of Capital Gain**

A. **"Realization" and "Recognition" Defined**
The realized capital gain is the amount that is earned upon the sale of a capital asset. The realized capital gain is subject to Federal income tax if it is also recognized. All recognized capital gains must be included in a taxpayer's gross income; however, in some cases specific provisions permit the non-recognition of capital gains income for Federal and state income tax purposes.

B. **Non-Recognition of Capital Gains Under Internal Revenue Code**
The capital gains from the sale or conveyance of certain capital assets are non-taxable; that is, the capital gains are either not realized, or such income is not recognized. The following is an overview of certain “non-recognition” provisions under the Internal Revenue Code.

1. **I.R.C. Section 1031 "Like-Kind Exchange"**
I.R.C. Section 1031 permits the exchange of "qualifying property" for other "like-kind" qualifying property without the recognition of capital gains on the transaction. In a like-kind exchange, the recognition of the capital gain income is deferred until the property received in the exchange is sold or otherwise transferred in a taxable event.

2. **I.R.C. Section 1033 "Involuntary Conversions"**
I.R.C. Section 1033 permits the non-recognition of capital gains realized from an "involuntary conversion" of a capital asset. An involuntary conversion occurs when the capital asset is destroyed, condemned or disposed of under the threat of condemnation, and the taxpayer receives money or other property in payment, such as an insurance payment or a condemnation award. Basically, to defer the gain from an involuntary conversion, I.R.C. Section 1033 requires that the taxpayer acquire

\(^{22}\) Wash. Rev. Code Section 82.04.010 et seq.
\(^{23}\) Tenn. Code Section 67-2-102.
\(^{24}\) Tenn. Code Section 67-4-2007(a).
property of the same or greater value, and one that is similar or related in service or use to the converted property.\textsuperscript{25}

3. \textbf{I.R.C. Section 121 “Personal Residences”}

Under the Taxpayer Relief Act of 1997,\textsuperscript{26} revised I.R.C. Section 121 provides that the seller of a principal residence can exclude capital gain up to $250,000 for single taxpayer, and $500,000 for married taxpayers filing a joint return, if the property was owned and used as the taxpayer’s principal residence for at least 2 years during the 5-year period ending on the date of the sale or exchange.\textsuperscript{27} Note that, if a taxpayer acquired property in a Section 1031 exchange, the Section 121 exclusion will not apply if the sale or exchange of the property occurs during the 5-year period beginning on the date of the acquisition of the property.\textsuperscript{28} Section 121 effectively replaced the deferral available under former I.R.C. Section 1034.\textsuperscript{29}

\textbf{C. Like-Kind Exchanges Under State Income Tax Laws}

1. \textbf{General Rule}

Most states which impose income taxes on capital gains permit the non-recognition of capital gains income when a like-kind exchange is effected under I.R.C. Section 1031. However, some of those states impose specific requirements to achieve deferral for state income tax purposes, or limit the effect of an exchange under I.R.C. Section 1031.

2. \textbf{Arkansas}

Has not adopted I.R.C. Section 1031, and the state non-recognition provision regarding like-kind exchanges does not have specific time limits.\textsuperscript{30}

3. \textbf{Illinois}

Has special provisions for non-resident taxpayers regarding the inclusion of capital gains and losses from sales or exchanges of real or personal property located in the State of Illinois.\textsuperscript{31}

\textsuperscript{25}I.R.C. Section 1033.
\textsuperscript{26}Taxpayer Relief Act of 1997, Pub.L. 105-34.
\textsuperscript{27}I.R.C. Section 121(a), Section 121(b)(2).
\textsuperscript{28}I.R.C. Section 121(d) (as amended by Section 840 of the American Jobs Creation Act of 2004, Pub. L. 108-357).
\textsuperscript{29}Former I.R.C. Section 1034 (Effective prior to May 7, 1997). Former Section 1034 permitted the non-recognition of some or all of the gain realized upon the sale of a principal residence if, within a period beginning two years prior to the closing date of the sale and ending two years after the date of sale, the taxpayer purchased or built a new principal residence. A complete deferral of the realized capital gain required that the “adjusted sales price” of the principal residence that was sold [(sales price) - (selling expenses + expenses to fix up the old residence for sale)] must be equal or less than the cost of the new residence (including commissions and costs of purchase). With the implementation of Section 121 under the Taxpayer Relief Act, Section 1034 became effective only for sales prior to May 7, 1997.
\textsuperscript{30}Ark. Code Section 26-51-412.
4. **Indiana**
Permits non-recognition only for a simultaneous exchange between two parties.\(^{32}\)

5. **Iowa**
Taxes Iowa taxpayers on the deferred capital gain from the sale of out-of-state real property but grants a credit for any capital gains taxes paid to the state where the real property was located.\(^{33}\)

6. **Oregon**
Imposes state income tax on the gain from the sale of out-of-state real property that was acquired as replacement property in an exchange under I.R.C. Section 1031 in the amount of the lesser of the original deferred gain or the capital gain realized on the sale of the real property.\(^{34}\)

7. **Pennsylvania**
Has a non-recognition provision that expressly applies only to corporations.\(^{35}\) Further, because of the way personal income taxes are calculated, effectively there is limited non-recognition for personal taxpayers for simultaneous exchanges, but not for delayed exchanges.\(^{36}\)

\(^{32}\) Ind. Code Section 62-1-12(g) & 6-2.5-1-6(c).
\(^{33}\) Iowa Code Section 422.7 & 422.8.
\(^{35}\) Penn. Stat. Title 72 Section 7401(3) & Section 7402.
\(^{36}\) Penn. Stat. Title 72 Section 7301(a), 7302 & Section 7303.
Chapter Two: Basic Requirements for a Section 1031 Like-Kind Exchange

I. Introduction
I.R.C. Section 1031(a)(1) provides:

"No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of a like-kind which is to be held either for productive use in a trade or business or for investment."

Dissecting Section 1031(a)(1) reveals the three basic requirements for all like-kind exchange under I.R.C. Section 1031 Exchanges, each of which is discussed more fully in this Chapter:

- Relinquished and Replacement properties that each qualify for an exchange
- Relinquished and Replacement properties that are "like-kind" to each other
- An "exchange" of properties

II. Property that Qualifies for an Exchange Under I.R.C. Section 1031

A. Excluded Property
Certain types of property are expressly excluded by statute or other rule from qualifying as property that may be exchanged under I.R.C. Section 1031. Other properties are excluded by being included in broad categories of statutory excluded properties.

1. Stock, Partnership Interests, Etc.
Stock, bonds, notes or other securities or evidences of indebtedness; interests in a partnership (general or limited); beneficial interests or certificates in a trust; "chooses in action" (e.g., a contract right).\(^{37}\)

2. Stock In Trade/Dealer Property
I.R.C. Section 1031 prohibits the exchange of "stock in trade or other "property held primarily for sale".\(^{38}\) "Stock in trade" is property held primarily for sale in the ordinary course of the taxpayer's business. What constitutes stock in trade is not defined in I.R.C. Section 1031 or Regulations, and is not the same as the definition of non-capital asset under I.R.C. Section 1221(1). Factors which courts have considered in determining what is dealer property under I.R.C. Section 1031 include the following:

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\(^{37}\) I.R.C. Section 1031 (a)(2)(B)-(F).
\(^{38}\) I.R.C. Section 1031 (a)(2)(A).
• The purpose for which the property was acquired
• The duration of ownership
• The extend and nature of attempts to sell the property;
• The number, extent, continuity and substantiality of sales prior to the exchange
• The extent of subdivision, development and improvements
• The extent of advertising, promotion, use of sales office and other solicitation efforts
• The listing of the property with brokers
• The ordinary business of the taxpayer
• The time and effort devoted by the taxpayer to sales compared to other business

3. Property Held Primarily For Sale
The definition of "property held primarily for sale" is broader than "stock in trade", and includes property held primarily for sale even if not within the course of the taxpayer's business. Treatment of the property as a capital asset does not exclude it from being held primarily for sale if facts indicate the taxpayer's intent was resale and not investment. Cases and rulings in this area reveal that a key element was whether the taxpayer segregated the property held for investment from property held for sale or other non-qualifying use.

For example, a bulk sale of subdivided lots may be property held primarily for sale when a developer did not distinguish such property from other property that was developed with homes for sale. Holding property not held primarily for sale in an entity different than one used for property development was found to evidence an investment, rather than resale, intent.

41 Neal T. Baker Enterprises, Inc. v. Comm., TC Memo 1998-302. The taxpayer acquired property in 1978 and, between then and 1989, platted, rezoned and subdivided the property into 62 lots. Fourteen of the lots were developed with homes and 48 of the lots were not developed. In denying exchange treatment for the sale of the 48 lots in 1989, the court noted that the property was held on the taxpayer's books in a "work in progress" account, and concluded that the property was acquired with the purpose of constructing and selling homes.
42 Paullus v. Comm., TC Memo 1996-419. Taxpayer had two entities, one of which was formed for construction of homes on residential lots, and another for the operation and development of golf course and country club on property adjacent to the residential lots. Relinquished property, which was platted with lots, was sold in bulk by the golf course entity. In allowing treatment of the bulk sale as an exchange under I.R.C. Section 1031, the court noted that only 8 real estate sales were made in the preceding 12 years by the taxpayer, the principal business of the taxpayer was development and operation of the golf course and not real estate sales, and that the sale was part of a larger plan by the taxpayer's parent to eliminate its golf courses and real estate.
B. Qualifying Use
Property must be "held for productive use in a trade or business or for investment". 43

1. Determining Qualifying Use
"Productive use in a trade or business" is not defined in I.R.C. Section 1031 or the 1031 Regulations, but has been interpreted to mean an activity that is undertaken with a profit motive and is regular and continuous. 44 "Investment" is also not defined in I.R.C. Section 1031 or the 1031 Regulations, but focuses on whether the intent of the taxpayer at the time of the exchange was primarily for investment or personal purposes. 45 The taxpayer's purpose for holding the property to be disposed of and the property to be acquired is determined when the exchange takes place. 46 Whether property is held for a proper purpose is a question of fact 47 of which the taxpayer has the burden of proof. 48

2. Trade or Business Properties
Properties used in a trade or business usually fall into one of two categories of business use, 49 or a mix of qualifying and non-qualifying uses:

(a) Rental Property
All types of properties used in the business of renting real property, for example:

- Single family residences
- Multi-family housing
- Commercial properties
- Vacant land leased for farming or ranching purposes

(b) Business Property
All types of properties used in a business carried on for profit, for example:

43 I.R.C. Section 1031(a)(1).
45 See Bolker v. Comm., 81 TC 782, 804 (1983), affd. 760 F.2d 1039 (9th Cir. 1985); Montgomery v. Comm., TC Memo 1997-279, affd. in part and revd. in part on another issue without published opinion 300 F.3d 866 (10th Cir. 1999).
49 See I.R.C. Section 1231(b)(1); I.R.S. Publication 544 "Sales and Other Dispositions of Assets" at page 27 (March 12, 2009).
• The property where a professional has offices and conducts his or her profession
• The property where a trades person has a shop and conducts his or her trade
• The property where a business has its offices, plant, warehouse, etc.
• Farm and ranch property
• Real property interests for the extraction or exploitation of natural resources (e.g., mineral, timber and water rights)

(c) Mixed-Use Properties (Including Rental Vacation Homes)
Properties that are used in part for a qualifying purpose and in part for a person non-qualifying purpose, for example:

• That portion of owner-occupied housing which is rented to others\(^{50}\)
• That portion of a farm or ranch used in the business of farming or ranching, which may or may not including the farm or ranch house depending on its use\(^{51}\)
• Farm property with crops that are not harvested at the time of the conveyance\(^{52}\)
• That portion of a personal residence used in a trade or business, such a home office which qualifies as such under I.R.S. guidelines\(^{53}\)
• Vacation property or second homes that are rented but also have with some personal use. (Effective March 10, 2008, Rev. Proc. 2008-16, discussed below, provides safe harbor guidelines for a 1031 exchange of vacation property or a second home.)

(i) Revenue Procedure 2008-16
Rev. Proc. 2008-16 provides a safe harbor for a like-kind

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\(^{50}\) See I.R.C. Section 280A(c)(3) (permitting treatment by a taxpayer of a portion of his/her personal residence as a rental).

\(^{51}\) Rev. Rul. 59-229, 1959-2 CB 180. This Revenue Ruling considers the tax treatment of residences with mortgages thereon exchanged with farm properties. It indicates that, if the residences are occupied by tenants acting, for example, in the capacity of caretakers or farm workers for the taxpayers, then the exchange is treated under I.R.C. Section 1031(a) as “property used in trade or business” in the same manner as the exchange of the farm lands and buildings. However, when the dwellings are used as personal residences by the taxpayers who are parties to the exchange, an exchange thereof is treated as a separate transaction. Any resulting gain is subject to the provisions pertaining to the sale or exchange of a residence.


\(^{53}\) See I.R.C. Section 280A(c)(1)(A) & (B) (permitting treatment by a taxpayer of a portion of his/her personal residence as a “home office”).
exchange of a vacation home or second home.\textsuperscript{54} However, it may also be possible to effect a like-kind exchange of a vacation or second home that does not meet the safe harbor guidelines may still qualify for tax-deferred treatment.\textsuperscript{55} Rev. Proc. 2008-16 provides as follows:

- A vacation home or second home relinquished in a 1031 exchange will be considered to be held for a qualify use if it is owned by the taxpayer for at least 24 months immediately before the exchange and, in each of the two 12-month periods within such 24-month period, (1) the taxpayer rents the dwelling unit at fair rental to another person for 14 days or more, and (2) the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10% of the number of days during the 12 month period that the dwelling unit was rented at fair rental value. (The 12-month period immediately preceding the exchange ends on the day before the exchange takes place and begins 12 months prior to that day. The prior 12-month period ends on the day before the following 12-month period and begins 12 months prior to that day).\textsuperscript{56}

- A vacation home or second home will qualify as like-kind replacement property if it is owned by the taxpayer for at least 24 months immediately following the exchange and, in each of the two 12-month periods within such 24-month period, (1) the taxpayer rents the dwelling unit to another person at fair rental value for 14 days or more, and (2) the taxpayer’s personal use of the dwelling unit does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit was rented at fair rental value. (The first 12-month period begins on the day after the exchange takes place and the second 12-month period begins on the day after the first 12-month period ends.)\textsuperscript{57}

- Rev. Proc. 2008-16 defines personal use applying the principals of I.R.C. Section 280A(d)(2) (taking into account Section 280A(d)(3) but not Section 280A(d)(4)).\textsuperscript{58} I.R.C. Section 280A(d)(2) defines

\textsuperscript{54} Rev. Proc. 2008-16 (March 10, 2008).
\textsuperscript{55} See "Properties Held for Investment", infra.
\textsuperscript{56} Rev. Proc. 2008-16 Section 4.02(1).
\textsuperscript{57} Rev. Proc. 2008-16 Section 4.02(2).
\textsuperscript{58} Rev. Proc. 2008-16 Section 4.03.
personal use as use of a dwelling unit for personal purposes for a day or part of a day by the taxpayer or other person having an interest in the dwelling unit, and any family member of the taxpayer.\footnote{I.R.C. Section 280A(d)(2)(A).} Also, any arrangement whereby fair market rent is not paid will be considered "personal use" by the taxpayer.\footnote{I.R.C. Section 280A(d)(2)(C).} However, rental of the dwelling unit to a family member will not be considered "personal use" by the taxpayer if the dwelling unit is rented at fair market rent and the family member uses it as his primary residence.\footnote{I.R.C. Section 280A(d)(3)(A).} Fair rental value is based upon all of the facts and circumstances that exist when the rental agreement is entered into, taking into account all rights and obligations of the parties under the rental agreement.\footnote{Rev. Proc. 2008-16 Section 4.04.}

- If the taxpayer files a return reporting a transaction as a like-kind exchange based on the expectation that the dwelling unit will meet the qualifying use standards and subsequently determines that the dwelling unit does not meet the qualifying use standards, the taxpayer, if necessary, should file an amended return.\footnote{Rev. Proc. 2008-16 Section 4.05.}
- Rev. Proc. 2008-16 is effective for exchanges of dwelling units occurring on or after March 10, 2008.\footnote{Rev. Proc. 2008-16 Section 5.}

(d) Personal Residences
The gain or loss from an exchange of a property used solely as a personal residence may not be deferred under I.R.C. Section 1031 because the residence is not property held for productive use in a trade or business or for investment.\footnote{Starker v. U.S., 602 F.2d 1341, 1350-51 (9th Cir. 1979); Rev. Rul. 59-229, 1959-2 CB 180; PLR 8915012.}

3. Properties Held for Investment

(a) Raw Land
Property held for investment includes unproductive raw land held for appreciation and which is not intended for personal use.\footnote{Regs. Section 1.1031(b). ("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.")} For example, in one case married taxpayers held two lots, one

\[\text{\footnotesize 59 I.R.C. Section 280A(d)(2)(A).} \]
\[\text{\footnotesize 60 I.R.C. Section 280A(d)(2)(C).} \]
\[\text{\footnotesize 61 I.R.C. Section 280A(d)(3)(A).} \]
\[\text{\footnotesize 62 Rev. Proc. 2008-16 Section 4.04.} \]
\[\text{\footnotesize 63 Rev. Proc. 2008-16 Section 4.05.} \]
\[\text{\footnotesize 64 Rev. Proc. 2008-16 Section 5.} \]
\[\text{\footnotesize 65 Starker v. U.S., 602 F.2d 1341, 1350-51 (9th Cir. 1979); Rev. Rul. 59-229, 1959-2 CB 180; PLR 8915012.} \]
\[\text{\footnotesize 66 Regs. Section 1.1031(b). ("Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.")} \]
purchased as a personal residence, and the other for investment. A developer proposed acquiring the north half of the residence lot, and all of the investment lot, in a simultaneous exchange for two town homes to be built on other property. The taxpayers had advertised the investment lot as for sale since 1979, but the residence lot had never been offered for sale. The I.R.S. determined that an exchange of the investment lot for the town homes would qualify as an exchange of like-kind properties both held for investment. The taxpayers, however, would have to recognize gain on the half of the residence lot, which was never represented as being held for investment.\footnote{PLR 9431025.} In another example, a vacation home and two lots across the street (purchased for the purpose of preserving the vacation home's view of the bay and for providing access to the bay) constituted a single property for residential purposes.\footnote{PLR 9503025.} In a final example, four legal parcels listed as a single tax lot was determined to be a single residential property and not property held for investment.\footnote{PLR 9529035.}

(b) 
**Vacation and Second Homes**

Property held for investment has, in the past, included a vacation home or second home that is not rented but acquired with an investment intent and which is not the primary or secondary residence of the taxpayer. Significant personal use of the property was indicative, but not conclusive proof, of whether or not a vacation or second home property was held primarily for investment. For example, the I.R.S. has ruled that use of a vacation home for personal enjoyment did not automatically disqualify the property for a Section 1031 exchange purposes.\footnote{See PLR 198103117. ("(t)he house and lot you acquire in this trade will be held for the same purposes and the properties exchanged therefore: to provide for personal enjoyment of the community and to make a sound real estate investment.").} But, the Tax Court has found a lack of investment intent where the taxpayer personally used for vacation purposes all of a two-week timeshare received in an exchange.\footnote{Devey v. Comm., TC Memo 1993-645.} Further, the mere hope or expectation that property may be sold at a gain was found to be insufficient to establish an investment intent if the taxpayer uses the property for only for personal purposes.\footnote{Jasionowski v. Comm., 66 TC 312, 323 (1976); Moore v. Commissioner, TC Memo 2007-134.} Finally, the safe harbor provided by Rev. Proc. 2008-16 may undercut a taxpayer who is seeking to qualify a vacation or second home that is not rented as a "property held for investment".
4. Holding Period

Property must be "held for productive use in a trade or business or for investment".73

(a) Factor In Determining Intent

The period of time during which a property is used for a business purpose or held for investment is a factor in determining a qualifying use. Generally, the longer the taxpayer uses or holds a property, the stronger the taxpayer’s argument that a qualifying purpose has been established.

(b) No Prescribed Holding Period

With certain exceptions discussed below, no minimum holding period is set by statute or regulation of how long a property must be held to qualify for a tax-deferred exchange. The I.R.S.’ position is that if the taxpayer’s property was acquired immediately before the exchange, the taxpayer acquired the property primarily to dispose of it, rather than hold it for productive use in trade or business or for investment.74 The I.R.S. has ruled that a two-year holding period is an adequate holding period.75 Courts seem have been more liberal in permitting exchange treatment for property acquired recently before the exchange of such property than for the disposition of property acquired in an exchange shortly after receipt. Examples include the following:

- Exchange allowed when property disposed of immediately upon its acquisition,76 or held for six months77 to as little as five days78 prior to the exchange
- Exchange treatment disallowed when acquired property listed for sale one month after exchange,79 sold under a contract entered into prior to the exchange,80 or sold two weeks81 to eight months after exchange82
- Exchange allowed when property sold one year after exchange83

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73 I.R.C. Section 1031(a)(1).
75 PLR 8429039.
77 124 Front St., Inc. v. Comm., 65 TC 6 (1975).
78 Allegheny County Auto Mart, Inc. v. Comm., TC Memo Op Dkt. 38166 (1953), affd. per curiam 208 F.2d 653 (CA3 1953).
79 Regals Realty Co. v. Comm., 127 F.2d 931 (CCA2 1942).
80 Griffin v. Comm., 49 TC 253 (1967).
(c) **Specific Minimum Holding Periods**

Certain rules impose minimum holding periods to qualify for like-kind exchange treatment, including the following (discussed elsewhere in detail):

- Two years for related party exchanges.\(^{84}\)
- Two years for vacation home exchanges under the safe harbor provided by Rev. Rul. 2008-16.\(^{85}\)

5. **Conversion of Property To or From a Qualifying Use**

(a) **Conversion of Non-Qualifying Relinquished Property**

A taxpayer may have acquired a property with an intent that would not be a qualified use under Section 1031, e.g. a personal residence. However, that intent may change and a qualifying use established by the taxpayer's actions in moving out of the personal residence and either renting it for an adequate period of time or holding it for appreciation that accrues after the conversion.\(^{86}\)

(b) **Conversion of Replacement Property to Non-Qualifying Use**

In the event that a taxpayer desires to convert a property acquired in a 1031 Exchange to a non-qualifying use, such as a rental house to a personal residence, the issue is the taxpayer's intent at the time the property was acquired as Replacement Property. Generally speaking, so long as the taxpayer did not have a definite intent to convert the property to personal use at the time of the exchange, the conversion should not compromise the exchange.\(^{87}\) How long the property was used for a qualifying purpose is perhaps the most important evidence of the taxpayer's intent at the time of its acquisition, and a two-year period of qualifying use has been suggested as adequate.\(^{88}\) An indeterminate intent to convert the use of a qualifying property at some point in time should not disqualify the exchange.\(^{89}\)

(c) **Rev. Proc. 2008-16**

Note that the safe harbor provisions of Rev. Proc. 2008-16 (discussed above under “Mixed Use Properties”) also apply to the conversion of a personal residence to or from a qualifying use under I.R.C. Section 1031.

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\(^{84}\) I.R.C. Section 1031(f)(1)(C).
\(^{85}\) Rev. Proc. 2008-16 Section 4.02(1)(a).
\(^{87}\) See Click v. Comm., 78 TC 225 (1982).
\(^{88}\) See PLR 8429039.
\(^{89}\) See Wagensen v. Comm., 74 TC 653 (1980).
C. Like-Kind Property

Property must be "exchanged solely for property of a like-kind".90

1. Nature of Property

(a) Nature or Character Test

A property is "like-kind" to another property if it is of the same nature or character without reference to its grade or quality.91

(b) Real Property

For exchange purposes, any real property interest is usually "like-kind" to any other real property interest.92 What is a "real property interest is determined according to state law where the interest is located.93

(i) General Examples of Like-Kind Real Property

- Unimproved real property for unimproved real property94
- Improved real property for unimproved real property95
- Urban real estate for rural property96
- A fee interest for a leasehold interest with a remaining term of 30 or more years97 including all unexercised extensions98

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90 I.R.C. Section 1031(a)(1).
91 Regs. Section 1.1031(a)-1(b). See Koch v. Comm., 71 TC 54, 64-65 (1978), wherein the court stated that section 1031(a) refers to property of a like, not an identical, kind. In making a determination of whether properties are like-kind, the Koch court stated that consideration is to be given to the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from their grade or quality. The Koch court further stated that the required comparison of the old and new exchanged properties should be directed to whether the taxpayer, in making the exchange, has used its property to acquire a new kind of asset or has merely exchanged its property for an asset of like nature or character.
92 Comm. v. Crichton, 122 F.2d 181 (5th Cir. 1941). (Exchange of an undivided interest in minerals from certain real property for an interest in an unimproved lot was an exchange of like-kind property.)
93 See Rev. Rul. 55-749, 1955-2 CB 295; Rev. Rul. 77-414, 1977-2 CB 299 (Development right in agricultural land constitutes "interest or right" in real property under local law.;) TAM 200424001 (June 11, 2004) ("... any relinquished property consisting of components of railroad track that are assembled and attached to the land and considered real property for state law purposes are not like-kind under Section 1.1031(a)-1(b) of the regulations to unassembled and unattached components, which are personal property under applicable state law.").
94 Regs. Section 1.1031(a)-1(c)(2); Rev. Rul. 72-515, 1972-2 CB 466; Barker v. Comm., 74 TC 55 (1980).
95 Regs. Section 1.1031(a)-1(b); Burkhard Inv. Co. v. U.S., 102 F.2d 642 (CCA 9 1938); PLR 9431025 (vacant lot held for investment and townhouses to be used as rental properties are like-kind).
96 Regs. Section 1.1031(a)-1(c)(2); Braley v. Comm., 14 BTA 1153 (1929); Rutland v. Comm., TC Memo 1977-8.
97 Regs. Section 1.1031(a)-1(c)(2); Century Electric Company v. Comm., 15 TC 581, 591 (1950), affd. 192 F.2d 155 (8th Cir. 1951), cert. denied, 342 U.S. 954 (1952); Rev. Rul. 78-72, 1978-1 CB 258. A short-term leasehold of real property is not like-kind to a fee interest for purposes of Section 1031.
Tenancy-in-common interest for a fee interest and vice versa 99
An easement for a fee interest 100
Fee interest in real property for development rights 101

(ii) Options to Acquire Real Estate
Conflicting authority exists whether an option to acquire real property is like-kind with an interest in real property. One view is that an option is a contract right to receive real property and therefore a "chose in action" that cannot be exchanged under I.R.C. Section 1031 (a)(2)(F). 102 Another view is that an interest in real estate is no more than a "bundle of rights" which could be like-kind to the contractual right to receive the real estate. 103 The I.R.S. has stated that an exchange of real property for an option to acquire real property should not disqualify the exchange, noting that the Ninth Circuit has permitted the exchange of real property interests with considerably different characteristics. 104

(iii) Water Rights
Generally, water rights are like-kind with a fee interest in real property for exchange purposes where such rights are treated as real property under state law. For example, the I.R.S. has held that where, under applicable state law, water rights are considered to be real property rights, the exchange of perpetual water rights for a fee interest may qualify as like-kind under Section 1031. 105 However, the general rule has been narrowly construed depending on the exact nature of the water rights in question. For example, in a non-binding General Counsel Memorandum, the Office of Chief Counsel concluded that, where such rights are stock in a mutual ditch company, such stock is not a real property interest, even though state law characterized it as real

100 Rev. Rul. 72-549, 1972-2 CB 472.
101 PLR 200805012; See also PLR 200649028.
102 Molbreak v. Comm., 61 TC 382 (1973), affd. 509 F.2d. 616 (7th Cir. 1975). ("Until an option is exercised it remains a mere right to acquire the property and not a legal interest therein.")
103 Starker v. Comm., 602 F2d 1341 (9th Cir. 1979), See also Biggs v. Comm. 632 F.2d 1171 (5th Cir. 1980).
104 FSA 1995-12.
property.\textsuperscript{106} And, the United States District Court in Arizona relied on Rev. Rul. 55-749 to hold that water rights of a limited duration would not constitute like-kind property to a fee interest, rejecting the taxpayer's argument that the 50 year duration of the water rights should be equated with a leasehold interest of 30 years or more which is like-kind to a fee interest under Regs. Section 1.1031(a)-1(c).\textsuperscript{107} Finally, in approving of the exchange of water rights for a fee simple interest in farm land, the I.R.S. noted that the water rights were a perpetual interest in real property under applicable state law and, unlike Wiechens, the water rights were limited in quantity to a specified amount per year rather than limited in quantity to a specific percentage of the overall supply of agricultural water.\textsuperscript{108}

(iv) **Timber Rights**

Real property with timber, and uncut standing timber, are considered to be real property.\textsuperscript{109} However, the right to remove timber for a limited period of time, or the right to remove a certain quantity of timber, is not considered to be like-kind with real property, even if the real property has standing timber.\textsuperscript{110} In one case, the taxpayer argued that the exchange of timber rights for real property was like-kind because, under Georgia law, such timber rights are considered a real estate interest, distinguishing Oregon Lumber Co., on the basis that such rights are not a real property interest under Oregon law. Unfortunately, the court did not decide the like-kind issue of whether the state law definition of real property controls or not.\textsuperscript{111}

(v) **Mineral Rights**

(A) **Introduction**

Certain mineral interests may be exchanged under I.R.C Section 1031 as real property, depending on the nature of the interest. Mineral interests are rights carved out from fee simple ownership usually by the granting of a mineral lease, which is often split into lesser interests. There are two types of mineral rights, depending on the rights conveyed as follows:

\textsuperscript{106} GCM 39536 (March 11, 1986).
\textsuperscript{108} PLR 200404044.
\textsuperscript{109} Rev. Rul. 78-163, 1978-1 CB 257.
\textsuperscript{110} TAM 9525002; Oregon Lumber Co., Inc. v. Comm., 20 TC 192 (1953).
(1) **Executive Rights**

An executive right is the right to enter upon the leasehold estate, explore, develop and produce the minerals.

(2) **Possessory Rights**

A possessory right is the right to some portion or all of the minerals produced.

(B) **Specific Types of Mineral Interests**

There is authority for the exchange of some, but not all, mineral interests under I.R.C. Section 1031. The following is a list of specific types of interests, and their status as real property for the purpose of a like-kind exchange.

(1) **Working Interests**

A “working interest”\(^{112}\) is one that includes the right to develop the mineral resource and the obligation to develop the resource at the expense of the interest owner/operator. It is an “economic interest” which qualifies the owner/operator to expense the intangible drilling and development costs (“IDC”).\(^{113}\) The owner/operator may also recover the cost by depletion.\(^{114}\) A working interest is considered to be an interest in real estate for the purpose of a like-kind exchange.\(^{115}\)

(2) **Royalty Interests**

A “royalty interest” is one that reserves an interest in the future production of the entire property (not limited in time or by the quantity of the resource extracted), and does not obligate the interest owner with an obligation to develop the resource. A royalty interest that has the same term as the mineral lease is an “economic interest” and its cost recovered by depletion. Royalty interests include both an “Underlying Royalty” (a reservation by the owner of the land to a fractional interest in all minerals in place) the creation of which is considered to be a lease and not a sale of the interest\(^{116}\), and an “Overriding Royalty” (a sublease or carve-out by the lessee under the mineral lease of a working

\(^{112}\) A “working interest” is also referred to as a “leasehold interest” or an “operating interest”.  
\(^{113}\) I.R.C. Section 263(c); Regs. Section 1.612-4(a).  
\(^{114}\) I.R.C. Section 611.  
\(^{116}\) Crooks v. Comm., 92 TC 816 (1989). However, note that the sale and purchase of an Underlying Royalty interest is a fee interest in the mineral rights and an interest in real property. Rev. Rul. 73-428, 1973-2 CB 303.
interest) and which is considered to be an interest in real estate.\textsuperscript{117}

(3) **Production Payments**

A “production payment” is created when the purchaser buys from the producer the right to receive future payments based on production (“dollar denominated”), or the right to receive a quantity of the resource for a set period of time (“volumetric”). A production payment is not considered to be an interest in real property.\textsuperscript{118}

(4) **Profits Interest**

A “profits interest” is created when the owner/operator of a working interest grants an interest that entitles the grantee to a share of the profits without the obligation to pay production costs, but contingent on the grantor earning a net profit. Like working interests, a profits interest is considered to be an economic interest that entitles the owner of the interest to depletion and is generally considered to be an interest in real property, unless limited in time or amount.\textsuperscript{119}

(5) **Supply Contracts**

Although not a true mineral interest, a contract that obligates one party to purchase a resource extracted from property owned by the other party, and obligates the other party to produce and sell that resource to the purchasing party, is another form of interest which may be like-kind to an interest in real property under Section 1031(a). The factors which have been found to be determinative of the like-kind issue include whether the interest is considered to be “real property” under applicable state law, whether the right to receive payments under the contract are incident to and inseparable from the party’s ownership of the real property, and whether the contract payment rights are limited in time or volume of the resource that may be removed.\textsuperscript{120}

(vi) **Cooperative Apartment Interests**

In a series of private letter rulings issued in the 1980s, the I.R.S. consistently found that taxpayers who exchanged stock in a cooperative corporation and the associated proprietary lease to occupy a unit in the corporation’s

\textsuperscript{117} Palmer v. Bender, 287 U.S. 551 (1932); Comm. v. Crichton, 122 F.2d 181 (5th Cir. 1941); Rev. Rul. 73-428, 1973-2 CB 303; PLR 8434134.

\textsuperscript{118} I.R.C. Section 636; Fleming v. Comm., 27 TC 818 (1955).


\textsuperscript{120} Peabody Natural Resources Co. v. Comm., 126 TC 14 (2006).
building was like-kind with the same unit as a condominium property. In these rulings, the I.R.S. relied on applicable state law that treated stock in a cooperative as real property, including a New York state law that treats stock in a cooperative as real property for some purposes and personal property for others.

(vii) Conservation Easements
The I.R.S. has ruled that a conservation easement was like-kind with a fee interest in other real property where state law provided that a conservation easement was an interest in real property, freely transferable and perpetual in duration. In ruling that a perpetual conservation easement ("PCE") was like-kind to a fee interest in other real property subject to a PCE, the I.R.S. relied on the status of a PCE as an interest in real estate under applicable state law, and prior rulings which concluded that water rights and easements can both be like-kind to a fee interest in real property where all are real property rights under state law.

(viii) Development Rights
Where the facts indicated that certain development rights that would permit the Taxpayer (or its lessee) to develop the taxpayer’s property with greater floor space than would otherwise have been allowed were, under state statutes and local ordinances, analogous to perpetual rights, the I.R.S. ruled that such rights were like-kind to a fee interest in real property.

2. Tenancy-In-Common Interests
A “tenancy-in-common interest”, as used in this book, refers to those interests available for purchase through various brokers and promoters which are an undivided fractional interest in a trade or business property,
often a retail center or other type of commercial property, that is professionally managed and in which the purchaser has little management or other responsibilities. Regarding like-kind exchanges under Section 1031, outstanding issues include whether a tenancy-in-common interest is like-kind to a real property interest, or whether such interests are interests in a partnership. The I.R.S. has attempted to bring some clarity to the first issue with the issuance of Rev. Proc. 2002-22 that outlines the guidelines for promoters and taxpayers to obtain rulings on the like-kind status of tenancy-in-common interests and will probably become the checklist for the structuring of such investments.  

3. **Foreign property**

Real property located within the United States is defined to mean real property located within the fifty states and the District of Columbia. Real property located outside the United States is not "like-kind" with real property located within the United States. However, property located in the U. S. territory of Guam and the Northern Mariana Islands and in the territory of the U.S. Virgin Islands is considered to be "like-kind" with real property located in the United States.

4. **"Like-Kind" for State Tax Purposes**

Certain states restrict a like-kind exchange for state law purposes depending on the location of the Relinquished Property, the Replacement Property, or both properties.

(a) **Vermont Land Gains Tax**

The Vermont Land Gains Tax imposes a significant tax on all exchanges of real property except when both the relinquished property and the replacement property are located in Vermont.

(b) **Georgia**

Until 2004, Georgia state income tax law required that replacement property acquired in an exchange under I.R.C. Section 1031 to be located in Georgia to qualify for non-recognition for state income

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127 I.R.C. Section 7701(a)(9).
128 I.R.C. Section 1031(h)(1). Presumably, this definition could be interpreted to mean that real property located outside of the United States is like-kind with other similarly-located "foreign" property.
129 Regs. Section 1.935-1T(c)(1)(ii)(E).
130 See PLR 9038030; PLR 200040017. The I.R.S. stated that the definition of the borders of the United States can be expanded to include the U.S. Virgin Islands so long as the taxpayer is a citizen or resident of the United States and has income derived from sources within the U.S. Virgin Islands, is effectively connected to the performance of a trade or business in the U.S. Virgin Island or files a joint tax return with an individual who derives sources of income or is connected to a trade or business within the U.S. Virgin Islands. Both requirements must be fulfilled in order for an exchange between real property located within the United States and real property located within the U.S. Virgin Islands to be valid under Section 1031.
tax purposes. These sections, applicable to individuals and corporations, were repealed in 2005 and made retroactive to include the 2004 tax year.\textsuperscript{132}

(c) Mississippi
State income tax law requires that both the relinquished property and the replacement property in an exchange under I.R.C. Section 1031 to be located in Mississippi to qualify for non-recognition for state income tax purposes.\textsuperscript{133}

D. Exchange of Property
Under I.R.C. Section 1031, "No gain or loss shall be recognized on the exchange of property".

1. Exchange Defined.
The transaction must be an exchange (i.e., a transfer of property for property, as distinguished from a transfer of property for money).\textsuperscript{134}

2. Intent to Exchange
A taxpayer must have the intent to exchange, plus an actual bona fide transfer of properties, for a transaction to qualify as a like-kind exchange under Section 1031.\textsuperscript{135}

3. “Forward” and “Reverse” Exchanges
In a Forward Exchange, the title to the property being relinquished in the exchange is conveyed to the buyer before title to the property being acquired is conveyed to the taxpayer. As described in Chapter Five, in a “Reverse Exchange”, title to the property the taxpayer desires to acquire is bought by a party other than the taxpayer and held on its behalf for a period of time until title to the property being sold can be conveyed by the taxpayer to the buyer.

4. Sale-Leaseback Transactions
A number of taxpayers have attempted to realize a loss on the sale of their real property when the sale was followed by a leaseback of the same property for 30 years or more. The I.R.S. has attempted to re-characterize such transactions as like-kind exchange of the property for a long-term lease and disallowed the loss may not be realized if the sale-leaseback is a single integrated transaction.\textsuperscript{136} The IRS will also examine purported

\textsuperscript{132}Ga. Code Section 48-7-21(b) and 48-7-27(b)(6), repealed by House Bill 488, Section 9 & 14 (2005).
\textsuperscript{133}Miss. Stat. Section 203.
\textsuperscript{134}Regs. Section 1.1031(k)-1(a).
\textsuperscript{135}PLR 200109022; Lincoln v. Commissioner, TC Memo 1998-421.
\textsuperscript{136}See Jordan Marsh Co. v. Comm., 269 F.2d 453 (2nd Cir. 1959). (Sale of real property to an unaffiliated third party for fair market value followed by a lease-back of 30 years and 3 days to the taxpayer at a fair market rent was a “sale” of the property and not an exchange of one interest for another.) Cf. TAM
sale-leasebacks to determine if the transaction is a financing transaction for income tax purposes.  

5. **Options**

Although an option to acquire real property may be like-kind with other interests in real property, the granting of an option to purchase property is not a taxable event to the grantor until the option is exercised, expires or is abandoned. In other words, the granting of an option to sell real property is not the same as a conveyance of title to the property for purposes of a like-kind exchange.

6. **Partition of Property.**

The partition of a contiguous property by tenants-in-common of such property is not a sale, exchange or other "realization event", but merely the severance of joint ownership.

E. **Related Parties**

1. **General Rules**

I.R.C. Section 1031(f) provides that, in an exchange of properties between a taxpayer and a "related party", if either party directly or indirectly disposes of the property such party received in the exchange within two years of the conveyance, then the taxpayer will be denied exchange treatment. The term "related parties" is defined by I.R.C. Sections 267(b) and (707(b), and generally include family members (siblings, spouse, ancestors and lineal descendants), individuals and their controlled corporations and partnerships (more than 50% ownership), corporations and partnerships under common control (more than 50% common ownership), and between and among grantors, fiduciaries, beneficiaries.

200346007. (I.R.S. National Office advised that a sale-leaseback for an initial lease term of less than 30 years, where the renewal option does not belong to the seller/lessee should not be re-characterized as a like-kind exchange even if all the other elements for a like-kind exchange under Section 1031 are met.)

137 TAM 12258603. In a complicated transaction which structured, in essence, a sale by the taxpayer of a corporate headquarters building coupled with a ground lease to the buyer, followed by a lease of the building back to the taxpayer, the IRS considered whether and under what conditions a sale-leaseback will be respected for federal income tax purposes or re-characterized as a financing arrangement. In a very complete discussion of prior case law, the IRS discussed specific criteria to apply a benefits and burdens test to determine if the rights of the purported owner were comparable to a mortgagee or an owner, and also considered the treatment of a bargain leaseback in determining the amount of realized gain on a sale.

138 See "Options to Acquire Real Estate", infra.


PLR 200328034; PLR 200303023.

140 U.S. Section 1031(f)(1)(A), (B) & (C). Under I.R.C. Section 1031(f)(2), certain dispositions will not disqualify the exchange as follows: (a) Any disposition after the earlier of the death of the taxpayer or of the related person; (b) any disposition in a compulsory or involuntary conversion within the meaning of I.R.C. Section 1033, if the exchange occurred before the threat or imminence of the conversion, or (c) any disposition if neither the disposition nor the exchange had as one of its principal purposes the avoidance of federal income tax.
and the trusts they created or control.\textsuperscript{142} The related party rules will not apply to any disposition of property, where the taxpayer establishes that neither the exchange nor the disposition has the principal purpose of avoiding federal income tax.\textsuperscript{143} But, any exchange which is part of a transaction or series of transactions that are structured to avoid the purposes of the related party rules will be denied exchange treatment under I.R.C. Section 1031.\textsuperscript{144}

2. Purpose of I.R.C. Section 1031(f)
The purpose of the related party rules is to prevent “basis-shifting transactions”; that is, transactions involving parties that are considered to be part of the same economic group (such as parents and their children, or entities under common control) that reduce the amount of capital gains recognized by the group by structuring the transaction as a like-kind exchange under Section 1031 rather than selling the capital asset outright.

3. Examples of “Basis-Shifting”

(a) “Direct” Basis-Shifting
Corporation A and Corporation B are under common control. A owns property #1 with a low basis that the group wishes to dispose of, and B owns property #2 with a high basis that the group wishes to keep. A basis-shifting transaction would have A and B swap their properties in a 1031 exchange, with A ending up property #2 to be retained with its low basis from property #1, and B ending up with property #1 with its high basis from property #2. Absent the related party rules, B could then dispose of property #1 and would recognize less capital gains than if A had sold property #1 directly to the buyer.\textsuperscript{145}

(b) “Indirect” Basis-Shifting
Taxpayer owns property #1 that it wishes to dispose of in a like-kind exchange under Section 1031 to avoid recognition of capital gains, and a related party owns property #2 the taxpayer desires to

\textsuperscript{142} I.R.C. Section 1031(f)(3).
\textsuperscript{143} I.R.C. Section 1031(f)(2)(C).
\textsuperscript{144} I.R.C. Section 1031(f)(4).
\textsuperscript{145} See Rev. Rul. 2002-83, 2002-2 CB 927. “[Section 1031(f)] is intended to deny non-recognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property.” There is evidence in the legislative history that the related party rules under I.R.C. 1031(f) were not intended to apply to exchanges intended to consolidate undivided interests in separate properties in whole interests. Senate Committee On Finance Report, (CCH) Special 4, Parts Two, Three, Standard Federal Tax Reports, No. 42 (Extra Edition October 11, 1989). However, in rulings on the consolidation of undivided interests among related parties, the I.R.S. has cautioned taxpayers of the possible application of the related party rules to these transactions, presumably referring to the two-year holding requirement for properties received in an exchange among related parties. See PLR 9439007; PLR 9522006.
acquire in the exchange as Replacement Property. The related party rules prevent the taxpayer from selling property #1 as the Relinquished Property in a like-kind exchange and then acquiring property #2 from the related party with proceeds from the exchange. In essence, the related party rules operate to prevent one member of a group of related parties from “walking away” with proceeds from a like-kind exchange by another member of the group.

4. No Tax Avoidance Purpose Exception
Section 1031(f) will not apply to any disposition where it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax. If a transaction is found by a court to be subject to the related party rules (e.g., a shifting of basis between related parties), then it should also determine whether or not the “non-tax-avoidance” exception of I.R.C. Section 1031(f)(2)(C) applies. It is the taxpayer’s burden to

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146 See Rev. Rul. 2002-83, 2002-2 CB 927. A taxpayer transferred low-basis Relinquished Property to a Qualified Intermediary in exchange for high-basis Replacement Property formerly owned by a related party within the meaning of I.R.C. Section 267(b). The related party received cash for the sale of the Replacement Property. The I.R.S. concluded that a taxpayer who transfers property to a Qualified Intermediary in exchange for property formerly owned by a related party is not entitled to non-recognition treatment under I.R.C. Section 1031 if, as part of the transaction, the related party received cash or other non like-kind property. See also TAM 10251997. The taxpayer owned an one-third interest in unimproved real estate, and the taxpayer's mother a two-thirds interest. The taxpayer entered into an agreement to sell his interest to an unrelated third party, and assigned his obligations under the agreement to the Qualified Intermediary. Then, the taxpayer assigned his obligation to acquire a residence owned by the mother to the Qualified Intermediary. The Qualified Intermediary sold the taxpayer's interest in the unimproved property to the buyer, and then paid the proceeds from such sale to the mother to acquire her property. The taxpayer also paid an additional amount to his mother. The mother then transferred the residence through the Qualified Intermediary to the taxpayer. Supposedly separate from the exchange, but at the same time, the unrelated third party purchased the mother's interest in the unimproved property. In disallowing the exchange, the I.R.S. reasoned that the economic result of this series of transactions was the same as if the taxpayer had exchanged ("swapped") his interest in the unimproved property for the residence owned by his mother, followed by a sale of the unimproved land by the mother. Applying the "related party" rule of Section 1031(f), the I.R.S. disallowed exchange treatment because the mother failed to hold the property she received in the exchange for at least two years. Further, the I.R.S. noted that the mere imposition of a Qualified Intermediary would not avoid the consequences of a series of transactions that would otherwise run afoul of the related party rules.

147 See also TAM 200126007; Teruya Bros., Ltd. & Subs. v. Comm., 124 TC 45, 52 (2005), affd. 9th Cir. No. 05-73779 (Sept. 8, 2009).


149 In Teruya, the taxpayer structured several exchanges of properties where all of the replacement properties were acquired through a Qualified Intermediary from a related party. In total, the taxpayer and related party recognized gain of approximately $2,227,000 from the disposition of investments with realized gain of approximately $13,400,000, and paid no tax on the recognized gain because of the related party's large net operating loss. The Ninth Circuit Court of Appeals found that the Tax Court was correct in determining that the transactions were structured to avoid the purposes of I.R.C. Section 1031(f)(4), and also concluded that the record supported the Tax Court’s determination applying I.R.C. Section 1031(f)(2) that the improper avoidance of federal income tax was one of the principal purposes.
establish the lack of a principal purpose to avoid income tax. In determining the taxpayer’s principal purpose for the exchange or disposition, a court will consider any factors presented by the taxpayer that may overcome the “negative inference” from the finding that a basis-shifting had occurred.

5. Structuring Exchanges Involving Related Parties
The related party rules do not prohibit like-kind exchanges under Section 1031 which involve properties owned by related parties, or even transactions that result in basis-shifting between related parties, but do require that such transactions comply with its specific rules. For example, a basis-shifting transaction can be structured so long as the disposition of any property received in an exchange from a related party occurs after the two-year holding period has passed. In situations where the exchange is not between related parties, but involve the sale of the Relinquished Property to a related party, the I.R.S. has ruled that the non-exchanging related party need not hold the Relinquished Property for the two-year period to comply with the related party rules. However, whenever structuring an exchange involving related parties, it is important to keep in mind that, if the facts support a finding that the taxpayer structured the transaction to avoid the application of Section 1031(f), then the exchange will be disallowed under I.R.C. Section 1031(f)(4).

behind the like-kind exchanges. The addition fact that the use of the related party’s net operating loss to reduce the net income tax paid by the combined taxpayer/related party economic unit to zero appears to have influenced the appellate decision.

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152 See FSA 2001-37003. A partnership and a corporation, both owned by a father and son, engaged in an exchange that was within the I.R.C. Section 1031(f) related party rules. More than two years after the exchange, the partnership disposed of the property received in the exchange. In deciding that the related party rules did not cause recognition of the gain upon the subsequent sale, the I.R.S. stated that the two-year rule set forth in Section 1031(f)(1)(C) was intended as a “safe harbor” that precludes application of Section 1031(f)(1) to any transaction falling outside of that period. The I.R.S. further stated, “... if a taxpayer exchanges property with a related party, intending to dispose of the replacement property after the two-year period, Section 1031(f)(4) would not require recognition of the original gain. This analysis would not apply, however, if the exchange were a sham.” See also PLR 200440002; PLR 200616005; PLR 200329021.
153 PLR 200706001; PLR 200712013; PLR 200728008.
Chapter Three: Procedure for a Forward Section 1031 Like-Kind Exchange

I. The "1031 Regulations"

In April 1991 the I.R.S. issued Final Regulations applicable to forward delayed and simultaneous like-kind exchanges under I.R.C. Section 1031. The "1031 Regulations" specify several "safe harbor" structures that will be respected by the I.R.S. for like-kind exchanges undertaken by taxpayers under Section 1031.

A. "Terms of Art" Under the 1031 Regulations

- "Exchangor" is not defined in the 1031 Regulations, but is a commonly used term to refer to the taxpayer who will report the transaction as a like-kind exchange under I.R.C. 1031.
- "Relinquished Property" is the property transferred by the Exchangor in a like-kind exchange.
- "Replacement Property" is the property received by the Exchangor in a like-kind exchange.
- "Simultaneous Exchange" is not a defined term in either I.R.C. Section 1031 or the 1031 Regulations, and opinions vary on the meaning of "simultaneous" in the exchange context. The most widely held view is that in a Simultaneous Exchange requires the conveyance of the Relinquished Property at the same time and place as the conveyance of the Replacement Property.
- "Deferred Exchange" is defined by the 1031 Regulations as an exchange in which the taxpayer receives the Replacement Property after the transfer of the taxpayer's Relinquished Property.
- "Safe Harbors" are specific procedures for like-kind exchanges provided by the 1031 Regulations which, if followed by the Exchangor, provide protection for the transaction that it qualifies as a like-kind exchange under I.R.C. Section 1031.
- "Disqualified Person" is a person who, by the performance of services for the Exchangor or by virtue of a business, legal or familial relationship to

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155 Regs. Section 1.1031(a)-(k) ("1031 Regulations").
156 Regs. Section 1.1031(k)-1(a).
157 Regs. Section 1.1031(k)-1(a).
158 A more expansive view is that a like-kind exchange is "simultaneous" so long as the conveyances of the Relinquished Property and the Replacement Property take place on the same day even if at different times and in different locations. An even more generous view is that a like-kind exchange is "simultaneous" so long as the Replacement Property is conveyed as soon possible after the conveyance of the Relinquished Property (e.g., as soon as funds transferred by wire transfer are available to close), even if the second conveyance occurs a day or two later and in a different location. Whether an exchange is "simultaneous" or "deferred" is relevant if a like-kind exchange is, intentionally or unintentionally, not structured to comply with the safe harbor rules provided by the 1031 Regulations, e.g., if a Qualified Intermediary is not used to facilitate the exchange.
159 Regs. Section 1.1031(k)-1(a). To avoid confusion with a so-called "tax-deferred exchange", in this book a "Deferred Exchange" is referred to as a "Delayed Exchange".
160 See "Safe Harbors Provided by the 1031 Regulations", infra.
the Exchangor, is prohibited from acting as a Qualified Intermediary for the Exchangor in a like-kind exchange under the 1031 Regulations.161

- “Identification Period” is the period that begins on the date the Exchangor transfers the Relinquished Property and ends at midnight on the 45th day thereafter.162

- “Exchange Period” is the period of time that begins on the date the Exchangor transfers the Relinquished Property and ends at midnight on the earlier of the 180th day thereafter or the due date (including extensions) for the Exchangor’s income tax return for the taxable year in which the transfer of the Relinquished Property occurs.163

- “Exchange Proceeds” is not defined in the 1031 Regulations, but is a commonly used term to refer to the cash proceeds from a transfer of Relinquished Property.164

B. Safe Harbors Provided by the 1031 Regulations

1. "Safe Harbor"

The general definition of a “safe harbor” in a legal context is something such as a statutory or regulatory provision that provides protection, such as from a penalty or liability.165 The term “safe harbor” is not defined in the 1031 Regulations, but is used to refer to any one of four designated procedures for structuring a delayed exchange, the use of which will result in a determination that the taxpayer is not in "Actual Receipt" or "Constructive Receipt" of Exchange Proceeds or other property for purposes of I.R.C. Section 1031 and the 1031 Regulations.166

2. "Qualified Intermediary" Safe Harbor

(a) Safe Harbor Provisions

In the case of a transfer by the Exchangor of Relinquished Property involving a Qualified Intermediary, the Qualified Intermediary is not

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164 Regs. Section 1.468B-6(b)(2) defines "exchange funds" as "... relinquished property, cash, or cash equivalent that secures an obligation of a transferee to transfer replacement property, or proceeds from a transfer of relinquished property, held in a qualified escrow account, qualified trust, or other escrow account, trust, or fund in a deferred exchange." In the notice of adoption of the final regulations under I.R.C. Section 468-B, the I.R.S. stated a broader definition of exchange funds is necessary under that section because it encompasses transactions contemplated in Regs. Section 1.1031(k)-1(g)(3) in which, for example, a transferee of the relinquished property pays a deposit before the property is transferred, or a transferee of the relinquished property agrees to transfer replacement property and deposits funds to secure the obligations of the transferee (See Regs. Section 1.468B-6(e) Example 1). TD 9413 (July 2, 2008). For simplicity, in this book only the cash proceeds from the sale of Relinquished Property are referred to as "Exchange Proceeds".
166 Regs. Section 1.1031(k)-1(g)(1). For the definitions of "Actual Receipt" and "Constructive Receipt" see "Actual" and "Constructive Receipt", infra.
considered the agent of the taxpayer for purposes of I.R.C. Section 1031(a). In such a case, the Exchangor's transfer of Relinquished Property and subsequent receipt of like-kind Replacement Property is treated as an exchange, and the determination of whether the Exchangor is in Actual or Constructive Receipt of the Exchange Proceeds or other property before the Exchangor actually receives like-kind Replacement Property is made as if the Qualified Intermediary is not the agent of the Exchangor. Of the several safe harbors provided in the 1031 Regulations, the Qualified Intermediary safe harbor is the one most commonly used to structure like-kind exchanges within the 1031 Regulations.

(b) “Qualified Intermediary” Defined
A Qualified Intermediary is a person who is not the Exchangor or a "Disqualified Person" and who, pursuant to a written agreement ("Exchange Agreement"), acquires the Relinquished Property from the Exchangor, sells the Relinquished Property, acquires the Replacement Property and transfers the Replacement Property to the Exchangor.

(c) Provisions Regarding a Qualified Intermediary Arrangement

(i) Conveyance of Properties and “Direct Deeding”
Regardless of whether a Qualified Intermediary acquires and transfers property under general tax principals, (A) a Qualified Intermediary is treated as acquiring and transferring property if the Qualified Intermediary acquires and transfers legal title to that property, and (B) a Qualified Intermediary is treated as acquiring and transferring the Relinquished Property if the Qualified Intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the Exchangor for the transfer of the Relinquished Property to that person and, pursuant to that agreement, the Relinquished Property is transferred to that person, and (C) a Qualified Intermediary is treated as acquiring and transferring Replacement Property if the Qualified Intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the Replacement Property for the transfer of that property and, pursuant to that agreement, the Replacement Property is transferred to the Exchangor.

167 Regs. Section 1.1031(k)-1(g)(4)(i).
168 Regs. Section 1.1031(k)-1(g)(4)(iii)(A) and (B).
169 Regs. Section 1.1031(k)-1(g)(4)(iv)(A)-(C).
(ii) **Assignment of Contracts**
A Qualified Intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the Qualified Intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of the property. For example, if a taxpayer enters into an agreement for the transfer of Relinquished Property and thereafter assigns its rights in that agreement to an Qualified Intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the Relinquished Property, then the Qualified Intermediary is treated as having entered into that agreement. If the Relinquished property is transferred pursuant to that agreement, the Qualified Intermediary is treated as having acquired and transferred the Relinquished property.\(^{170}\) The I.R.S. has ruled that this "naked assignment" of rights, but not obligations, under the agreement is sufficient to satisfy the requirements of the 1031 Regulations permitting the Exchangor to "direct deed" the property to the buyer without having the Qualified Intermediary acquire legal title.\(^{171}\)

(iii) **Termination of Safe Harbor Upon Constructive Receipt**
The Qualified Intermediary Safe Harbor ceases to apply at the time the Exchangor has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the Exchange Proceeds or other property held by the Qualified Intermediary. Rights conferred upon the Exchangor under state law to terminate or dismiss the Qualified Intermediary are disregarded for this purpose.\(^{172}\)

(iv) **Receipt of Boot Does Not Violate Safe Harbor**
An Exchangor may receive money or other property directly from a party to the transaction other than the Qualified Intermediary ("Boot") without affecting the Qualified Intermediary Safe Harbor.\(^{173}\)

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\(^{170}\) Regs. Section 1.1031(k)-1(g)(4)(v).

\(^{171}\) Rev. Rul. 90-34, 1990-1 CB 154; PLR 9448010.

\(^{172}\) Regs. Section 1.1031(k)-1(g)(4)(vi).

\(^{173}\) Regs. Section 1.1031(k)-1(g)(4)(vii). See "Boot", infra.
3. "Qualified Escrow Account" and "Qualified Trust" Safe Harbors

(a) Safe Harbor Provisions
In the case of a Delayed Exchange, the determination of whether the taxpayer is in Actual Receipt or Constructive Receipt of the Exchange Proceeds or other property will be made without regard to the fact that the obligation of the Exchangor's transferee to convey the Replacement Property to the Exchangor is or may be secured by cash or cash equivalent if the cash or cash equivalent is held in a "Qualified Escrow Account" or in a "Qualified Trust". 174

(b) Requirements for a Qualified Escrow Account
A Qualified Escrow Account is an escrow account where the escrow holder is not the Exchangor or a Disqualified Person and the escrow agreement expressly limits the Exchangor's rights to receive, pledge, borrow, or otherwise obtain the benefits of the Exchange Proceeds (or a cash equivalent of the Exchange Proceeds) held in the escrow account. 175 However, a Qualified Escrow Account may provide that no funds may be paid out of the account without prior written approval of both the Exchangor and the other party to the escrow agreement being given to the Escrow Holder. 176

(c) Requirements for a Qualified Trust
A Qualified Trust is a trust where the trustee is not the Exchangor or a Disqualified Person (except that for this purpose the relationship between the Exchangor and the trustee created by the Qualified Trust will not be considered a relationship under I.R.C. Section 267(b)), and the trust agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the Exchange Proceeds or cash equivalent held by the trustee. 177

4. Safe Harbors Apply to Simultaneous and Delayed Exchanges.
All Safe Harbors provided for under the 1031 Regulations will shelter both simultaneous and delayed exchanges from I.R.S. scrutiny. 178

174 Regs. Section 1.1031(k)-1(g)(3)(i).
176 Regs. Section 1.1031(k)-1(g)(8) Example 2.
178 Regs. Section 1.1031(b)-(2)(a).
C. “Actual” and "Constructive Receipt"

1. “Actual Receipt”
   An Exchangor is deemed to be in “Actual Receipt” of the Exchange Proceeds or other property received from the transfer of the Relinquished Property at the time the taxpayer actually receives the money or other property or receives the economic benefit of the money or other property. In addition, the actual receipt of money or other property by an agent of the Exchangor (determined without regard toRegs. Section 1.1031(k)) is deemed to be Actual Receipt by the Exchangor.179

2. "Constructive Receipt"
   An Exchangor is deemed to be in “Constructive Receipt” of the money or other property received from the transfer of the Relinquished Property when the Exchangor has the unrestricted right to receive, pledge, borrow or otherwise obtain the benefits of such money or property. In addition, the constructive receipt of money or other property by an agent of the Exchangor (determined without regard toRegs. Section 1.1031(k)) is deemed to be Constructive Receipt by the Exchangor.180

3. Restrictions Incorporated Into Safe Harbors
   For any of the Safe Harbors to apply, the Exchangor cannot have Actual Receipt or Constructive Receipt of the Exchange Proceeds before the taxpayer actually receives like-kind Replacement Property.181 Like-kind exchanges under Section 1031 have been disallowed when the Exchangor had effective control over the Exchange Proceeds, regardless of the provisions of the Exchange Agreement.182

   (a) Required Restriction
   Any written agreement intended to satisfy the requirements for a Qualified Exchange Escrow, Qualified Trust or Qualified Intermediary Safe Harbor must expressly limit the Exchangor’s rights by providing that the Exchangor has no rights to receive,

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179 Regs. Section 1.1031(k)-1(f)(2).
180 Regs. Section 1.1031(k)-1(f)(2). Regarding what constitutes the right to obtain the benefits of the money or other property, Regs. Section 1-1031(k)(f)(2) states, “The taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer’s account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given. Although the taxpayer is not in constructive receipt of money or property if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions, the taxpayer is in constructive receipt of the money or property at the time the limitations or restrictions lapse, expire, or are waived.”
182 See Florida Industries Investment Corp. v. Comm., 252 F.3d 440 (11th Cir. 2001).
pledge, borrow, or otherwise obtain the benefits of the Exchange Proceeds or other property before the end of the Exchange Period.\textsuperscript{183}

(b) Optional Provisions

(i) No Identification of Replacement Property
The agreement may provide that if the Exchangor has not identified Replacement Property by the end of the Identification Period, then the Exchangor may have the right to receive, pledge, borrow, or otherwise obtain the benefits of the Exchange Proceeds or other property at any time after the end of the Identification Period.\textsuperscript{184}

(ii) Receipt of All Identified Property
The agreement may provide that if the Exchangor has identified Replacement Property, then the Exchangor may have rights to receive, pledge, borrow, or otherwise obtain the benefits of the Exchange proceeds or other property upon or after the receipt by the Exchangor of all of the Replacement Property to which the Exchangor is entitled under the agreement.\textsuperscript{185}

(iii) Occurrence of a Contingency
The agreement may provide that if the Exchangor has identified Replacement Property, then the Exchangor may have rights to receive, pledge, borrow, or otherwise obtain the benefits of the Exchange proceeds or other property upon or after the occurrence after the end of the identification period of a material and substantial contingency that (1) Relates to the deferred exchange, (2) is provided for in writing, and (3) Is beyond the control of the Exchangor and of any Disqualified Person other than the person obligated to transfer the Replacement Property to the Exchangor.\textsuperscript{186}

\textsuperscript{183}Regs. Section 1.1031(k)-1(g)(6)(i), TAM 200130001. See also Michael Hillyer v. Comm., TC Memo 1996-214. In a complicated case that occurred after the 1031 Regulations became effective, the Relinquished Property was sold and the net proceeds being deposited with a bank under an escrow agreement that did not set forth any restrictions other than the 180-day time limit to complete the exchange. In finding that no exchange occurred under Section 1031 and a taxable sale of the Relinquished Property occurred, the Tax Court found the escrow agreement deficient in failing to contain the appropriate restrictions on "constructive receipt" of the exchange proceeds by the taxpayer set forth in Regs. Section 1.1031(k)-1(g)(6).

\textsuperscript{184}Regs. Section 1.1031(k)-1(g)(6)(ii).

\textsuperscript{185}Regs. Section 1.1031(k)-1(g)(6)(iii)(A).

\textsuperscript{186}Regs. Section 1.1031(k)-1(g)(6)(iii)(B).
(c) Items Disregarded in Applying Safe Harbors

In determining whether an Exchangor has Actual Receipt or Constructive Receipt of the Exchange Proceeds, the receipt of or right to receive any of the following items will be disregarded:

(i) **Prorated Rents, Etc.**

Items that a seller may receive as a consequence of the disposition of property and that are not included in the amount realized from the disposition of property (e.g., prorated rents).  

(ii) **Transactional Expenses**

The payment on behalf of the seller from the sale proceeds of items that relate to the disposition of the Relinquished Property or to the acquisition of the Replacement Property and appear under local standards in the typical closing statements as the responsibility of a buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees).

5. Security of Exchange Proceeds

(a) **Unauthorized Distribution of Exchange Proceeds**

A tension exists between the 1031 Regulations and providing for the security of the funds held by a Qualified Intermediary. It is reasonable that an Exchangor would want some control over the distribution of the Exchange Proceeds generated by the sale of the Exchangor’s Relinquished Property to prevent the unauthorized distribution of such funds. However, the 1031 Regulations are clear that the Exchangor cannot have any direct control over the Exchange Proceeds while they are being held in a Safe Harbor to avoid being deemed to be in Constructive Receipt of such proceeds. The 1031 Regulations do provide for three forms of permissible security devices as follows:

- Letters of credit
- Deeds of trust
- Third party guarantees

With the exception of a third party guarantee (such as a parent bank or title company guaranteeing the obligations of a qualified intermediary subsidiary to pay over Exchange Proceeds held on

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187 Regs. Section 1.1031(k)-1(g)(7)(i).
188 Regs. Section 1.1031(k)-1(g)(7)(ii).
189 Regs. Section 1.1031(k)-1(g)(2)(ii).
behalf of its clients) in practice, these security devices are often too cumbersome or expensive to be practical for use in everyday business practice. A more useful structure to provide some measure of control to an Exchangor over the distribution of the Exchange Proceeds is to use more than one Safe Harbor. For example, an exchange could use both the “Qualified Intermediary” Safe Harbor and also "Qualified Exchange Escrow" Safe Harbor (between the Qualified Intermediary with a bank or other depository as the Escrow Holder), under which the Exchangor would have to approve any distribution of Exchange Proceeds from the escrow account. The "layering" of safe harbors is specifically permitted by the 1031 Regulations if the requirements for each safe harbor are separately satisfied.

(b) Investment of Exchange Proceeds

It is common practice for professional exchange accommodators to invest the Exchange Proceeds to generate income that would be paid to either the Exchangor or the accommodator, or allocated between them, as provided in the Exchange Agreement. It is the practice of many accommodators to limit the types of accounts and investments in which Exchange Proceeds are deposited to those that are liquid and have the lowest risk of default. Accommodators have considered such “safe” investments to include not only deposit accounts with banks but also money market funds offered by large securities firms which limit their investments to treasury bills, notes and other securities backed by the full faith and credit of the federal government. However, as returns on such accounts and investments have decreased, some accommodators have broadened the range of investments they considered appropriate for Exchange Proceeds, sometimes with unfortunate results for their clients. Therefore, in selecting an exchange accommodator, it is important for Exchangers to understand where the Exchange Proceeds may be invested to protect themselves from the possible loss of their funds due to risky

190 There is a lack of guidance from the I.R.S. or other authority whether a "dual signature" bank account (where the terms of the account require the signatures of both the Exchangor and the Qualified Intermediary for any distributions) would give an Exchangor too much control over the funds and constitute a Constructive Receipt of the Exchange Proceeds. However, given the option of using a Qualified Exchange Escrow, it seems an unnecessary risk to use a dual-signature account.

191 Regs. Section 1.1031(k)-1(g)(1).

192 The FEA Code of Ethics provides, “[An Exchange Accommodator shall] the duty to . . . keep the exchange proceeds in a stable financial institution or other reliable investment program unless the client expressly requests an alternative investment. . .” Federation of Exchange Accommodators, Code of Ethics, Article VI.

193 For example, in the Fall of 2008 an accommodator that was a subsidiary of a national title company found itself with insufficient liquidity when the market for its investments in auction rate securities collapsed. See "LandAmerica’s Collapse Leaves Investors Looking for Cash", The Wall Street Journal (December 3, 2008).
investment practices.

6. **Interest on Exchange Proceeds**

The 1031 Regulations provide that the Exchangor may receive interest (or a "growth factor") on funds held by a Qualified Intermediary, so long as all accrued interest is handled in the same manner as the Exchange Proceeds to prevent Actual or Constructive Receipt of the interest by the Exchangor.\(^{194}\) The Exchangor is entitled to receive interest with respect to a Delayed Exchange if the amount interest depends upon the length of time elapsed between transfer of the Relinquished Property and receipt of the Replacement Property.\(^{195}\) Interest received by an Exchangor as part of a deferred exchange will be treated as interest regardless of whether it is paid to the taxpayer in cash or in property (including property of a like-kind). The Exchangor must include the interest in income according to the Exchangor's method of accounting.\(^{196}\) In addition, for exchanges where the Qualified Intermediary is holding $2,000,000 or more in Exchange Proceeds, if the Exchange Proceeds are held in a separately identified account using the Exchangor's taxpayer identification number and all of the interest earned on such funds is not paid to the Exchangor, then the arrangement be treated as a loan from the Exchangor to the Qualified Intermediary, and interest will be imputed to the Exchangor at the lower of the short term, semi-annual Applicable Federal Rate or the investment rate on a 13 week (generally 91 day) Treasury Bill rate.\(^{197}\)

D. **Disqualified Persons**

Under the 1031 Regulations, a Disqualified Person is defined as a person who has any of the following relationships to the Exchangor:

1. **Agent of the Exchangor**

Any person who has acted as the Exchangor's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two-year period ending on the date of the transfer of the first Relinquished Property. For purposes of determining if a person is an agent of the taxpayer, the performance of the following services will not be taken into account:

- Services for the Exchangor with respect to like-kind exchanges
- Routine financial, title insurance, escrow, or trust services for the Exchangor by a financial institution, title insurance company, or escrow company\(^{198}\)

\(^{194}\) Regs. Section 1.1031(k)-1(h), Section 1.1031(k)-1(g)(5).

\(^{195}\) Regs. Section 1.1031(k)-1(h)(1).

\(^{196}\) Regs. Section 1.1031(k)-1(h)(2).

\(^{197}\) Regs. Section 1.468B-6(c)(1).

\(^{198}\) Regs. Section 1.1031(k)-2.
2. **Personal Relationships and Controlled Entities**

The person and the Exchangor have a relationship described in I.R.C. Section 267(b) or I.R.C. Section 707(b) (determined by substituting in each section "10 percent" for "50 percent" each place it appears in the original statutes) as follows:

- Members of a family, defined as individual’s brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants;
- An individual and a corporation more than 10 percent in value of the outstanding stock of which is owned, directly or indirectly, by the individual;
- Two corporations which are members of the same "controlled group" as defined in I.R.C. Section 267(f);
- A grantor and a fiduciary of any trust;
- A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
- A fiduciary of a trust and a beneficiary of such trust;
- A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
- A fiduciary of a trust and a corporation more than 10 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
- A person and an organization to which I.R.C. Section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;
- A corporation and a partnership if the same persons own more than 10 percent in value of the outstanding stock of the corporation, and more than 10 percent of the capital interest, or the profits interest, in the partnership;
- An S corporation and another S corporation if the same persons own more than 10 percent in value of the outstanding stock of each corporation;
- An S corporation and a C corporation, if the same persons own more than 10 percent in value of the outstanding stock of each corporation;
- Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate;
- A partnership and a person owning, directly or indirectly, more than 10 percent of the capital interest, or the profits interest, in such partnership, or
Two partnerships in which the same persons own, directly or indirectly, more than 10 percent of the capital interests or profits interests\textsuperscript{199}

3. **Entities Controlled by an Agent of the Exchangor**

The person and a person who is determined to be an agent of the Exchangor as described above have a relationship described in either I.R.C. Section 267(b) or I.R.C. Section 707(b) (determined by substituting in each section "10 percent" for "50 percent" each place it appears) as described above, except for banks, or wholly-owned affiliates of banks whose primary business is providing services to facilitate exchanges under I.R.C. Section 1031, who have provided investment banking or brokerage services to the Exchangor in the preceding two-year period.\textsuperscript{200}

E. **Procedure for a Delayed Exchange Using a Qualified Intermediary**

1. **Analysis of an Exchange**

The analysis of the potential tax benefits for an owner who is considering disposing of qualifying property should be made by a tax advisor (such as a tax attorney, accountant or other qualified tax professional) who is knowledgeable and up-to-date in the federal statutory, regulatory, administrative and case law which governing like-kind exchanges, and any differences in applicable state tax laws. In counseling a client, it may be malpractice for a tax professional to fail to advise the client of the potential benefits of a like-kind exchange under Section 1031.\textsuperscript{201} However, usually reaching a decision whether it is more advantageous to exchange rather than sell a qualifying property requires an additional analysis of factors other than just the tax benefits, such as a financial analysis of the specific properties involved, transaction costs, property taxes, portfolio management and estate planning. These additional considerations will usually require the involvement of other professionals (such as financial advisors and real estate professionals) who may or may not be familiar with like-kind exchanges. How to structure the exchange will usually involve a legal or accounting professional experienced with like-kind exchanges, and an established and reputable Qualified Intermediary. Although nearly all Qualified Intermediaries will discuss specific situations with potential clients and render assistance in the structuring of their like-kind exchange, most Qualified Intermediaries will not act as an

\textsuperscript{199} **Regs. Section 1.1031(k)-1(k)(3)**. See also **PLR 200338001**, wherein the I.R.S. made it clear that it was ownership, not control, of the Qualified Intermediary that was determinative of whether or not it was a disqualified person.

\textsuperscript{200} **Regs. Section 1.1031(k)-1(k)(4)**.

\textsuperscript{201} See **Jose Montes v. Kim Asher, CPA**, 182 F.Supp. 2d 637 (N. D. Ohio 2002). Taxpayer who sold a restaurant and recognized the capital gain was awarded judgment against his CPA firm for failing to advise him of potential benefits of like-kind exchange under Section 1031. See also **Jobe v. International Ins. Co.**, 933 F.Supp. 844 (D. Ariz. 1995).
Exchangor’s tax, legal or accounting advisor to avoid the potential of being deemed a Disqualified Person.

2. Listing and Contracting for Sale of Relinquished Property

Most real estate transactions will involve property listed with a real estate broker and all transactions will involve a sale and purchase agreement. A potential Exchangor, the listing broker and any other advisors need to be aware of several issues if a like-kind exchange of real property is being planned or considered.

(a) Listing Agreement and M.L.S

A broker listing a property which the owner may desire to exchange under I.R.C. Section 1031 need not specify the exchange intent in the Listing Agreement or any M.L.S. listing. In fact, in certain situations, disclosure of the owner’s desire to structure a like-kind exchange may be disadvantageous in negotiations if, for example, the Exchangor’s intended Replacement Property is already under contract with a set closing date that creates a deadline by which the Relinquish Property must also close.

(b) Contract for Sale of Relinquished Property

(i) Non-Assignability.

Many standard form contracts for the sale and purchase of real estate include a prohibition on assignment by either party without the written consent of the other party. Assuming the like-kind exchange is being structured using the Qualified Intermediary Safe Harbor, because the 1031 Regulations require that the Exchangor assign its rights in the sale and purchase agreement to the Qualified Intermediary, any prohibition on assignment must be deleted or made ineffective by inclusion of language specifically permitting assignment.

(ii) Cooperation.

Although a minimum amount of cooperation is required of the other party in a sale and purchase of a property involved in an exchange using the Qualified Intermediary Safe Harbor, inclusion of language specifically requiring the other party's cooperation will mitigate the possibility of potential problems arising at the closing. Provisions requiring the other party's “participation” should be avoided because such language could be interpreted as requiring the other party to acquire title to the Replacement Property and convey it to
the Exchangor in exchange for title to the Relinquished Property.\textsuperscript{202}

(c) Selecting and Retaining a Qualified Intermediary

The 1031 Regulations require that the Exchangor retain a Qualified Intermediary by a written Exchange Agreement executed before the closing of the sale or escrow of the Relinquished Property.\textsuperscript{203} Exchangors and their advisors can choose among a large number of persons willing to act as a Qualified Intermediary in a like-kind exchange, including attorneys, accountants, real estate brokers, title companies and independent companies which specialize in accommodating exchanges. It is important to note that Exchange Accommodators are not licensed or regulated by the I.R.S. or any other federal agency, and in many states are not required to have any license, or professional or financial credentials, to operate.\textsuperscript{204} Most professional Exchange Accommodators are a member of the Federation of Exchange Accommodators ("FEA"), a national trade association organized to represent professionals who conduct like-kind exchanges under I.R.C. Section 1031.\textsuperscript{205} FEA members include qualified intermediaries, their primary tax and legal counsel, and affiliated industries (banks, real estate brokers, title companies, escrow agents, etc.), and are required to adhere to the FEA's Code Of Ethics.\textsuperscript{206}

The vast majority of qualified intermediaries perform their services for taxpayers without any problem. However, when a Qualified Intermediary does not meet its fiduciary responsibilities, the consequences for the taxpayer can be significant. Therefore, an Exchangor should select a Qualified Intermediary based primarily on its experience, reputation and financial security, and secondarily on the fees it will charge to handle the exchange. Exchangors and their advisors should not hesitate to request business, banking and professional references from a potential Qualified Intermediary. Exchangors and brokers should be wary of any Qualified Intermediary who is not well-versed in all aspects of like-kind exchanges.\textsuperscript{202}

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\textsuperscript{202} Language such as the following could be included as an additional provisions on behalf of a potential Exchangor: "Buyer [non-exchanging party] agrees to cooperate with Seller [Exchangor] in a like-kind exchange of the Property under Section 1031 of the Internal Revenue Code at no cost or liability to Buyer including, without limitation, assignment of Seller's rights, but not Seller's obligations, under this Agreement to Seller's Qualified Intermediary." Some states, such as Colorado, have approved forms with exchange cooperation language.

\textsuperscript{203} Regs. Section 1.1031(k)-1(g)(4)(iii)(B). Presumably, the Qualified Intermediary could not, pursuant to a written agreement, acquire the Relinquished Property from the Exchangor if the sale of such property to a buyer has already occurred.

\textsuperscript{204} See "The Regulation of Qualified Intermediaries", infra.

\textsuperscript{205} See Federation of Exchange Accommodators, "About the FEA" at www.1031.org.

\textsuperscript{206} See Federation of Exchange Accommodators, Code of Ethics.
\end{flushleft}
exchanges, or who is willing to facilitate an exchange for an unrealistically low fee. Finally, most reputable Qualified Intermediaries will be covered by a fidelity bond that insures its clients from financial loss due to the dishonesty or malfeasance of the owners and employees of the Qualified Intermediary, or other security devices for Exchange Proceeds held by the Qualified Intermediary such as Qualified Exchange Escrow Accounts.

(d) Pre-Closing Documentation

(i) Preparation of Exchange Documentation
A Qualified Intermediary will require information about the Exchangor, copies of the real estate contract and title commitment for each Relinquished Property and, if known, for the Replacement Property. Once the Qualified Intermediary has all necessary information and documents, it will prepare the necessary exchange documentation (principally the Exchange Agreement, an Assignment of Contract for each property involved in the exchange, and closing or escrow instructions for each closing or escrow agent). The Exchangor should be provided with copies of all exchange documents for review prior to the closing of the Relinquished Property, and have the opportunity to have the documents reviewed by a qualified tax advisor have any questions answered before the closing.

(ii) Closing Instructions
The Qualified Intermediary will need the identity and contact information for the closing or escrow agent responsible for the closing of each property in the exchange. The Qualified Intermediary will provide each closing or escrow agent with instructions for the preparation of Settlement Statements/HUD-1 to document the exchange transaction, and for the conveyance and other closing documents.

3. Closing of Sale of Relinquished Property

(a) Assignment of Contract
In lieu of taking legal title to the Relinquished Property, the Qualified Intermediary will usually have the Exchangor assign its rights (but not obligations) under the sale and purchase contract to the Qualified Intermediary as permitted by the 1031 Regulations.\textsuperscript{207} The Qualified Intermediary will provide the closing agent with an Assignment of Contract to be executed by the Exchangor. To evidence compliance with the requirement in the 1031 Regulations

\textsuperscript{207} Regs. Section 1.1031(k)-1(g)(4)(v).
that the other party to the agreement be notified of the assignment in writing prior to the closing or close of escrow, the buyer should execute an acknowledgment of receipt of the Assignment of Contract, or be provided with a form of notification of the assignment. Failure to provide adequate notice of the assignment, and the ability to prove the buyer received such notice, is grounds for the like-kind exchange being disallowed under the 1031 Regulations.

(b) Settlement Statements/HUD-1
The 1031 Regulations do not dictate the use of any specific format for the Settlement Statements/HUD-1 that are prepared in connection with a like-kind exchange, or require that the Qualified Intermediary sign the Settlement Statements. The Exchanger’s advisors, Qualified Intermediaries and closing or escrow agents all have many different ways that they believe most accurately document an exchange transaction. Many Qualified Intermediaries only require that the Settlement Statements/HUD-1 indicate that the net proceeds from the sale were paid directly to the Qualified Intermediary, and not to the Exchanger to document that the Exchanger did not have Actual Receipt of the Exchange Proceeds. Most Qualified Intermediaries also have their fees and expenses itemized on the Settlement Statement/HUD-1 as costs of selling the Relinquished Property. Finally, most Qualified Intermediaries will review the Exchanger’s Settlement Statements prior to the closing or close of escrow.

(c) Commissions, Property Taxes and Other Closing Costs
The 1031 Regulations provide that closing costs that are customarily paid from the Exchange Proceeds and appear in a typical closing statement may be paid with Exchange Proceeds, and will not constitute Constructive Receipt by the Exchanger. The closing costs and other expenses typically paid at closing are considered to be "exchange expenses" which may be deducted from the realized and recognized capital gain without creating taxable boot to the Exchanger. "Exchange expenses" include real estate commissions, title insurance premiums, closing/escrow fees,

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208 PLR 200236026. In this ruling the I.R.S. agreed that an email notice of taxpayer's assignment of contract to a Qualified Intermediary satisfied the requirement that the other party be notified "in writing".
209 TAM 200130001. In an exchange using the Qualified Intermediary safe harbor, the I.R.S. determined that the taxpayers' assignments of contracts to sell the Relinquished Properties did not meet the requirements of the 1031 Regulations because the taxpayers failed to give any actual or written notice of the assignments to the purchasers of the properties.
210 It has become less common for the Qualified Intermediary to be specified on the closing statement as a party to the transaction, or for dual sets of statements (one for the “transfer” of the Relinquished Property to the Qualified Intermediary and the second for the sale to the buyer) to be prepared.
211 Reg. Section 1.1031(k)-1(g)(7)(ii).
legal fees, inspection/testing fees, exchange fees and expenses, transfer taxes and recording costs. "Non-exchange expenses" include prorated interest, property taxes, utilities, property liability insurance and association fees.\(^{12}\)

(d) **Rents and Security Deposits**

If the Exchangor retains security deposits and prorated rents already in its possession, and gives the buyer a credit towards the purchase price in an equal amount, then the Exchangor will receive taxable boot in the amount of the credit because the credit is reducing the net Exchange Proceeds and the Exchangor is, in essence, putting the deposits and prorated rents in its pocket. This result can be avoided by having the Exchangor deposit the security deposits and prorated rents with the closing agent, not giving a credit to the buyer, and itemizing the deposits and rents on the settlement statement. In the alternative, the Exchangor can pay the amount of deposits and rents to the buyer outside of the sale and purchase closing or escrow, and not account for such items on the settlement statements.

(e) **Disbursement of Sales Proceeds: Net Exchange Proceeds, Costs of Sale, and Taxable Boot.**

The closing or escrow agent should have specific instructions that the net sales proceeds otherwise due to the Exchangor are to be paid directly to the Qualified Intermediary as Exchange Proceeds. Usually the Qualified Intermediary will instruct the closing or escrow agent to have a separate Seller's debit item for "Exchange Proceeds to 1031 Exchange Intermediary" or similar language to indicate clearly that the sales proceeds are not being paid to the seller.

(f) **Conveyance and Other Documents.**

The 1031 Regulations provide that, when using the Qualified Intermediary Safe Harbor, title to the Relinquished Property may be deeded directly from the Exchangor to the buyer if the Exchangor has assigned its rights under the sale and purchase agreement to the Qualified Intermediary at or prior to the closing and the buyer

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\(^{12}\) *Rev. Rul. 72-456, 1972-2 CB 468.* In the only authority that has addressed the treatment of costs associated with a like-kind exchange, the I.R.S. ruled that the payment of brokerage commissions would reduce the cash received and increase the basis of the Replacement Property. The Tax Section of the American Bar Association has classified the expenses customary paid at closing into “exchange expenses” (which reduce boot and increase Replacement Property basis) and “non-exchange expenses” (taxable as boot). *ABA Tax Section Report on Open Issues in Like-Kind Exchanges* (July 14, 1995). Note that although “non-exchange expenses” will be treated as taxable boot if paid with proceeds from the sale of the Relinquished Property, the Exchangor should receive offsetting deductions for property taxes, operating expenses, etc.
received written notice of the assignment. Assuming the Qualified Intermediary has not acquired legal title to the Relinquished Property, the Exchangor continues to hold "legal" title to the property notwithstanding the assignment of the right to sell the property ("equitable" title) to the Qualified Intermediary. Therefore, the Exchangor will execute the deed or other document conveying title to the Relinquished Property to the buyer, and it is generally accepted practice for the Exchangor to execute all "miscellaneous" closing documents, including real estate tax agreements, title insurance indemnifications, utility agreements, etc.

(g) State Income Tax Withholding.
A number of states impose a withholding requirement on the proceeds from sales of real property by out-of-state residents. Some examples of different states withholding requirements are as follows:

(i) Colorado
The closing agent is required to withhold 2% of total sales price on sales by non-resident sellers of Colorado property with a sales price in excess of $100,000. If the income will not be recognized by the seller for federal income tax purposes (e.g., part of an exchange under I.R.C. Section 1031), then the withholding requirement may be satisfied by executing Colorado Department of Revenue Form 1083 ("Affirmation Of No Reasonably Estimated Tax To Be Due") at the time of closing.

(ii) California
California imposes a withholding requirement of 3.33% of the total sales price. Individual resident or non-resident sellers may satisfy the requirement by submitting Form 593-C ("Real Estate Withholding Exemption Certificate for Individual Sellers") at the close of escrow stating under penalty of perjury that the taxpayer is selling the property as part of an I.R.C. Section 1031 exchange. The taxpayer's Qualified Intermediary will be responsible for withholding the required amount if the exchange is not completed or on any boot and forwarding the withheld amount to the Franchise Tax Board. Non-individual sellers seeking an exemption must submit a Form 593-W ("Withholding Exemption Certificate and Waiver Request for Non-Individual Sellers") to the

\[213\ь Regs. Section 1.1031(k)-1(g)(4)(v).\]
\[214\ь Colo. Rev. Code Section 39-22-604.5.\]
\[215\ь Cal. Rev. & Tax Code Section 18662.\]
California Franchise Tax Board Withhold-At-Source-Unit.  

(iii) Hawaii
Hawaii imposes a withholding requirement of 5% of the amount realized by the seller. The withholding requirement may be satisfied by providing the buyer with a completed Form N-289 stating that the seller is not required to recognize any gain or loss with respect to the transfer for federal income tax purposes.  

(iv) Maine
The buyer of real property in Maine from a nonresident seller for $50,000 or more is required to withhold 2.5% of the consideration. However, a nonresident Seller may obtain a waiver from withholding by submitting a Form REW 5 ("Request for Exemption or Reduction in Withholding of Maine Income Tax on the Disposition of Main Real Property") to the Maine Revenue Services.  

(v) Mississippi
The buyer of real property in Mississippi is required to withhold 5% of the "amount realized by the seller on the sale", if the gross proceeds exceed $100,000 and the sale "is not considered an exchange or trade of such property".  

(vi) Oregon
If an Oregon resident or non-resident taxpayer (either individual or an entity) effects a like-exchange under Section 1031 of Relinquished Property in Oregon for Replacement Property outside of Oregon, then the taxpayer may elect to defer payment of the state capital gains taxes until such time as a taxable sale of the Replacement Property occurs, at which time the deferred state income tax is due.  

(vii) New York
Nonresident owners (individuals, estates or trusts) of New York real property are required to pay the estimated state income tax on the gain from the sale before the settlement of

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216 Cal. Rev. & Tax Code Section 18668. Forms and information may be obtained by telephone 888-792-4900, by facsimile 800-998-3676, or at www.ftb.ca.gov. Forms may be submitted by facsimile 916-845-4831.
218 Me. Rev. Stat. Title 36 Section 5250-A. Forms and information may be obtained by telephone at 207-626-8473 and by facsimile at 207-287-4028.
the sale at the rate of 7.7% (2003 rate). Recording of the deed requires the payment of the estimated tax or obtaining a certification that no tax will be due. The certification that no tax will be due may be obtained by filing Form IT-2663 before the settlement date with New York State Department of Taxation and Revenue, which will return the certification to the taxpayer by facsimile or mail within three days.\(^{221}\)

(viii) Other States

Other states with withholding requirements include Alabama, Maryland, New Jersey, Rhode Island, South Carolina and West Virginia, some of whom have an exemption from withholding for like-kind exchanges.\(^{222}\)

(h) FIRPTA Withholding

Under the Foreign Investment In Real Property Tax Act of 1980 ("FIRPTA"), the sale of an interest in United States real property by a nonresident alien or foreign corporation generally requires the withholding of an amount equal to 10% of the amount realized (e.g., the sales price) regardless of the amount of cash actually paid by the buyer.\(^{223}\) Where the seller is not a nonresident alien or foreign corporation, the closing agent will routinely prepare for execution under penalty of perjury a "Certification Of Non-Foreign Status".\(^{224}\) Where the seller is a nonresident alien or foreign corporation, the seller may apply for a "Notice of Non-Recognition" for a simultaneous like-kind exchange under Section 1031 if the seller receives no boot in the transaction.\(^{225}\) If the taxpayer is nonresident alien or foreign corporation who desires to effect a delayed like-kind exchange, the taxpayer must obtain a "Withholding Certificate" by applying to the IRS using Form 8288-B.\(^{226}\) In both procedures the nonresident alien or foreign corporation must have a taxpayer identification number to make such applications.\(^{227}\)

4. Identification and Acquisition of Replacement Property

(a) Identification

Section 1031 requires that the Replacement Property in a 1031 exchange must be identified within 45 days after the transfer of the

\(^{221}\) N.Y.R.S. Section 60.22.663. Form IT-2663 and Instructions are available at http://www.nystax.gov/forms/form_number_order_income.htm.
\(^{223}\) I.R.C. Section 1445(a).
\(^{224}\) Regs. Section 1.1445-2(b)(2).
\(^{225}\) Regs. Section 1.1445-2(d).
\(^{226}\) Regs. Section 1.1445-3(b)(6).
\(^{227}\) TD 9082 (August 5, 2003).
Relinquished Property, or such Replacement Property will not be like-kind with the Relinquished Property. The 1031 Regulations provided much-needed clarity as to what constituted timely and adequate identification that would satisfy the statutory requirements of Section 1031.

(i) Identification Period
The 1031 Regulations define the “Identification Period” as the period of time beginning on the date that the Relinquished Property is transferred by the Exchangor (the day after closing or close of escrow being “day 1”) and ending on midnight of the 45th calendar day thereafter, including weekends and holidays. The 45-day deadline is absolute and not subject to extension, but in cases of natural disasters and other circumstances that affect the ability of all similarly-situated Exchangors to comply with the deadlines set forth in the 1031 Regulations, a blanket extension may be issued by the Commissioner.

(ii) Method of Identification
An identification of Replacement Property must be in writing, executed by the Exchangor, and hand delivered, mailed, sent by facsimile or “otherwise sent” before the end of the

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229 Identification Prior to the 1031 Regulations. Prior to the 1031 Regulations, the identification requirement spawned a number of cases that interpreted what constituted adequate and timely identification, some of which still provide useful guidelines. For example, in David Dobruch v. Comm., TC Memo 1997-477, taxpayers in a pre-1031 Regulations exchange failed to identify their intended Replacement Properties to anybody involved in the exchange. Further, the taxpayers did not even discuss the properties that were eventually acquired with the proceeds from the Relinquished Property with the Qualified Intermediary, the real estate brokers involved in the transactions, or the owners of such properties. Instead, approximately 3 months after the expiration of the 45-day Identification Period, the taxpayers and real estate brokers for the Replacement Properties created letters purporting to identify such properties and backdated such letters to before the deadline. After the taxpayers’ accountant reported the transactions as an exchange under Section 1031 in reliance on the fraudulent identifications, the taxpayers plead guilty to violating I.R.C. Section 7202 (causing the delivery of false documents to the I.R.S.). In disallowing exchange treatment, the I.R.S. found that no valid written identification had been made and, further, that oral discussions between the taxpayers (a husband and wife) about the Replacement Properties did not constitute “identification”. Additionally, the Tax Court found that the assessment of a 75% penalty for the underpayment of taxes resulting from fraud was appropriate. The Tax Court ruling was affirmed by the Ninth Circuit Court of Appeals in an unpublished opinion. See Daily Tax Report (BNA), 9/13/99 at K-23.
230 Regs. Section 1.1031(k)-1(b)(2).
231 Rev. Proc. 2005-73. This Revenue Procedure provides for the extension of like-kind exchange deadlines provided under the 1031 Regulations when the I.R.S. issues a Notice or other form of guidance granting relief to taxpayers in regions that are declared Federal disaster areas by the President. Generally, the 45-day Identification Period, the 180-day Exchange Period and deadlines relating to reverse exchanges will be extended by 120 days, or the last day of the general disaster extension period authorized by the I.R.S. guidance, whichever date is later.
Identification Period. The identification must "unambiguously" describe the identified properties by address, legal description or recognizable name (e.g., the "Empire State Building"). The written identification must be to someone "involved" in the exchange who is not a Disqualified Person, or the person obligated to transfer the Replacement Property to the Exchangor regardless of whether that person is a Disqualified Person. Also, receipt of Replacement Property prior to the expiration of the Identification Period will in all events be treated as identified before the end of the Identification Period.

(iii) Number of Properties that May be Identified
Under the 1031 Regulations, regardless of the number of Relinquished Properties transferred in the "same" delayed exchange, an Exchangor may identify up to three (3) Replacement Properties of any value ("3 Property Rule") or any number of Replacement Properties the aggregate fair market value of which do not exceed 200% of the aggregate fair market value of the Relinquished Property ("200% Rule").

(iv) Identification of Too Many Properties
If too many properties are identified, the identification is deemed to be invalid and the same as if no identification was made. However, even if too many properties were identified, the identification will still be valid as to any properties received by the Exchangor before the end of the Identification period, or if before the end of the Exchange

232 Regs. Section 1.1031(k)-1(c)(2).
233 Regs. Section 1.1031(k)-1(c)(3). See also Michael Hillyer v. Comm., TC Memo 1996-214. Regarding what constitutes an adequate description of an identified property, in a complicated case after the 1031 Regulations became effective the Relinquished Property was sold with the net proceeds being deposited with a bank under an escrow agreement where the taxpayer could identify Replacement Properties, but set forth no restrictions other than the 180-day time limit to complete the exchange. In finding that no exchange was accomplished under Section 1031 and a taxable sale of the Relinquished Property occurred, the Tax Court found the identification of one of the three Replacement Properties as "property zoned M-2 located south and east of Route 41 in Galesburg Township, Knox County, Illinois" as ambiguous in that it could describe many properties in Galesburg Township.
234 Regs. Section 1.1031(k)-1(c)(2). Examples of persons "involved in the exchange" include any of the parties to the exchange, a Qualified Intermediary, an escrow agent, and a title company. Also, the parties an agreement between them for the exchange of properties can identify the Replacement Property in such agreement.
235 Regs. Section 1.1031(k)-1(c)(1).
236 Regs. Section 1.1031(k)-1(c)(4)(i)(A).
237 Regs. Section 1.1031(k)-1(c)(4)(i)(B).
238 Regs. Section 1.1031(k)-1(c)(4)(ii).
239 Regs. Section 1.1031(k)-1(c)(4)(iii)(A).
Period the Exchangor receives properties equal to at least 95% of the aggregate fair market value of all of the identified properties ("95% Rule").

(v) What Constitutes a "Property"

The 1031 Regulations provide no guidance when separate properties (e.g., contiguous lots under common ownership) may be considered as a single property for purposes of identification. Some guidelines may include whether the separate parcels are being sold under a single contract, whether they will be conveyed by a single or by multiple deeds, or whether multiple parcels could be considered to be a single "economic unit" (e.g., a farm comprised of several legal parcels operated as a one farming operation).

(vi) Revocation and Amendment of Identification

Before the end of the Identification Period, the Exchangor may revoke or amend a previously made identification in the same manner that an identification may be made, except that an identification made in a written agreement for the exchange of properties must be made in an amendment to that agreement or by a written notice by the Exchangor to all parties to the agreement.

(b) Acquisition of Identified Properties

(i) Number of Properties Acquired

The Exchangor may acquire as many or as few of the identified properties the Exchangor desires and as is necessary to meet the requirements of the Safe Harbor (e.g., if the 95% Rule is used, the number of properties whose value will satisfy the rule) and to satisfy the economic requirements of the exchange.

(ii) Property Received Must be Substantially the Same as Property Identified

The 1031 Regulations require that, to be considered as Replacement Property, each parcel of property acquired must be "substantially" the same property as a property that was identified, determined on a property-by-property basis.

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240 Regs. Section 1.1031(k)-1(c)(4)(ii)(B). The fair market value of identified Replacement Property under the 95% Rule is determined as of the earlier of the date of receipt by the Exchangor or the last day of the Exchange Period.

241 Regs. Section 1.1031(k)-1(c)(6).

242 See "Economic Issues of Like-Kind Exchanges", infra.
basis. Whether the Replacement Property is "substantially" the same as the identified property depends on whether the property is of the same "nature and character". (e.g., if a two acre parcel is identified, but the Exchangor actually receives only 1.5 acres at 75% of the original cost, the Replacement Property received meets the "substantially" identified test, because it is not difference from the basic "nature or character" of the identified property).244

(c) Effect of No Identification on Refund of Exchange Proceeds
If no identification of Replacement Properties is made timely, then the Exchangor will be entitled to receive any Exchange Proceeds held by a Qualified Intermediary (or in a Qualified Escrow or a Qualified Exchange Trust) if the optional provision permitted under the Constructive Receipt provisions is included in the Exchange Agreement.245

(d) Effect of Identification on Refund of Exchange Proceeds
Under the restrictions imposed by the 1031 Regulations to avoid Constructive Receipt of the Exchange Proceeds by the Exchangor, if an identification is made and the Identification Period passes, then the Exchangor is not entitled to a refund of all or any part of the Exchange Proceeds unless and until the Exchangor: (a) Has received all of the identified Replacement Property; or (b) the end of the 180 day Exchange Period.246 The exchange agreements may not be modified to allow for an early distribution of the Exchange Proceeds if the Exchangor determines that it is unable to reach a contract to acquire the Replacement Property.247

5. Contract for Purchase of Replacement Property

(a) Cooperation Provision
Although a minimum amount of cooperation is required of the other party in a sale and purchase of a property involved in an exchange using the Qualified Intermediary Safe Harbor, inclusion of language specifically requiring the other party's cooperation will mitigate the possibility of potential problems arising at the closing.248

243 Regs. Section 1.1031(k)-1(d)(ii).
244 Regs. Section 1.1031(k)-1(d)(ii) Example 4.
245 Regs. Section 1.1031(k)-1(g)(6)(ii).
246 Regs. Section 1.1031(k)-1(g)(6)(i), Regs. Section 1.1031(k)-1(g)(6)(iii)(A).
247 PLR 200027028.
248 Language such as the following could be included as an additional provision on behalf of an Exchangor purchasing Replacement Property: "Seller [non-exchanging party] agrees to cooperate with Buyer [Exchangor] in a tax-deferred exchange of the Property by Buyer under Section 1031 of the Internal Revenue Code at no cost or liability to Seller including, without limitation, assignment of Buyer's
(b) **Earnest Money Deposits**

The contract may provide that the earnest money deposit may be either: (1) Paid by the Exchangor and held by the broker or closing agent (which deposit may be refunded to the Exchangor at the closing if the funds are not required); or (2) paid out of the Exchange Proceeds held by the Qualified Intermediary if the Qualified Intermediary is a party to the sale and purchase contract by an assignment or otherwise, and it is clear such funds are to be returned to the Qualified Intermediary in the event the transaction fails to close. Otherwise, using Exchange Proceeds for the deposit under a contract to which the Qualified Intermediary is not a party would be Constructive Receipt of such funds by the Exchangor. The same result occurs if the Qualified Intermediary "refunds" an amount equal to an earnest money deposit from the Exchange Proceeds to the Exchangor prior to assignment of the contract.

6. **Acquisition Financing**

The Exchangor may arrange for financing to acquire the Replacement Property in the same manner as for a "normal" purchase of the property. A Lender seeking verification of the Exchange Proceeds as the source of funds to close the purchase should be instructed to send a "Request for Verification of Deposit" to the Qualified Intermediary as would be done with a financial institution.

7. **Closing of Purchase of Replacement Property**

(a) **Assignment of Contract**

The Qualified Intermediary will provide the closing or escrow agent with an Assignment of Contract to be executed by the Exchangor assigning all of the Exchangor's rights in the sale and purchase contract to the Qualified Intermediary, which Assignment will also be acknowledged by the Seller.

(b) **Settlement Statements**

The Settlement Statements/HUD-1 will indicate that the Exchange Proceeds were paid directly to the closing agent by the Qualified Intermediary to further evidence that there was no Constructive Receipt by the Exchangor. The fees and expenses payable to the Qualified Intermediaries will be itemized on the Settlement Statement/HUD-1 so that such items are clearly a cost of acquiring the Replacement Property. If an earnest money deposit made by the Exchangor is refunded to the Exchangor at the closing, it should

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rights, but not Buyer's obligations, under this Agreement to Buyer's Qualified Intermediary. Seller acknowledges and agrees that any earnest money deposit made by Buyer may be refunded to Buyer at the closing and replaced with funds held by Buyer's Qualified Intermediary." Some states, such as Colorado, have approved forms with exchange cooperation language.
be clearly identified as such on the settlement statements so as not to appear that the Exchangor is receiving any of the Exchange Proceeds.

(c) Closing Costs and Loan Expenses

Certain expenses typically paid at closing are considered to be "exchange expenses" which may be deducted from the realized and recognized capital gain without creating taxable boot to the Exchangor. "Exchange expenses” include real estate commissions, title insurance premiums, closing/escrow fees, legal fees, inspection/testing fees, exchange fees and expenses, transfer taxes and recording costs. “Non-exchange expenses” include prorated interest, property taxes, utility prorations, property liability insurance and association fees.249 The correct treatment of costs to secure a loan to acquire the Replacement Property is unclear with limited authority for treating such expenses as a cost of acquiring the property.250 However, most practitioners treat such expenses as the cost to acquire the loan and therefore not an "exchange expense".251

(d) Prorated Rents & Security Deposits

If the Exchangor receives a credit for prorated rents and security deposits retained by the seller, such credit may reduce the amount of exchange proceeds necessary to close the purchase. There is no issue if the Exchangor must bring an amount equal to or more than the amount of the credit. But, if the credit reduces the amount of Exchange Proceeds used to close the purchase, and an amount equal to some or all of the credit is refunded to the Exchangor at the end of the exchange, then there will be receipt by the Exchangor of taxable boot. To avoid such a result, the seller can deposit the security deposits and prorated rents with the closing agent, not show a credit to the Exchangor, and itemize the deposits.

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249 Exchange Expenses. The only authority regarding the treatment of costs associated with a like-kind exchange addressed the question of brokerage commissions. Under Rev. Rul. 72-456, 1972-2 CB 468, the I.R.S. ruled that the payment of brokerage commissions would reduce the cash received and increase the basis of the Replacement Property. The Tax Section of the American Bar Association has classified the expenses customary paid at closing into “exchange expenses” (which reduce boot and increase Replacement Property basis) and “non-exchange expenses” (taxable as boot). ABA Tax Section Report on Open Issues in Like-Kind Exchanges (July 14, 1995). Note that although “non-exchange expenses” will be treated as taxable boot if paid with proceeds from the sale of the Relinquished, the Exchangor should receive offsetting deductions for property taxes, operating expenses, etc.

250 Blatt v. Comm., TC Memo 1994-48. (Treatment of loan costs associated with acquisition of Replacement Property as exchange expenses allowed.)

251 Loan Expenses. The Tax Section of the American Bar Association treats loan expenses (including loan acquisition fees such as points, mortgage insurance, application fees, lender’s title insurance and assumption fees) as “non-exchange expenses” which will be taxable as boot. ABA Tax Section Report on Open Issues in Like-Kind Exchanges (July 14, 1995). However, that the Exchangor should be able to amortize the loan costs.
and rents on the settlement statement. Or, the seller can pay the amount of deposits and rents to the Exchangor outside of the sale and purchase closing or escrow, and not account for such items on the settlement statements.

(e) **Payment of Purchase Price: Exchange Proceeds, Acquisition Financing, Cash From Buyer**

The Replacement Property will be acquired with all or a combination of the Exchange Proceeds sent by the Qualified Intermediary, the earnest money deposit, purchase money financing from a financial institution or the seller and, if necessary, additional cash from the Exchangor. To avoid a possible violation of the construction receipt prohibitions, the closing agent should have specific instructions to refund to the Qualified Intermediary any excess exchange proceeds remaining after the closing.

(f) **Title and Direct Deeding**

Title to the Replacement Property should be taken in the same name(s) as title was held to the Relinquished Property. However, title can be taken in the name of an entity that is disregarded for federal income tax purposes as separate from the owner or beneficiary, such as a single member limited liability company. Title to the Replacement Property should be deeded directly from the Seller to the Exchangor.

(g) **Other Closing Documents**

The Exchangor should execute all "miscellaneous" closing and conveyance documents customarily executed by the buyer.

8. **180-Day Exchange Period**

(a) **Calculation of Deadline**

The 1031 Regulations require that all Replacement Property to be acquired as a part of the exchange must be transferred to the Exchangor by the date that is the earlier of either: (1) On or before midnight on the 180th calendar day after the closing of the conveyance of the Relinquished Property (the day after closing or close of escrow being "day 1"); or (2) the due date (including

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252 PLR 9448010. The 1031 Regulations failed to address how a taxpayer could add funds into an exchange using a Qualified Intermediary without raising issues concerning whether the Qualified Intermediary an agent of the taxpayer. However, the I.R.S. has ruled that, to the extent that the cost of the Replacement Property exceeds the amount of Exchange Proceeds, the taxpayer may deposit additional funds with the seller or with the escrow agent holding the Exchange Proceeds under an escrow agreement between the taxpayer and the Qualified Intermediary. This ruling would seem to confirm the compliance with the 1031 Regulations of the common practice of having the taxpayer deposit additional funds needed to close the acquisition directly with the closing agent for the Replacement Property.

253 See "Single Member LLCs", infra.
extensions) for the Exchangor's tax return for the year in which the Relinquished Property was transferred.\textsuperscript{254} Therefore, if an Exchangor who is an individual or a partnership transfers the Relinquished Property after October 17th, then to have a full 180-day Exchange Period an extension of the April 15th tax return due date must be filed. For corporations, whose tax returns are due on March 15th, the critical transfer date is September 16\textsuperscript{th}.\textsuperscript{255}

(b) Extension of Exchange Deadline

The 180-day deadline is absolute and not subject to extension on a case-by-case basis.\textsuperscript{256} However, in cases of natural disasters and other circumstances that affect the ability of all similarly-situated Exchangors to comply with the deadlines set forth in the 1031 Regulations, a blanket extension may be issued by the Commissioner.\textsuperscript{257}

\textsuperscript{254} Regs. Section 1.1031(k)-1(b)(1)(ii) & (b)(2)(ii).

\textsuperscript{255} See Raymond St. Laurent v. Comm., TC Memo 1996-150. In a case decided under the post-1986 amendment of Section 1031 but before the promulgation of the 1031 Regulations, the taxpayer acquired one Replacement Property within the 180-day Exchange Period but failed to acquire a second property within the Exchange Period. The Tax Court found that the taxpayer did not successfully complete the exchange of the second property for two reasons: First, an extension of the taxpayer's return was not filed on April 15th which terminated the Exchange Period and, second, because the second property was acquired on the 194th day after conveyance of the Relinquished Property. See also Orville E. Christensen v. Comm., TC Memo 1996-254. In another case decided before the 1031 Regulations, a taxpayer entered into an Exchange Agreement with a third-party exchange facilitator in December 1988. The taxpayer subsequently identified 19 Replacement Properties by assessor's parcel number to the facilitator. Between April 25th and June 20, 1989, the facilitator acquired and transferred to the taxpayer 6 of the 19 designated properties. The taxpayer filed its 1989 tax return on the due date of April 17, 1989 without requesting an extension. The Tax Court found that the taxpayer had acquired all of the designated properties outside of the 180-day Exchange Period, which was terminated by the tax return filing. The Court rejected the taxpayer's argument that the automatic 4-month extension should apply because the taxpayer did not file a Form 4868 request. However, the Court did find that the taxpayer had effected an installment sale of the Relinquished Property, because no payment was received until 1989, a result consistent with the later Regulations on combining exchanges and installment sales. Regs. Section 1.1031(k)-1(j)(2).

\textsuperscript{256} See PLR 200211016. A taxpayer properly initiated a like-kind exchange and the exchange proceeds from the sale of the Relinquished Property were deposited with a Qualified Intermediary. Less than 45 days after the closing, a state agency assumed control of the QI and appointed a receiver, which was subsequently confirmed by a court and an order was issued freezing all assets of the Qualified Intermediary, including the taxpayer's exchange proceeds. The taxpayer designated a Replacement Property to the Qualified Intermediary by the 45-day deadline for identification, but was unable to acquire the identified Replacement Property because the Qualified Intermediary's assets were frozen beyond the 180-day deadline for acquisition. In ruling that no relief was available from the 180-day deadline, the I.R.S. noted that the case law supports the preposition that taxpayers must comply literally with the deadlines set forth in I.R.C. Section 1031, and that it had no authority so suspend the running of the deadline.

\textsuperscript{257} Rev. Proc. 2005-73, 2005-2 CB 72. Rev. Proc. 2005-73 provides for the extension of like-kind exchange deadlines provided under the 1031 Regulations when the I.R.S. issues a Notice or other form of guidance granting relief to taxpayers in regions that are declared Federal disaster areas by the President. Generally, the 45-day Identification Period, the 180-day Exchange Period and deadlines relating to reverse exchanges will be extended by 120 days, or the last day of the general disaster extension period authorized by the I.R.S. guidance, whichever date is later.
(c) Early Termination of Exchange
An Exchangor in an Exchange where the Exchange Period deadline falls prior to the due date for the Exchangor's tax return may terminate the exchange prior to the full 180th day by not filing the appropriate extension form. This would permit the refund of any Exchange Proceeds held by the Qualified Intermediary as if the full Exchange Period had elapsed without violating the restrictions on Actual or Constructive Receipt.

(d) Exchange Accommodator's Failure to Timely Complete Exchange
The I.R.S. has indicated that the bankruptcy of an Exchange Accommodator and its failure of to complete a like-kind exchange will not provide a basis for relief from the time deadlines of Section 1031.258

9. Auctions and Foreclosures
Sometimes like-kind exchange transactions will involve an auction of either the sale of the Relinquished Property or in the acquisition of the Replacement Property. For example, mineral interests are often sold at private sale and auction, or a Replacement Property may be acquired through a foreclosure sale. To be part of a successful like-kind exchange under the 1031 Regulations, it is necessary for the assignment and notification procedures, and proper handling of Exchange Proceeds, be incorporated into the auction procedure.

(a) Auctions
By their nature, auctions do not have a sale and purchase agreement and thus nothing that can be assigned to a Qualified Intermediary prior to the sale to satisfy the requirements for "direct deeding" of the property. Therefore, if a Relinquished Property is to be sold at auction, one alternative would be for the Exchangor to convey the property to the Qualified Intermediary (or to an "Exchange Accommodation Titleholder" owned by the Qualified Intermediary), who would then convey the property to the buyer at auction.259 Another alternative would be for the Relinquished Property to be held in an entity that is disregarded for Federal income tax purposes (such as a single-member limited liability company), and have the Exchangor convey all of the membership interest in the disregarded entity to the Qualified Intermediary who would then convey the property to the buyer at auction.260 These same concepts could also be used for the purchase of a

258 See Chief Counsel INFO No. 2008-0021 (June 27, 2008).
259 See "Parking Arrangements Within the "QEAA Safe Harbor", infra.
260 See "Receipt of Replacement Property in a Single Member LLC", infra.
Replacement Property at auction by a Qualified Intermediary.

(b) **Foreclosures**

Even if an owner has no equity in a property, the conveyance of that property through a foreclosure proceeding, or by a deed-in-lieu of foreclosure, may still create a taxable gain if the owner has nonrecourse debt relief in excess of the property's adjusted basis\(^ {261} \) or recourse debt relief in excess of the property's adjusted basis up to the fair market value of the property.\(^ {262} \) As with an auction, structuring a like-kind exchange to roll the realized gain into a like-kind property requires the transfer of legal title to the Relinquished Property to the Qualified Intermediary (or the ownership interest of a disregarded entity which owns the Relinquished Property) prior to the foreclosure sale of the property. In the alternative, if there is an agreement with the lender to give a deed-in-lieu of foreclosure, if the lender is cooperative the Exchangor should be able to assign all of its rights under the agreement to the Qualified Intermediary prior to executing the deed-in-lieu. However, using either of these structures, the Exchangor will need to have adequate financial resources to fund the acquisition of Replacement Property.

10. **Multiple Property Exchanges**

It is not uncommon for an exchange to have more than one Relinquished Property, more than one Replacement Property, or multiple properties of both types. In these cases, it is important to be sure that attention is paid to making a property identification and that the deadlines are properly calculated.

(a) **Number of Identified Properties**

Regardless of the number of properties relinquished by the Exchangor in a single tax-deferred exchange, the maximum number of properties that may be identified is still proscribed by the 3 Property Rule or the 200% Rule (aggregating the fair market value of all the parcels of Relinquished Property as of the date such parcels were transferred by the Exchangor).\(^ {263} \)

(b) **Identification Period**

When multiple parcels of Relinquished Property are transferred, the

\(^{261}\) See Regs. Section 1.1001-2(a)(1) & (2)(b); Tufts v. Comm., 461 US 300 (1983). (Realization of gain to the extent that the adjusted basis is less than the total amount of outstanding non-recourse debt being satisfied in the foreclosure.)

\(^{262}\) Regs. Section 1.1001-2(a)(1); Rev. Rul. 90-16, 1990-1 CB 12. Note that the cancellation of recourse debt in excess of the property's fair market value will create cancellation of debt ("COD") income. COD income is ordinary income, not capital gain, and may not be rolled into another property using a like-kind exchange. However, the COD income may be excluded from income if the borrower is in bankruptcy or to the extent the borrower is insolvent. See I.R.C. Section 108.

\(^{263}\) Regs. Section 1.1031(k)-1(c)(4)(i).
Identification Period begins on the date that the first parcel of Relinquished Property is transferred by the Exchangor.\textsuperscript{264}

(c) Exchange Period
When multiple parcels of Relinquished Property are transferred, the Exchange Period begins on the date that the first parcel of Relinquished Property is transferred by the Exchangor.\textsuperscript{265} In a single like-kind exchange involving multiple parcels of Replacement Property, all the parcels of Replacement Property must be received before the Exchange Period expires.

11. Conversion of Sale to Exchange
If a taxpayer has realized and recognized capital gain in a taxable sale, or failed to meet the initial requirements to set up a tax-deferred exchange, it may be possible to rescind the taxable sale and restructure the transaction as an exchange under I.R.C. Section 1031. A transaction can be rescinded for federal income tax purposes provided certain requirements are met as follows:\textsuperscript{266}

- The parties to the transaction must be returned to their status quo ante, with all consideration being returned to the buyer and the property being returned to the seller;
- The rescission must occur in the same tax year as the taxable sale; and
- The parties must have no further obligations to one another after the rescission, such as a "side agreement" to close a sale of the property immediately after the rescission is effective.

\textsuperscript{264} Regs. Section 1.1031(k)-1(b)(2)(iii).
\textsuperscript{265} Regs. Section 1.1031(k)-1(b)(2)(iii).
\textsuperscript{266} Rev. Rul. 80-58, 1980-1 CB 181.
Chapter Four: Economic Issues Of Like-Kind Exchanges

I. Requirements To Defer All Capital Gain; Boot

A. General Rule

For a complete deferral of all capital gain, the Exchangor must satisfy three "economic" requirements:

1. Exchange Value

The Exchange Value of the Replacement Property must equal or exceed the Exchange Value of the Relinquished Property. The Exchange Value of the Relinquished Property is the Selling Price less Costs of Sale. The Exchange Value of the Replacement Property is the Purchase Price plus Costs of Purchase.

Example: Property A is being sold for $200,000, is encumbered with debt of $75,000, and has costs of sale of $10,000. Property B is being purchased for $225,000, and has costs of purchase of $5,000.

<table>
<thead>
<tr>
<th>Exchange Value A</th>
<th>Sales Price</th>
<th>$ 200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Costs of Sale</td>
<td>(10,000)</td>
</tr>
<tr>
<td><strong>Net Exchange Value</strong></td>
<td><strong>$ 190,000</strong></td>
<td></td>
</tr>
<tr>
<td>Exchange Value B</td>
<td>Purchase Price</td>
<td>$ 225,000</td>
</tr>
<tr>
<td></td>
<td>Costs of Purchase</td>
<td>$ 5,000</td>
</tr>
<tr>
<td><strong>Net Exchange Value</strong></td>
<td><strong>$ 230,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Value Increase</th>
<th>Property B</th>
<th>$ 230,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Property A</td>
<td>(190,000)</td>
</tr>
<tr>
<td><strong>Net Increase</strong></td>
<td><strong>$ 40,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

2. Equity

The Exchangor’s total Equity in the Replacement Property must equal or exceed the total Equity in the Relinquished Property. The total Equity in the Relinquished Property is equal to the Selling Price less Costs of Sale and all Secured Encumbrances.

Example: Same facts as above.

<table>
<thead>
<tr>
<th>Property A Equity</th>
<th>Sales Price</th>
<th>$ 200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Debt</td>
<td>(75,000)</td>
</tr>
<tr>
<td></td>
<td>Costs of Sale</td>
<td>(10,000)</td>
</tr>
<tr>
<td><strong>Net Equity</strong></td>
<td><strong>$ 115,000</strong></td>
<td></td>
</tr>
</tbody>
</table>
3. Debt
The Exchangor's total Debt Secured by the Replacement Property must equal or exceed the total Debt Secured by the Relinquished Property; provided that, the Debt Secured by the Relinquished Property may be less than the Debt Secured by the Replacement Property if such "old" debt is replaced with "new" Equity in the Replacement Property (in other words, the Exchangor may reduce the amount of debt secured by the Replacement Property by putting additional cash into the transaction).\(^{267}\)

Example: Same facts as above.

<table>
<thead>
<tr>
<th>Property B Debt/Equity</th>
<th>Purchase Price</th>
<th>$ 225,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Costs of Purchase</td>
<td>$ 5,000</td>
</tr>
<tr>
<td></td>
<td>Total Cash to Close</td>
<td>$ 230,000</td>
</tr>
<tr>
<td></td>
<td>Property A Equity</td>
<td>$(115,000)</td>
</tr>
<tr>
<td></td>
<td>New Debt/Equity</td>
<td>$ 115,000</td>
</tr>
</tbody>
</table>

4. Aggregation of Exchange Value, Debt and Equity for Multiple Properties
In calculating the exchange value, debt and equity of the Relinquished Property or Replacement Property in a tax-deferred exchange involving multiple parcels of either Relinquished Property or Replacement Property, or both, such amounts are the aggregate for all parcels of Relinquished Property or Replacement Property, as the case may be.

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\(^{267}\) **Widdig v. Comm.**, TC Memo 1995-461 (1995). The 1031 Regulations have been historically been interpreted to permit the netting of liabilities secured by the Relinquished Property against all liabilities secured by the Replacement Property, including liabilities assumed from the seller, taken "subject to", and new acquisition financing. However, in the Widdig case, the language of the 1031 Regulations stating that liabilities secured by the Relinquished Property could be offset by "an assumption of liabilities or a receipt of property subject to a liability" was interpreted literally. Judge Swift's opinion held that "new" acquisition financing secured by the Replacement Property would not offset an existing mortgage secured by the Relinquished Property, and found that the taxpayer had received "mortgage boot" in the amount of the debt relief. For a brief time the Widdig decision caused significant concern among like-kind exchange practitioners, many of whom feared a chilling effect on new transactions while the anomalous decision was considered by an appellate court. However, after an informal conference among Judge Swift, an attorney representing the Federation Of Exchange Accommodators, and counsel for the I.R.S., the judge issued an order dated November 9, 1995 withdrawing his earlier opinion in its entirety. However, because the taxpayer and the I.R.S. later reached a settlement of the matter, no new opinion was issued in the Widdig case. The court's reasoning has not been followed in any subsequent cases and Widdig has become an interesting oddity in the history of like-kind exchanges.
B. **Boot**

1. **"Boot" Defined**

   Although the term "Boot" is not used in the Code or the 1031 Regulations, it is commonly used to refer to either non-qualifying property or non-like-kind property received by the Exchangor in a tax-deferred exchange. Examples of boot include:

   - Cash
   - Relief from debt secured by the Relinquished Property (if not replaced by new, assumed or "subject to" debt secured by the Replacement Property or "new" equity in the Replacement Property)
   - Non-qualifying property such as property for the personal use of the Exchangor
   - Non like-kind property such as an automobile for real estate, or real estate for fixtures, furniture and equipment
   - Non-exchange expenses paid at closing

2. **Taxation of Boot**

   Boot received by the Exchangor is recognized and taxed as capital gain only to the extent of the total capital gain realized in the transaction. For example, in a like-kind exchange where the total capital gain realized is $10,000, the receipt of $5,000 cash boot would be recognized fully, whereas the receipt of $12,000 cash boot would be recognized only to the extent of the $10,000 gain. Therefore, with planning, an Exchangor can achieve a "partial" exchange, deferring part of the gain from the Relinquished Property into the Replacement Property, and choosing to pay tax as boot on cash received, net mortgage relief, or an installment note received.

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268 Exchange Expenses. The only authority regarding the treatment of costs associated with a like-kind exchange addressed the question of brokerage commissions. Under Rev. Rul. 72-456, 1972-2 CB 468, the I.R.S. ruled that the payment of brokerage commissions would reduce the cash received and increase the basis of the Replacement Property. The Tax Section of the American Bar Association has classified the expenses customary paid at closing into "exchange expenses" (which reduce boot and increase Replacement Property basis) and "non-exchange expenses" (taxable as boot). "Exchange expenses" include sales commissions, legal fees, escrow/closing fees, inspection/testing fees, transfer taxes, title insurance fees and recording fees. "Non-exchange expenses" include rent prorations, utilities, property taxes, and loan acquisition fees such as points, mortgage insurance, application fees, lender’s title insurance and assumption fees. ABA Tax Section Report on Open Issues in Like-Kind Exchanges (July 14, 1995). Note that although “non-exchange expenses” will be treated as taxable boot if paid with exchange proceeds, the Exchangor should be able to receive offsetting deductions for property taxes, operating expenses, etc. and amortize the loan costs.

269 I.R.C. Section 1031(b); Regs. Section 1.1031(b)-1(a)(1).

270 See Regs. Section 1.1031(b)-1(b) Example 1.
3. Timing the Receipt of Boot

If the Exchangor is certain that it will not need all of the Exchange Proceeds to acquire the Replacement Property, then the Exchangor may receive boot upon the sale of the Relinquished Property by so informing the Qualified Intermediary and having the right to receive cash in the desired amount of boot excluded from the rights assigned under the sale and purchase agreement to the Qualified Intermediary. If the Exchangor is uncertain about the amount of exchange proceeds that will be necessary to acquire the Replacement Property, it is advisable for the Exchangor to not receive boot at the beginning of the exchange because once received such boot will be taxable and cannot be deposited back into the exchange. If at the end of the exchange there are excess exchange proceeds, then the Exchangor may receive such funds subject to the restrictions on Constructive Receipt, which funds shall be taxable as capital gain.

4. Boot and Section 1250 Gain

A taxpayer may have boot comprised of both Section 1250 Gain (taxed at 25%) and other capital gain (taxed at a maximum of 15%) with respect to a Relinquished Property. If the taxpayer recognizes some but not all of the realized gain in the exchange, the Section 1250 Gain that is not recaptured probably must be taken into account before the other capital gain.\(^\text{271}\) The issue is addressed in Section 453 that provides that if gain from an installment sale includes both Section 1250 Gain that is not recaptured and other capital gain, the Section 1250 gain that is not recaptured is taken into account before the other capital gain.\(^\text{272}\)

C. Adjusted Basis of Replacement Property

The calculation of the adjusted basis of the Replacement Property under I.R.C. Section 1031(d) may be summarized as follows: The adjusted basis of the Replacement Property is equal to the Relinquished Property’s adjusted basis plus the amount of net mortgage and/or cash boot given less the amount of net mortgage and/or cash boot received.\(^\text{273}\) Stated another way, the Replacement Property’s adjusted basis is equal to the purchase price for the Replacement Property plus costs of purchase less the amount of deferred gain. These two methods of calculating the adjusted basis of the Replacement Property are illustrated by the examples below:

1. Add New Net Investment to Old Adjusted Basis

Using the method provided in the Regulations, the Adjusted Basis of the Relinquished Property is adjusted by the amount of new debt/equity on the Replacement Property netted against the old debt on the Relinquished Property.

\(^{271}\) See “Section 1250 Depreciation Recapture”, infra.
\(^{272}\) Regs. Section 1.453-12.
\(^{273}\) Regs. Section 1.1031(d)-1(a); See also I.R.S. Publication 551 “Basis of Assets” at page 7 (May 2002).
Example: Relinquished Property A had an Adjusted Basis of $95,000 and "old" debt of $75,000, and Replacement Property B has "new" debt/equity of $115,000.

<table>
<thead>
<tr>
<th>Method #1</th>
<th>Adjusted Basis</th>
<th>$ 95,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>New Debt/Equity B</td>
<td>$ 115,000</td>
</tr>
<tr>
<td></td>
<td>Old Debt A</td>
<td>$ (75,000)</td>
</tr>
<tr>
<td></td>
<td>Adjusted Basis B</td>
<td>$ 135,000</td>
</tr>
</tbody>
</table>

2. Reduce New Exchange Value by Capital Gains Deferred
With this alternative method, the Exchange Value of the Replacement Property is reduced by the amount of Capital Gains deferred.

Example: Relinquished Property A had deferred Capital Gains of $95,000, and Replacement Property B has Exchange Value (Purchase Price plus Costs of Purchase) of $230,000.

<table>
<thead>
<tr>
<th>Method #2</th>
<th>Exchange Value</th>
<th>$ 230,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Deferred Gain</td>
<td>$ (95,000)</td>
</tr>
<tr>
<td></td>
<td>Adjusted Basis B</td>
<td>$ 135,000</td>
</tr>
</tbody>
</table>

3. Adjusted Basis When Boot Is Received
The 1031 Regulations state that when gain is recognized in a like-kind exchange, the adjusted basis of the Replacement Property is equal to that of the Relinquished Property, decreased by the amount of cash received and increased by the amount of recognized gain.274 Stated simply, when a capital gain is realized upon the exchange of property, all of the Adjusted Basis from the Relinquished Property will be allocated to the Replacement Property first, and any remaining basis will be allocated to any boot (non-like-kind property) received in the exchange. This concept is illustrated by the following example:

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274Regs. Section 1.1031(d)-1(b). See also I.R.S. Publication 551 "Basis of Assets" at page 8 (May 2002).
Example: Taxpayer exchanges Relinquished Property with Adjusted Basis of $250,000 for like-kind Replacement Property with a FMV of $240,000 and $20,000 in cash. The Taxpayer realizes a gain of $10,000 all of which is recognized under I.R.C. Section 1031(b).

<table>
<thead>
<tr>
<th>Relinquished Property</th>
<th>Adjusted Basis</th>
<th>$250,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less Cash Boot Rec'd</td>
<td>$ (20,000)</td>
<td></td>
</tr>
<tr>
<td>Plus Gain Recognized</td>
<td>$ 10,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Replacement Property</th>
<th>Adjusted Basis</th>
<th>$240,000</th>
</tr>
</thead>
</table>

D. Recapture Provisions

1. Section 1250 Depreciation Recapture

   (a) General Provisions

   “Section 1250 Property” is defined as any real property that is or has been property of a character subject to the allowance for depreciation provided in IRC Section 167. I.R.C. Section 1250 provides that, upon the sale of depreciable real property, some or all of the “Section 1250 Gain” (the gain which results from a reduction in basis by depreciation previously taken) will be recaptured and taxed at a higher rate. Section 1250 Gain will be taxed at a rate of 25%, and any gain in excess of the amount of Section 1250 gain is taxed at the applicable capital gains rate. Further, any “Additional Depreciation” (discussed below) taken with respect to the property will be taxed at ordinary income rates.

   (b) Determining the Amount of Section 1250 Gain and Additional Depreciation

   For Section 1250 Property placed in service after 1986, all depreciation deductions taken before the disposition will result in Section 1250 Gain. For Section 1250 Property placed in service before 1987, the amount of Section 1250 Gain depends on the method of depreciation used, which in turn depends on whether the property was residential or nonresidential property and when it was placed into service. For residential Section 1250 Property placed in service before 1987 but after 1980, the amount of Section 1250 Gain is the same as for post-1986 property, unless an accelerated method of depreciation was used. In that case, a portion of the Section 1250 gain will be "Additional Depreciation", which is the

275 See Regs. Section 1.1031(d)-1(b) Example 1.
276 I.R.C. Section 1250(c).
277 I.R.C. Section 1250(b).
difference between the depreciation deduction taken and the amount of deduction that would have been taken using the straight-line method. For non-residential Section 1250 Property placed in service before 1987 but after 1980, the amount of Section 1250 Gain is the same as for post-1986 property, unless an accelerated method of depreciation was used. In that case, all of the Section 1250 Gain taken will be considered to be ordinary income. For Section 1250 Property placed in service prior to 1981, whether residential or nonresidential, the amount of Section 1250 Gain is the same as for post-1986 property, unless an accelerated method of depreciation was used, in which case a portion of the Section 1250 gain will be Additional Depreciation.  

(c) **Section 1250 Recapture in a 1031 Exchange**

The provisions of I.R.C. Section 1250 override the non-recognition provisions of Section 1031. Therefore, Section 1250 Gain and Additional Depreciation will be recognized in a like-kind exchange as follows:

(i) **Section 1250 Gain**

In a like-kind exchange of Section 1250 Property under Section 1031, the amount of Section 1250 Gain recognized cannot exceed the amount of gain recognized in the exchange (e.g. Boot).

(ii) **Additional Depreciation**

In a like-kind exchange of Section 1250 Property under Section 1031, Additional Depreciation is recaptured and taxed as ordinary income only to the extent of the greater of:

- Taxable boot recognized under Section 1031; or
- The excess of the amount of Additional Depreciation over the fair market value of the Section 1250 Property acquired in the exchange.

For example, if no Boot is received in the exchange and the value of Section 1250 Property received in the exchange equals or exceeds the amount of Additional Depreciation, then no Section 1250 Gain or Additional Depreciation will be recaptured in the transaction. On the other hand, if the Replacement Property is not Section 1250 Property, such as

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278 I.R.C. Section 168(b)(3)(A) & (B); Section 168(e)(2); Section 1250(a)(1)(A)(ii) & (2)(A)(ii); Section 1250(a)(3)(A)(ii); Section 1250(b)(1); Section 1250(c).  
279 Regs. Section 1.1250-1(c)(2).  
280 I.R.C. Section 1250(d)(4)(A).  
281 I.R.C. Section 1250(d)(4)(E).
raw land, all of the Additional Depreciation is recaptured at the time of the exchange, whether or not any Boot is received in the exchange.

(iii) **Roll-Over of Section 1250 Gain and Additional Depreciation**

(A) **Unreported Section 1250 Gain**

The current Code provisions do not address whether any unreported Section 1250 Gain that was not taxed upon the disposition of the Relinquished Property in an exchange under Section 1031 carries forward into the Replacement Property, so that if and when the Replacement Property is sold and capital gains are recognized the taxpayer will pay the higher 25% rate on some or all of the Section 1250 Gain. However, since the depreciation recapture provisions of Section 1250 provide that the amount of any Additional Depreciation carries over, consistency suggests that a similar rule would apply to the Section 1250 Gain attributable to the Relinquished Property and is not "recaptured". The issue is less clear when the Relinquished Property is Section 1250 property and the Replacement Property is not, such as an exchange of depreciable real property for unimproved land.

(B) **Additional Depreciation**

The Additional Depreciation not recognized in a 1031 exchange is carried over to the Section 1250 Property acquired in the exchange and, therefore, can be recaptured upon a taxable disposition of the Replacement Property.\(^282\)

2. **Section 1245 Depreciation Recapture**

The recapture provisions of I.R.C. Section 1245 generally apply only to a taxable sale of depreciable personal property to the extent of all previous depreciation deductions (allowed or allowable). Section 1245 property does, however, include components of real property whose basis has been adjusted for items such as the election to expend certain depreciable business assets under Section 179 or the election to deduct the cost of the removal of transportation barriers for handicapped or elderly persons under I.R.C. Section 190.\(^283\) I.R.C. Section 1245 property may include

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\(^{282}\) I.R.C. Section 1031(d)(4)(D); Regs. Section 1.1250-3(d)(5).

\(^{283}\) I.R.C. Section 1245(a)(3)(B)-(F). Note also that Section 1245 property applies generally to property that “is or has been” depreciable in nature. Regs. Section 1.1245-3(a)(3).
"Section 1245 recovery property," or nonresidential real property placed into service after 1981 and before 1987, which was not depreciated on the straight-line method. 284 If Section 1245 property is exchanged under Section 1031, depreciation is recaptured as ordinary income only to the extent that:

- Taxable Boot is recognized under Section 1031, plus
- The fair market value of property received in the exchange which is not Section 1245 property, but which still qualifies for non-recognition under Section 1031 (e.g., not Boot).285

3. Section 1254 IDC Recapture Rules
A like-kind exchange involving mineral rights may cause the recapture of Intangible Drilling and Development Costs ("IDC"). The owner of a "working interest" may deduct the amount of IDC, which are those costs of drilling or developing a well that have no salvage value. 286 IDC are subject to recapture if the working interest is sold or conveyed, with exceptions for financing transactions, a lease or sublease, and other types of transactions. 287 Section 1254 creates a class of property known as Natural Resource Recapture Property ("NRRP"), which generally includes property that is subject to IDC or the basis is subject to adjustment due to cost depletion under I.R.C. Section 611, et seq. In a like-kind exchange under Section 1031, the disposition of NRRP that is not replaced with NRRP will cause the recognition of gain to the extent of the total amount of gain recognized (e.g., Boot received) plus the fair market value of qualifying property received that is not NRRP (e.g., real property that is not subject to IDC or depletion).288

4. At-Risk Recapture
I.R.C. Section 465 limits a taxpayer's deductible losses to the amount the taxpayer is "at-risk" with respect to the activity. The general rule is that a taxpayer is at-risk with respect to a debt if the taxpayer is personally liable for the debt or, in the case of a debt secured by real estate, if the debt is non-recourse and from a lender in the business of lending. Regarding the at-risk rules and like-kind exchanges, taxpayers and their advisors should be aware that if a taxpayer exchanges out of a Relinquished Property secured by a recourse debt, and into a Replacement Property secured by non-recourse debt from a lender not regularly in the business of lending (e.g., seller financing), then the taxpayer will have recapture income on the exchange to the extent the at-risk amount is reduced below zero.289

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284 I.R.C. Section 1245(a)(2).
286 I.R.C. Section 263(c); Regs. Section 1.612-4(a); Rev. Rul. 70-314, 1970-2 CB 132.
287 I.R.C. Section 1254, Regs. Section 1.1254-1(b)(3)(ii).
288 Regs. Section 1.1254-2(d).
289 I.R.C. Section 465(e).
E. Reporting A Like-kind Exchange Under Section 1031

1. General Reporting Requirements

Like-kind exchanges must be reported on two I.R.S. forms, Form 8824 ("Like-Kind Exchanges") and either Form 4797 ("Sales of Business Property" for depreciable property) or Schedule D ("Capital Gains and Losses" for non-depreciable property). The exchange should be reported in the tax year that the sale of the Relinquished Property closed. Note that an exchange commenced less than 180 days before the due date for the Exchangor’s tax return will require the filing of an extension if the exchange has not been completed by the return due date to obtain the benefit of the full 180 day Exchange Period. The failure to file the extension form timely will result in a termination of the exchange upon the due date of the Exchangor’s tax return.

2. Special Reporting Requirements

(a) Related Parties

Line 7 of Form 8824 inquires the taxpayer to disclose whether the property involved in a like-kind exchange was relinquished to, or received from, a related party, either directly or indirectly, such as through an intermediary. Line 9 inquires whether during the current tax year did the related party directly or indirectly sell or dispose of any part of the like-kind property received from the taxpayer in the like-kind exchange. The instructions to Form 8824 state that special rules apply to like-kind exchanges made with related parties, that a "related party" includes a taxpayer's spouse, child, grandchild, parent, brother, sister, or a related corporation, S corporation, partnership or trust, that an exchange structured to avoid related party rules is not a like-kind exchange, and that if the taxpayer or a related party disposes of property received in an exchange before the date that is two years after the last transfer of property from the exchange, the deferred gain (or loss) must be reported for the year of disposition (unless an exception applies). Form 8824 must be filed for the two years following the year of a related party exchange.

(b) Identification of Replacement Property

Line 5 of the Form 8824 requires the taxpayer to specify the date that the Replacement Property received in the like-kind exchange was identified "to another party". The instructions for line 5 state the requirements for a valid identification of Replacement Property, including the form and timing of the identification, and to whom an identification may be made.

See Calculation of Exchange Deadline, infra.
(c) Tax Shelter Reporting Rules
Simultaneously with the publication of the final regulations on tax shelter reporting,\textsuperscript{291} the IRS exempted like-kind exchanges from the reporting requirements contained in the final regulations.\textsuperscript{292}

F. Mixed-Use Personal Residence/Business Property

1. Section 121 Sale of Personal Residence

(a) General Provisions
I.R.C. Section 121(a) provides that a taxpayer may exclude gain realized on the sale or exchange of property if the property was owned and used as the taxpayer's principal residence for at least 2 years during the 5-year period ending on the date of the sale or exchange. Section 121(b) provides generally that the amount of the exclusion is limited to $250,000 ($500,000 for certain joint returns). Under Section 121(d)(6), any gain attributable to depreciation adjustments (as defined in Section 1250(b)(3)) for periods after May 6, 1997, is not eligible for the exclusion. This limitation applies only to depreciation allocable to the portion of the property to which the Section 121 exclusion applies.\textsuperscript{293}

(b) Partial Exclusion of Gain for Former Non-Qualified Use
The Housing Assistance Tax Act of 2008\textsuperscript{294} modified I.R.C. Section 121 to limit the amount of gain that may be excluded by owners of properties that were acquired in a like-kind exchange and later converted to a personal residence or used as a second home. For sales after December 31, 2008, the exclusion will not apply to gain allocated to periods of "non-qualified use"; that is, periods of time that the property was not used as the owner's principal of residence. The gain is allocated between periods of qualified use (e.g. personal residence) and non-qualified use (e.g. rental, which conversely under Section 1031 is considered a qualifying use for exchange purposes) by multiplying the total gain realized upon sale by a ratio, the numerator of which is the total length of time the property was used for a non-qualified use on or after September 1, 2009 and the denominator of which is the total length of time of ownership. For example, if the property acquired in a like-kind exchange on or after September 1, 2009 is used for two years as a rental, and then for three years as a principal residence, then the ratio of excluded Section 121 gain would be 2/5. If the total amount of gain was $250,000 (which under former Section 121 would be all

\textsuperscript{291} See Regs. Section 1.6011-4.
\textsuperscript{293} I.R.C. Section 121-1(d)(1).
excluded), applying the new rule the amount of gain that could not be excluded under Section 121 is $100,000, and 3/5ths of the gain ($150,000) would be eligible for exclusion.295

2. **Revenue Procedure 2005-14**

Revenue Procedure 2005-14296 applies to taxpayers who exchange property that satisfies the requirements for both the exclusion of gain from the exchange of a principal residence under I.R.C. Section 121 and the non-recognition of gain on the exchange of like-kind properties under I.R.C. Section 1031. This may be a mixed-use property (such as a personal residence a portion of which is used for business purposes) or a personal residence that has been converted to a business use (such as rental). With careful planning and by applying the procedures set forth in Rev. Proc. 2005-14, taxpayers may take advantage of the provisions for the exclusion of gain under Section 121 and for the non-recognition of gain under Section 1031. Rev. Proc. 2005-14 has specific examples of how to apply its provisions that may be summarized as follows:

(a) **Application of Section 121 before Section 1031.**

I.R.C. Section 121 must be applied to gain realized before applying Section 1031.297 For example, if a taxpayer has $280,000 in realized gain from the partial sale/partial exchange of a property that was used as a personal residence for at least 2 of the last 5 years, and then converted the property to a rental and subsequently conveyed it within the 5 years, then $250,000 of the realized gain will be excluded under Section 121 before applying the non-recognition rules of Section 1031.

(b) **Application of Section 1031 to Section 1250 Gain**

Under I.R.C. Section 121(d)(6), any gain attributable to depreciation adjustments (as defined in Section 1250(b)(3)) for periods after May 6, 1997 is not eligible for the exclusion. However, Section 1031 may apply to such gain.298

(c) **Treatment of Boot**

In applying Section 1031, cash or other non-like-kind property (e.g. Boot) received in an exchange of the Relinquished Property (that is, the business portion of a mixed-used property), is taken into account only to the extent the Boot exceeds the gain excluded under Section 121 with respect to the Relinquished Property.299 For example, if a taxpayer is eligible to exclude all of $250,000 in gain

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295 I.R.C. Section 121(d)(10).
297 Rev. Proc. 2005-14 Section 4.02(1).
298 Rev. Proc. 2005-14 Section 4.02(2).
299 Rev. Proc. 2005-14 Section 4.02(3).
from a partial-sale/partial-exchange, and receives $10,000 in cash boot from the transaction, the taxpayer is not required to recognize gain because the Boot is taken into account for purposes of Section 1031(b) only to the extent the Boot exceeds the amount of excluded gain.

(d) **Computation of Replacement Property Basis**

In determining the basis of the Replacement Property, any gain excluded under Section 121 is treated as gain recognized by the taxpayer. Therefore, under Section 1031(d), the basis of the Replacement Property is increased by any gain attributable to the Relinquished Property that is excluded under Section 121.\(^3\) For example, if a taxpayer excludes $250,000 in gain under Section 121 from a partial-sale/partial-exchange, and the adjusted basis of the Relinquished Property was $100,000, then the basis of the Replacement Property will be $350,000.

G. **Installment Sales and Like-Kind Exchanges**

1. **I.R.C Section 453**

In a transaction that qualifies as an "installment sale", the seller may report the capital gain income as each payment is received, and only that pro rata share of each payment that is capital gain. To put it another way, the portion of each payment that represents the return of the seller's adjusted basis is not reported as income.\(^4\)

2. **Incorporating an Installment Sale in a Like-Kind Exchange**

Exchangors who are willing to provide seller financing for a Relinquished Property may either exclude the promissory note from the exchange or incorporate it as part of the proceeds from the sale as follows:

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\(^3\) *Rev. Proc. 2005-14 Section 4.03.* Also, it should be noted that *Rev. Proc. 2005-14* specifies that the basis of a property is its cost under I.R.C. Section 1012, and that allocation of the residential and business portions of the property based on the square footage is an appropriate method of allocating the basis and the amount realized. *Poague v. U.S.,* 66 A.F.T.R.2d (RIA) 5825 (E.D. Va. 1990), affd. 947 F.2d 942 (4th Cir. 1991). This provision would seem to settle the question of how to allocate basis in the situation where a property is converted from a residence to a business use and then exchanged under Section 1031. See *Bundren v. Comm.,* TC Memo 2001-2 (2001), affd. 32 Fed. Appx. 527 (10th Cir. 2002), wherein the Tax Court found that the taxpayers' basis in the Relinquished Property at the time of its conversion from personal to rental use would be the lesser of its then fair market value or its adjusted cost basis.

\(^4\) *I.R.C. Section 453(c).*
(a) **Note Treated as Boot**

The Exchangor may receive an installment note for a portion of the sales price and have a Qualified Intermediary handle the balance of the transaction as a like-kind exchange. Because all of the Relinquished Property's adjusted basis is allocated to the Replacement Property, the entire principal amount of the installment note is treated the same as Cash Boot received by the Exchangor and is fully taxable as capital gain. But, as an installment sale, the Exchangor is only required to report as capital gain income the principal amount of each payment when it is actually received.

(b) **Note Used to Acquire Replacement Property**

To be incorporated in a like-kind exchange, the installment note (and any mortgage or deed of trust securing the note) must be payable to the Qualified Intermediary and delivered to it at the closing of the Relinquished Property. The settlement statement/HUD-1 should reflect that the note was payable to the Qualified Intermediary as "additional exchange proceeds" or similar language. After receipt of the note by the Qualified Intermediary, it may be used to acquire Replacement Property as follows:

(i) **Liquidate Note**

The installment note may be sold by the Qualified Intermediary to generate cash for the acquisition of the Replacement Property. Possible purchasers of the note may include the Exchangor or a related party at any time during the Exchange Period. In the alternative, the note could be sold to a third party, usually at a discount, with the amount of discount possibly treated as a reduction in the sale price and, therefore, the Exchange Value, of the Relinquished Property.

(ii) **Note Used Towards Purchase**

The installment note and any underlying security may be transferred to a seller of Replacement Property willing to take the note in payment of all or a part of the purchase price. However, the seller of the Replacement Property will not be entitled to report the transaction as an installment sale, because the maker of the note (the buyer of the Relinquished Property) will not be the same person who purchased the Replacement Property (the Qualified Intermediary/Exchangor).

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303 I.R.C. Section 453(f)(3).
(c) Payments Of Principal And Interest
During the period an installment note is held by the Qualified Intermediary, payments of principal should be treated as additional cash paid by the purchaser of the Relinquished Property, and constitute boot only to the extent such cash is distributed to the Exchangor at the end of the exchange. Any payments of interest should be taxed as ordinary interest income to the Exchangor as the person to whom the interest will ultimately be paid.

(d) Note Received Later By Exchangor
If an installment note received by an Qualified Intermediary is later transferred to the Exchangor (e.g., if the note is not used to acquire Replacement Property, or the exchange terminates without acquiring Replacement Property), the Exchangor may report the payments received from the note as an installment sale.

3. Installment Sale Reporting for a Failed Exchange
In 1994 Regulations were issued that coordinate like-kind exchanges under I.R.C. Section 1031 and installment sales under Section 453. If a like-kind exchange is initiated in good faith by an Exchangor, and the Exchange Proceeds are received and held by a Qualified Intermediary, and the exchange is either completed or terminated under the terms of the Exchange Agreement (which incorporate the required restrictions on the taxpayers receipt of the Exchange Proceeds), and some or all of the Exchange Proceeds are received by the Exchangor in the following tax year, then the Exchangor may report the receipt of the Exchange Proceeds as if the transaction were an installment sale of the Relinquished Property.

Evidence of "good faith" intent to accomplish an exchange would include, for example, a diligent effort to locate and acquire suitable Replacement Property. In effect, this provision allows

An unusual case presented the Tax Court with the opportunity to consider the issue of what constitutes "bona fide intent" on the part of a taxpayer to enter into a like-kind exchange under Section 1031 and be able to take advantage of installment sale reporting for a failed exchange. In Smalley, the taxpayer sold standing timber in late 1994 and had the proceeds paid to an escrow agent under an exchange agreement. The taxpayer timely identified three replacement properties that were real property, all of which were purchased in the exchange and transferred to him. The remaining balance of the Exchange Proceeds was paid to the taxpayer in 1995. The taxpayer reported the transaction as a like-kind exchange for the 1994 tax year, and the I.R.S. subsequently denied non-recognition treatment of the capital gain and levied a deficiency on the grounds that the Relinquished Property was personal property and not like-kind to the real property received as Replacement Property.

The Tax Court ignored the issue of whether the Relinquished and Replacement Properties were like-kind, and focused on whether the taxpayer was entitled to installment sale reporting. The Tax Court reasoned this was the critical issue because if the taxpayer was entitled to installment sale reporting then the
an Exchangor who meets the criteria set forth in the Regulations to delay payment of the capital gains tax on the sale of the Relinquished Property until the tax year after the sale.

H. Refinancing of Property Involved in an Exchange

Often an Exchangor that owns Relinquished Property with substantial equity will want to gain access to the equity by placing new debt or refinancing existing debt on the Relinquished Property prior to the exchange, or by placing new debt or refinancing existing debt on the Replacement Property soon after the exchange is completed. In general, the courts have been sympathetic to pre and post-exchange refinancing, if such refinancing has an independent business purpose and not for tax avoidance purposes.\(^{307}\) The I.R.S. has consistently taken a stand against such pre and post-exchange refinancing, arguing that receipt of the loan proceeds constitutes cash boot to the Exchangor resulting from a trade down in equity. Absent more definitive guidance from the I.R.S., a cautious Exchangor will refinance a Relinquished Property well prior to the contemplated exchange and for reasons independent from the exchange (e.g., to obtain a lower interest rate, or to obtain cash for other business purposes). Most commentators agree that it is less risky to refinance the Replacement Property after its acquisition rather than the Relinquished Property before its disposition. This is because the post-exchange liability survives the transaction and remains a liability of the taxpayer and a lien against the Replacement Property.

I. Depreciation of Property Involved in a Like-Kind Exchange

On February 27, 2004, proposed and temporary Regulations were issued under I.R.C. Section 168 that provided more detailed guidance for the depreciation of property acquired in a like-kind exchange, and formerly applicable Notice 2000-4 question of whether he failed to report all the income from the sale in 1995 was not before the court and possibly tolled by the statute of limitations.

In deciding whether the taxpayer was entitled to installment sale reporting, the Tax Court applied the rules added in 1994 coordinating installment sales and like-kind exchanges under Section 1031. Specifically, the Tax Court analyzed whether the taxpayer had a bona fide intent to enter into a deferred exchange, a requirement under the regulations for reporting a failed exchange as an installment sale. The Tax Court framed the question as whether the taxpayer reasonably believed that he could satisfy the requirements for a like-kind exchange. The Tax Court found that the requisite reasonable belief was present, based on information the taxpayer had received at a seminar on like-kind exchanges of timber and from consulting his accountant on the like-kind issue. The Tax Court held that the taxpayer was entitled to installment sale reporting for the transaction and thus had no actual or constructive receipt of property in 1994. Accordingly, the taxpayer had no recognized capital gain in 1994 from the transaction.

\(^{307}\) See Fredricks v. Comm., TC Memo 1994-27. A taxpayer refinanced property received one week after entering into a contract to sell such property as part of a like-kind exchange under Section 1031. In rejecting the I.R.S.’ argument that the taxpayer had received cash boot in the amount of the loan proceeds, the court relied on the fact that the taxpayer had “reasons for the refinancing that were unrelated to the exchange”. Specifically, the court noted that the existing short-term financing secured by the property needed to be replaced with long-term financing, especially if the contemplated exchange failed to be completed.
became obsolete after that date. In 2007, Final Regulations were issued which apply to all like-kind exchanges occurring on and after February 27, 2004 and which may be applied to exchanges occurring before such date. Highlights of these detailed Regulations include the following:

- The Regulations provide guidance only when both the Relinquished and Replacement Property are subject to MACRS, including where the taxpayer has elected to exclude the Relinquished Property from MACRS under Section 168(f)(1);
- Depreciation of carryover basis is treated the same as under Notice 2000-4, subject to rules when both, either or neither the recovery period or depreciation method are the same for the Relinquished Property and the Replacement Property, and the allocation of depreciation between the properties in the same year;
- Partial year depreciation of the Relinquished Property is calculated on the number of months in service in such year;
- The "exchange basis" or "carryover basis" is the lesser of the adjusted basis of the Relinquished Property or the basis of the Replacement Property;
- Generally, improved residential and non-residential real estate is subject to the mid-month convention which affects the annual depreciation allowance by defining when a property is placed in service;
- If non-depreciable property is acquired in a like-kind exchange, the basis is allocated between depreciable and non-depreciable property as provided in the Regulations under Section 1031(d), and newly acquired MACRS Replacement Property attributable to non-depreciable Relinquished Property is treated as placed in service in the year of acquisition and depreciated as provided in Section 168 for the specific type of property;
- "Excess basis" is treated as newly acquired MACRS Replacement Property attributable to non-depreciable Relinquished Property placed in service in the year of acquisition and depreciated as provided in Section 168 for the specific type of property;
- Only the excess basis in the Replacement Property is eligible for Section 179 election to expense property newly placed in service;

308 Temp. Regs. Section 1.168(i)-6T; TD 9115 (March 1, 2004). Under Notice 2000-4, property acquired in a like-kind exchange was depreciated under Section 168 as follows: (1) Replacement Property that was MACRS property was required to be depreciated in the same manner as the Relinquished Property to the extent that the Replacement Property's adjusted basis did not exceed the Relinquished Property's adjusted basis ("carryover basis"); (2) as to that portion of the Replacement Property's adjusted basis required to be depreciated in the same manner as the Relinquished Property, the portion would be depreciated over the remaining recovery period and using the same method as that of the Relinquished Property; and (3) any "excess basis" in the Replacement Property not attributable to the carryover basis from the Relinquished Property would be treated as newly acquired MACRS property.
309 TD 9314 (February 26, 2007).
310 Regs. Section 1.168(i)-6(k)(2).
• A taxpayer can elect not to apply these regulations, in which case the entire basis of the Replacement Property (both the carryover basis and the excess basis) is treated as being placed in service at the time of acquisition, and the Relinquished Property is treated as disposed of at the time of disposition; and

• The "opt-out" election must be made in writing on I.R.S. Form 4562 or as otherwise provided for on the form or in the instructions, must be filed by the extended due date of the return for the year of Replacement Property acquisition, and may be revoked only with the consent of the Commissioner and only in extraordinary circumstances.
Introduction. There will be situations when, by design or by circumstance, it will be necessary for a taxpayer to acquire title to the Replacement Property before conveying title to the Relinquished Property. There will also be situations where the taxpayer will want to make improvements to the Replacement Property using funds from the sale of the Relinquished Property. Unless there is a non-exchange alternative (discussed at the end of this Chapter), the solution to both of these situations may be to use an a "parking arrangement" where a third party acquires and hold title to one of the properties in the exchange so that the proper order in which the taxpayer first conveys and then receives title to the properties in the exchange is preserved. Additionally, by using a "parking arrangement" the property to be acquired may be improved using funds from the sale of the Relinquished Property without violating the restrictions on Constructive Receipt.

I. "Reverse" Exchanges

A. Types of Reverse Exchanges

1. "True" Reverse Exchange
A "true" reverse exchange occurs when title to the Replacement Property is received by the Exchangor before title to the Relinquished Property is transferred by the Exchangor. Because there is limited authority for a reverse exchange qualifying for non-recognition treatment under I.R.C. Section 1031, most tax commentators agree that a "true" reverse exchange should be avoided if at all possible.

2. "Parking Arrangement" or "Title Holding" Reverse Exchange
A "parking arrangement" or "title holding" type of reverse exchange occurs when title to the Replacement Property is acquired by a title-holding entity not affiliated with the Exchangor and held pending sale of the Relinquished Property, or the Exchangor conveys holds title to the Relinquished Property to an unaffiliated title-holding entity pending its sale to a third party. Parking Arrangements have become common when business reasons compel the acquisition of the Replacement Property before disposition of the Relinquished Property in a like-kind exchange. The preamble to the 1031 Regulations expressly state that the rules for a Delayed Exchange under I.R.C. Section 1031(a)(3) do not apply to a reverse exchange where title to the Replacement Property is acquired before title to the Relinquished Property is transferred.312

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311 See PLR 9823045. A taxpayer exchanged utility easements with another utility company in a transaction where the Relinquished Property was to be conveyed by the taxpayer after receipt of the Replacement Property. The I.R.S. noted that "The facts of this case present a reverse exchange transaction between two parties . . ." and, without providing any legal analysis whether Section 1031(a)(a)(1) encompasses reverse exchanges, held that the transaction qualified as a like-kind exchange under Section 1031.
312 TD 8346 (May 1, 1991).
B. Structure of a Title-Holding Reverse Exchange

Title-holding reverse exchanges may be structured within a Safe Harbor provided by Rev. Proc. 2000-37, or case law that provides the parameters for transactions outside of such Safe Harbor, or in a manner that will comply with both sets of rules. Each of these alternatives are discussed below.

1. Parking Arrangements Within the “QEAA Safe Harbor”

On September 15, 2000, the IRS issued Rev. Proc. 2000-37 that provides a safe harbor for "title-holding" types of reverse exchanges. Rev. Proc. 2000-37 specifically provides that the IRS will not challenge either (a) the qualification of property as either "Relinquished Property" or as "Replacement Property", or (b) the treatment of an "exchange accommodation titleholder" ("EAT") as the beneficial owner of property held by it for federal income tax purposes, if the property is held in a "qualified exchange accommodation arrangement" ("QEAA") under the guidelines set forth in the procedure. Stated more directly, a reverse exchange which follows the safe harbor guidelines will not be challenged by the IRS on the basis that the EAT is merely holding title to the parked property as an agent of the Exchangor, which would result in the Exchangor owning the Replacement Property before conveying title to the Relinquished Property.

(a) Overview of Rev. Proc. 2000-37

Rev. Proc. 2000-37 provides specific rules for a Parking Arrangement ("QEAA Safe Harbor Rules") by structuring an exchange similar, in some respects, to the transaction between a Qualified Intermediary and an Exchangor for a forward delayed exchange under the 1031 Regulations. The rules provide, in essence, for the parking of title to either the Replacement Property or the Relinquished Property in an entity that is not controlled by the Exchangor, the permissible methods of financing the acquisition of the parked Replacement Property, the permitted degree of control that the Exchangor may have over the parked property, and time limits for the identification of the Relinquished Property in the QEAA and the conveyance of the parked property by the EAT. The QEAA Safe Harbor Rules are intended to supplement the general provisions regarding tax-deferred exchanges under I.R.C. Section 1031 and the 1031 Regulations, and in several instances refer to specific 1031 Regulations.

Usually the function of the QEAA will be to acquire and park title to the Replacement Property pending the sale of the Relinquished Property, the sale of which will be set up as a forward Delayed

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Exchange using one of the Safe Harbors provided in the 1031 Regulations. The Exchange Accommodator in the forward Delayed Exchange may be the same or a different person as the EAT in the QEAA. After the sale of the Relinquished Property, the Exchange Accommodator will acquire the parked property from the EAT as Replacement Property in the forward Delayed Exchange, and the parked property will be deeded directly to the Exchangor. Other Replacement Property may also be acquired in the forward Delayed Exchange as well.

(b) Specific Rules and Requirements of Rev. Proc. 2000-37

(i) Written Exchange Agreement
The Exchangor and the EAT must enter into a written agreement establishing a QEAA and providing that (i) the EAT is holding title to the parked property for the benefit of the Exchangor in order to facilitate an exchange under I.R.C. Section 1031 and Rev. Proc. 2000-37, (ii) the Exchangor and the EAT will report the acquisition, holding and disposition of the parked property as provided under Rev. Proc. 2000-37, and (iii) the EAT will be treated as the beneficial owner of the parked property for all federal income tax purposes. The written agreement must be entered into within five (5) business days after the EAT acquires legal title to the parked property.315

(ii) Legal Title Held By EAT
Legal title to the parked property, called "qualified indicia of ownership", must be held in the name of an EAT, which is defined as a "person" (individual or legal entity) that is not the Exchangor or a "disqualified person", and who is subject to federal income tax or is a partnership or S corporation owned by persons subject to federal income tax. The legal title to the parked property may also be held in a single member limited liability company that is disregarded for Federal income tax purposes and is owned by a person who qualifies as an EAT.316 The EAT may also be the Qualified Intermediary for a simultaneous or delayed exchange under I.R.C. Section 1031 and the 1031 Regulations.317

(iii) Time Deadlines
Within 45 days after conveyance of legal title to the EAT, the

315 Rev. Proc. 2000-37 Section 4.02(3).
316 Rev. Proc. 2000-37 Section 4.02(1).
Relinquished Property must be identified.\textsuperscript{318} Not later than 180 days after the EAT acquires title to the parked property, then legal title to such property must be conveyed to the Exchangor if Replacement Property or, if the Relinquished Property in the exchange, to a person who is not the Exchangor or a disqualified person (e.g., sold to a bona fide third party buyer).\textsuperscript{319} If the exchange is one where title to both the Replacement Property and the Relinquished Property is held at various times by the EAT, then the combined time of holding both properties cannot exceed the 180 day limit.\textsuperscript{320} (Note that, by referencing the 1031 Regulations, the days are counted as calendar, not business, days for purposes of calculating the deadlines.)

(iv) Identification
The Relinquished Property must be identified in the same manner as for delayed exchanges under the Qualified Intermediary Safe Harbor.\textsuperscript{321} In the situation where other properties than the Parked Property will be acquired as Replacement Property in the forward delayed exchange of the Relinquished Property, identification of only that portion of the Relinquished Property's exchange value that will be reinvested in the Parked Property should be identified in the QEAA to satisfy the "substantially same property" rule of Regs. Section 1.1031(k)-1(d).

(v) Financing Arrangements
The QEAA Safe Harbor rules permit the Exchangor or a disqualified person to advance or loan funds to the EAT, or guarantee loans or advances made to the EAT by other persons, for the acquisition of the parked property which is Replacement Property in the exchange.\textsuperscript{322} Presumably, loans to the EAT by the Exchangor or a third party, including the seller of the parked property, may be secured by a lien on the parked property. (Note that the QEAA Safe Harbor Rules do not expressly permit the pledging of the parked property to secure a loan to the Exchangor which may be used to acquire such property by the EAT, or having the Exchangor borrow funds secured by the Relinquished Property.)

\textsuperscript{318} Rev. Proc. 2000-37 Section 4.02(4).
\textsuperscript{319} Rev. Proc. 2000-37 Section 4.02(5).
\textsuperscript{320} Rev. Proc. 2000-37 Section 4.02(5).
\textsuperscript{321} Rev. Proc. 2000-37 Section 4.02(4).
\textsuperscript{322} Rev. Proc. 2000-37 Section 4.03(2) \& (3).
(vi) **Control and Improvement of Parked Property**

The parked property may be leased to the Exchangor or a disqualified person under the QEAA Safe Harbor Rules.\(^{323}\) This provision should authorize the EAT to lease the parked property to the Exchangor on a "triple net" basis to make the Exchangor/lessee responsible for the payment of all expenses of the property, maintaining and insuring the property, and permitting the Exchangor to receive rental income from subleasing the parked property. The Exchangor or a disqualified person may also manage the parked property, supervise improvements of the parked property, and act as a contractor or "otherwise provide services" to the EAT with respect to the parked property.\(^{324}\)

(vii) **Variation in Value of Properties**

The Exchangor and the EAT may enter into "agreements or arrangements" relating to the purchase or sale of the parked property, including "puts or calls at fixed or formula prices" effective for a period not to exceed 185 days from the date legal title to the parked property is acquired by the EAT.\(^{325}\)

When the Relinquished Property is held by the EAT, the QEAA Safe Harbor Rules expressly permit the Exchangor and the EAT to enter into agreements providing that "any variation in the value of a Relinquished Property from the estimated value on the date of [EAT's] receipt of the property be taken into account upon the [EAT's] disposition of the property through the taxpayer's advance of funds to, or receipt of funds from, the [EAT]."\(^{326}\)

(viii) **Property Previously Owned by Exchangor**

The safe harbor does not apply to Replacement Property held in a QEAA if the property is owned by the Exchangor within the 180-day period ending on the date qualified indicia of ownership of the property is transferred to an EAT.\(^{327}\)

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324 Rev. Proc. 2000-37 Section 4.03(5).
325 Rev. Proc. 2000-37 Section 4.03(6).
327 Rev. Proc. 2004-51. In an effort to curb perceived abuses of the QEAA Safe Harbor, the I.R.S. amended Rev. Proc. 2000-37 by adding a new Section 4.05 which states, "This revenue procedure does not apply to replacement property held in a QEAA if the property is owned by the taxpayer within the 180-day period ending on the date of transfer of qualified indicia of ownership of the property to an exchange accommodation titleholder." The modification of Rev. Proc. 2000-37 was effective for all transfers to an EAT on or after July 20, 2004. By adding the 180-day look-back period to pre-QEAA ownership, the I.R.S. is clearly intending to exclude from the safe harbor protection transactions where the taxpayer or a related party conveys legal ownership of property to an EAT and then the taxpayer receives such property back as Replacement Property at the end of the QEAA.
(ix) **Open Tax Reporting Issues**

Rev. Proc. 2000-37 provides that the EAT must be treated as the beneficial owner of the property for all federal income tax purposes, but expressly leaves open the question whether or not the EAT may claim depreciation deductions for the parked property. However, because the EAT would acquire the parked property solely for the purpose of reconveying it within 180 days, and would not be holding it for the production of income, then under I.R.C. Section 167(a) the EAT would not seem to qualify to take a deduction for depreciation.\footnote{\text{328}}

(c) **Application of QEAA Rules**

The I.R.S. has ruled favorably on title-holding exchanges that have followed the requirements for a QEAA under Rev. Proc. 2000-37.\footnote{\text{329}}

2. **Parking Arrangements Outside Of The QEAA Safe Harbor**

Parking Arrangements outside of the QEAA Safe Harbor may be necessary where, for example, it is not possible to convey the Replacement Property to the taxpayer within 180 days of its acquisition by the EAT. Rev. Proc. 2000-37 states "... the Service recognizes that "parking" transactions can be accomplished outside of the safe harbor provided by this revenue procedure. Accordingly, no inference is intended with respect to the federal income tax treatment of 'parking' transactions that do not satisfy the terms of the safe harbor ..."\footnote{\text{330}} Prior to the issuance of Rev. Proc. 2000-37, Parking Arrangements were usually structured in one of the manners described below so that the title holding entity had enough "benefits and burdens" of ownership to be considered the owner of the parked property for tax purposes. Such "classic" Parking

\footnote{\text{328}} See Regs. Section 1.168(i)-6(c)(5)(iv)(B). The final regulations that provide guidelines how to depreciate MACRS property acquired in a like-kind exchange specifically reserve the issue of whether an intermediary or an exchange accommodation titleholder is entitled to depreciation on a parked property. See "Depreciation of Property Involved in a Like-Kind Exchange", infra.

\footnote{\text{329}} See PLR 200148042. In this letter ruling the I.R.S. provided some clarification of the boundaries of the QEAA Safe Harbor. Specifically, an EAT under the QEAA Safe Harbor (which was an affiliate of a Qualified Intermediary and held title to Replacement Property in a Parking Arrangement under the QEAA Safe Harbor with the taxpayer), requested guidance on adding a provision to the QEAA which existed among the Qualified Intermediary, the EAT and the taxpayer, which expressly made the EAT an agent of the taxpayer for "... all purposes except for federal income tax purposes". The stated purpose of the provision was to avoid payment of duplicate transfer taxes to local governments, and compliance with all of requirements under the QEAA Safe Harbor were assumed. In its ruling, the I.R.S. stated that, so long as the requirements of the QEAA safe harbor were met and its boundaries were not exceeded, then the taxpayer would be entitled to enjoy the protection of the QEAA Safe Harbor, notwithstanding inconsistent treatment or characterization under state or local law. Such provisions have since become common in many QEAA agreements. See also PLR 200329021. In another letter ruling, the IRS approved a title-holding reverse exchange between related parties (a corporate parent and a subsidiary) that met the requirements of Rev. Proc. 2000-37.

Arrangements qualified for non-recognition treatment under I.R.C. Section 1031, and should continue to do so even after creation of the QEAA Safe Harbor, with the caveat that such classic Parking Arrangements may be subject to closer scrutiny by the IRS than before the creation of the safe harbor.

(a) Possible Structures for Non-Safe Harbor Parking Arrangements

(i) Park Replacement Property

In the preferred method of accomplishing a Parking Arrangement, an EAT, using funds loaned to it by the taxpayer and possibly third-party financing, acquires and holds title to the Replacement Property. Sometime later (which may be longer than the 180-day deadline provided in the QEAA Safe Harbor), the sale of the Relinquished Property closes, and the Exchange Proceeds are paid to a Qualified Intermediary as in a typical forward Delayed Exchange under the 1031 Regulations. Within the 180-day forward exchange deadline, the EAT sells the Parked Property to the Exchangor as the Replacement Property for its purchase price plus acquisition costs. The Exchange Proceeds are used to repay any funds advanced by the Exchangor to the EAT to acquire the Parked Property, and any balance is used to pay down any other acquisition debt, so that when the Exchangor acquires title to the Replacement Property, all of the Exchange Proceeds have been reinvested. This transaction structure is sometimes called an "exchange last" Parking Arrangement.

(ii) Park Relinquished Property

In situations where parking the Replacement Property is not desirable or possible (e.g., favorable financing on the Replacement Property is available only if the Exchangor takes legal title), a Parking Arrangement can be structured where the EAT holds title to the Relinquished Property pending its sale. In this "exchange first" structure, the EAT acquires legal title to the intended Relinquished Property for its estimated fair market value. The EAT gives consideration for the property by taking title "subject-to" any existing financing and by giving the Exchangor a promissory note in an amount equal to the estimated net equity in the property. The promissory note goes to the Qualified Intermediary as Exchange Proceeds from the sale of the Relinquished Property, and is then acquired by the Exchangor or a related
party from the Qualified Intermediary for its face value. After the liquidation of the promissory note, the Qualified Intermediary uses the cash Exchange Proceeds to acquire the target property as the Replacement Property in the exchange that is deeded directly to the Exchangor. At this point the forward exchange is complete. Thereafter, the EAT holds the Relinquished Property until it is sold, at which time the EAT’s promissory note to the Exchangor is repaid to the extent of the net proceeds from the sale. Note that, if the Relinquished Property is encumbered by a mortgage or deed of trust at the time it is conveyed to the EAT, then the lender’s cooperation may be required to permit conveyance of the Relinquished Property without causing an acceleration of the indebtedness under a "due on sale" clause.

(iii) Replacement Property Preferred Method
Most commentators agree that if the financing issues can be overcome using the "exchange last" structure and having the EAT hold title to the intended Replacement Property is preferred for several reasons:

(A) Advance of Full Equity Not Required
When the EAT acquires title to the Replacement Property in an "exchange last" structure, the Exchangor need only advance the minimum amount of funds necessary to acquire the property (e.g., the downpayment required by a purchase money lender), which may be substantially less than the amount of the equity in the Relinquished Property. Following the sale of the Relinquished Property, the required amount of cash equity that must be reinvested in the Replacement Property is available as cash Exchange Proceeds To achieve a complete deferral of all gain in an "exchange first" structure, upon the Exchangor’s acquisition of the Replacement Property it must advance to the EAT funds at least equal to the estimated equity in the Relinquished Property.

(B) Equity Not Estimated
In an "exchange first" structure, because the exact sales price and net equity will probably not be known until the sale of the Relinquished Property, delaying the initiation of the exchange until such property is sold facilitates the exchange of all equity into the Replacement Property, and leaves open the option of acquiring additional Replacement Property if

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331 Occasionally the promissory note will be sold at a discount to a third party, and the amount of the discount is treated as a reduction in the Exchange Value of the Relinquished Property.
necessary to prevent the receipt of taxable boot. In addition, if the exchange spans two tax years (e.g., a return is filed for the year the exchange occurred, but the sale of the parked Relinquished Property closes in a following year), an "exchange last" structure eliminates the possible need to file an amended return to correctly report the amount of the sales price, net proceeds, etc. if the Relinquished Property is sold for a different price or the amount of equity is different than the estimated amounts reported on the original return.

(C) Later Deadlines
The 45-day identification and 180-day exchange deadlines do not begin to run until the Relinquished Property is conveyed, making it easier to acquire more than one Replacement Property (e.g., one Replacement Property is acquired through a Parking Arrangement before the sale of the Relinquished Property, and another after such property is sold in a continuation of the forward exchange).

(D) Undetermined Relinquished Property
If the Exchangor is uncertain which of several possible Relinquished Properties will be sold, parking the Replacement Property defers such decision until one of the possible Relinquished Properties is actually placed under contract or in escrow.

(E) Control of Relinquished Property
Some commentators believe that having the Relinquished Property remain under the Exchangor’s control after its sale to an EAT (as sometimes happens in an "exchange first" transaction) raises an issue whether an actual conveyance of the property by the Exchangor occurred. This problem may be avoided by having a market-rate lease to the Exchangor and third-party management of the property after the conveyance.

(b) Benefits and Burdens Test
To be considered the owner of the parked property for tax purposes, the EAT must have adequate benefits and burdens of ownership to avoid being the taxpayer’s agent in a Parking Arrangement.332 Application of the “benefits and burdens test” to

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332 DeCleene v. Comm., 115 TC 34 (2000). In this case, the taxpayers acquired unimproved property upon which they intended to relocate their business from improved property already owned by them. After the acquisition of the unimproved property, a third party expressed interest in acquiring the improved property. Upon the advice of their accountant, the taxpayers attempted to structure the transaction as a like-kind exchange by conveying their unimproved property by a quit-claim deed to the third party, who
determine the ownership of the parked property is more appropriate than a test based on the principals of agency. For an EAT to have the benefits and burdens of ownership of the Parked Property the structure should include some or all of the following factors:

(i) **Income**
The EAT should realize some net lease income from the property over expenses paid by it or the lessee.

(ii) **Appreciation**
The EAT should have the potential of realizing some capital appreciation on the property, especially if the Parked Property is sold to a party other than the taxpayer.

would improve the property to the taxpayers' specifications and then convey it to them in exchange for receiving title to the improved property. More specifically, the third party acquired the unimproved property from the taxpayers for a non-interest bearing non-recourse promissory note secured by the property, due in one year or the closing of the exchange. The parties then entered into an "Exchange Agreement" wherein the taxpayers agreed to convey their improved property to the third party in exchange for conveyance of the land improved with a new building. Notably, the Exchange Agreement provided that the taxpayers would pay the third party the construction costs of the building at closing, as well as insurance premiums, real estate taxes, interest and all other "soft" costs incurred incident to the construction of the building. In addition, the taxpayers guaranteed a construction loan to the third party for the building, and acted as the "owner's representative" under the construction contract with a builder. In upholding the IRS' position that the transaction did not qualify as a like-kind exchange under Section 1031, the Tax Court relied on the fact that the taxpayers acquired the unimproved property without engaging an exchange facilitator more than a year before their property was relinquished. Further, the Tax Court determined that because the third party never acquired the benefits and burdens of ownership during the construction period (e.g., non-recourse financing, no liability for expenses of ownership, and the taxpayers' control of the construction), the taxpayers remained the owners of the property and could not engage in an exchange with themselves. In substance, the Tax Court found that the taxpayers never disposed of the unimproved property, and its re-conveyance to them was merely a reuniting of legal title with their beneficial ownership.

333 PLR 200111025. In this ruling, the I.R.S. approved a parking arrangement to accomplish a reverse exchange, where the taxpayer entered into a contract with an "accommodation party" to acquire and hold certain property. The acquisition was funded by a bank loan to the accommodation party and guaranteed by the taxpayer. The property was leased under a triple net lease to the taxpayer after its acquisition. Prior to acquiring title to the property, the taxpayer and accommodation party entered into an agreement granting the taxpayer an option to purchase the property at the same cost as that paid by the accommodation party. The taxpayer agreed to indemnify the accommodation party against any loss if it did not exercise the option and the property was sold to a third party and against environmental liabilities. The I.R.S. stated that the three general requirements that must be satisfied for a like-kind exchange under Section 1031 are: (1) The taxpayer must have the intent to exchange of the relinquished property for the replacement property; (2) there must be an interdependent and integrated plan to achieve the like-kind exchange; and (3) no agency relationship exists between the party holding title to the replacement property and the taxpayer. Applying the six criteria set forth in Comm. v. Bollinger, 485 U.S. 340 (1988), to determine whether or not the accommodation party was the taxpayer's agent, the I.R.S. determined that under the facts presented no agency relationship existed, and ruled that the transaction described qualified for non-recognition treatment under Section 1031. This private letter ruling has been questioned widely by tax practitioners as providing any useful guidance principally because there is no analysis under the benefits and burdens criteria set forth in DeCleene v. Comm, and other precedent. It has also been pointed out that, applying the criteria set forth in the ruling, it is unlikely that an accommodation party would ever be determined to be an agent of the taxpayer.
(iii) **Risk**

The EAT should not be insulated fully from all risks of owning the Parked Property including, for example, risks from recourse financing, environmental exposure and/or making an equity investment in the property.

(c) **Integrated Exchange Plan**

The I.R.S. has indicated that a valid Parking Arrangement (outside of the QEAA Safe Harbor rules) also requires an integrated plan to exchange the Relinquished Property for the Replacement Property with mutuality of intent among the parties to effect the exchange.\(^{334}\)

(d) **Financing Issues**

Under either an "exchange first" or an "exchange last" structure for a Parking Arrangement, the Exchangor usually must advance funds to the EAT or arrange for financing from a third-party. It is common for the funds to come from the Exchangor's personal liquid assets or borrowed by the Exchangor and secured by other assets (e.g., a personal residence or investment portfolio). Occasionally the seller of the Replacement Property in an "exchange last" scenario will be willing to carry a note from the EAT pending the sale of the Relinquished Property. Arranging institutional financing to acquire the Parked Property with the EAT holding legal title is sometimes difficult and is usually accomplished only with portfolio lenders. In such cases, a lender may loan funds to the EAT on a non-recourse basis secured by the Parked Property, with the Exchangor giving a personal guarantee and/or pledging other real estate or assets as additional security for the loan. In the past, loans have also been made directly to the Exchangor and secured by the Replacement Property, although this method is now disfavored in light of the permitted financing arrangements set forth in the QEAA Safe Harbor Rules.

\(^{334}\) TAM 200039005. In this situation, the taxpayer had intended to structure a forward delayed exchange using a Qualified Intermediary. However, the sale of the Relinquished Property failed to close, and the seller demanded the taxpayer acquire the intended Replacement Property per their contract. The taxpayer closed the purchase and the Qualified Intermediary took title to the Replacement Property, using funds provided by the taxpayer and purchase money financing that was recourse to the taxpayer. Sometime later, after the taxpayer contracted to sell the Relinquished Property, the taxpayer and the Qualified Intermediary entered into an exchange agreement and assigned the purchase and sale contract to the Qualified Intermediary. After the sale was closed, the Qualified Intermediary deeded the Replacement Property to the taxpayer. The IRS concluded that the Qualified Intermediary acquired the Replacement Property as the taxpayer's agent and, therefore, the transaction constituted a reverse exchange and the Qualified Intermediary safe harbor was not available. In the ruling the IRS noted the lack of an exchange agreement at the time the Replacement Property was acquired by the intermediary, and that there was no mutuality of intent among the taxpayer, the Seller of the Replacement Property and the buyer of the Relinquished Property (who came along after the Replacement Property had already been acquired) to effect an exchange. Accordingly, the IRS concluded, the transaction was a non-interdependent purchase and sale of properties by the taxpayer.
(e) Management and Lease of Parked Property
Whether the EAT holds title to the Relinquished Property or the Replacement Property, such property is usually leased to the Exchangor on a "triple net" basis, and also managed by the Exchangor or an affiliate under a management agreement. The triple net lease makes the Exchangor/lessee responsible for the payment of all expenses of the property, maintaining and insuring the property, and permits the Exchangor to receive rental income from subleasing the parked property.

3. "Super" Parking Arrangements
Because of the 180-day time limit and other requirements for a Parking Arrangement to qualify under the QEAA Safe Harbor rules, it may not be possible for a taxpayer to determine at the structuring stage whether the Parking Arrangement can be completed within the Safe Harbor. However, the Parking Arrangement can be structured so that it complies with both the technical requirements of the QEAA Safe Harbor and with the more general requirements for a Parking Arrangement outside of the safe harbor. If structured properly, an Exchangor can enter into a Parking Arrangement with the intention that it will comply with the QEAA Safe Harbor and the back up position that the parked property will be held in a valid non-QEAA Parking Arrangement where it will not be considered to have been acquired by the Exchangor or its agent.

(a) Combination Parking Arrangement and Forward Delayed Exchange
As noted, to achieve the desired beneficial tax result, a forward Delayed Exchange will always be a part of a successful QEAA. This is accomplished by understanding and integrating the safe harbor provisions for a forward Delayed Exchange under Regs. Section 1.1031(k)-1(g) and for a QEAA under Rev. Proc. 2000-37. Such integrated transactions can acquire other Replacement Property than just the Parked Property and extend up to 360 days from the acquisition of the Parked Property to the acquisition of all Replacement Property.

For example, a Exchangor who owns Property A (with a fair market value of $100) desires to acquire Property B (with a fair market value of $40) before the sale of Property A closes, and other property (with a fair market value of $60 or more) to be acquired after the sale of Property A. This transaction could be structured as follows:

- Property B is acquired by an EAT for $40 in a QEAA established between the Exchangor and the EAT within the requirements of Rev. Proc. 2000-37, including funding of the
acquisition with loans from the Exchangor and/or third parties;

- Within 45 days of the date that Property B is acquired by the EAT in the QEAA, the Exchangor identifies that portion of the value which Property A is expected to be sold that will be exchanged into Property B (in this example, Parked Property FMV$40 = 40% of Property A);

- Within 180 days of the date that Property B is acquired by the EAT in the QEAA, the Exchangor enters into an exchange agreement with a Qualified Intermediary (who may or may not be the same entity as the EAT) for the forward Delayed Exchange of Property A under the safe harbor provided by Regs. Section 1.1031(k)-1(g)(4), and the sale of Property A closes with the Exchange Proceeds being paid to the Qualified Intermediary and other requirements of the safe harbor for a forward Delayed Exchange being met;

- Within 45 days of the sale of Property A in the forward Delayed Exchange, the Exchangor identifies the Replacement Property including Property B held in the QEAA by the EAT;

- Prior to the expiration of the 180-day deadline in the QEAA, Property B is sold by the EAT to the Exchangor as a Replacement Property in the forward delayed exchange (note that up to $40 of the Exchange Proceeds may be used to repay the acquisition loans made to the EAT from the Exchangor or a third-party, and becomes equity reinvested in such property); and

- Prior to the expiration of the 180-day deadline in the forward Delayed Exchange, the desired parcels of identified Replacement Property using the remaining Exchange Proceeds (note that the total time from the acquisition of the Parked Property by the EAT in the QEAA to the acquisition of the last Replacement Property in the forward Delayed Exchange may be up 360 days).

C. Parking Arrangements and Real Property Transfer Taxes

1. Transfer Taxes
Taxes on transfers of real property are imposed by some states, local governments and other agencies (especially in resort communities). The expense of paying transfer taxes first on the conveyance of a parked
property to an EAT and then a second time to the taxpayer or purchaser can significantly increase the cost of a title-holding transaction. Fortunately, many of these governmental authorities also have exceptions for multiple transfers of the same property as part of a unified transaction under I.R.C. Section 1031, such as in a Parking Arrangement. Some examples include the following:

- **Florida Exception for Parking Arrangement Transfers**
  The State of Florida imposes a documentary stamp tax on the conveyance of real property. The Department of Revenue has ruled that the initial transfer of property by an Exchangor to an EAT as part of a "titleholding" type of Section 1031 exchange is an exempt transfer between a principal and its agent and the documentary stamp tax will not be applied.

- **Martha's Vineyard MA Land Bank**
  The Martha's Vineyard Land Bank Commission imposes a 2% assessment on the purchaser of real property within its jurisdiction. Exemptions have been granted for the acquisition and subsequent conveyance of the same property as part of Parking Arrangement.

- **Telluride CO**
  A real estate transfer assessment of 4.85% is imposed on the purchaser of real property in the Town of Telluride and nearby Telluride Mountain Village. An exemption is available for the transfer by a Qualified Intermediary for no consideration of a property held as part of a 1031 exchange for up to six months.

2. **Conveyance of Title-Holding Entity**

The transfer of a membership interest in a single member limited liability company that owns real property, rather than conveyance of fee title to the real property, has become a common structure to save the costs of real estate transfer fees and other costs that would be imposed on the real property transfer. For purposes of a 1031 exchange, receipt by an Exchangor of the sole ownership interest in the single member limited liability company which owned legal title to the Replacement Property would be treated the same as the receipt of the Replacement Property directly by the taxpayer. However, an increasing number of states and

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335 Fla. Stat. Section 201.02(1). The tax rate for documents that transfer an interest in real property is $.70 per $100 (or portion thereof) of the total consideration paid, or to be paid, for the transfer. An exception is Miami-Dade County, where the rate is $.60 per $100 (or portion thereof) when the property is a single-family residence. If the Miami-Dade property is anything other than a single-family residence, the tax rate is $.60 plus $.45 surtax per $100 (or portion thereof).

336 Florida Department of Revenue Technical Assistance Advisement No. 01B4-001 (January 2, 2001).

337 Town of Telluride Municipal Ordinance Section 3.12.010 et seq.

338 Town of Telluride Municipal Ordinance Section 3.12.060.S.

339 See PLR 200118023.
local taxing jurisdictions have recognized the possibility of avoiding real estate transfer taxes by conveying the ownership interest in the entity that holds legal title to the real property. For example, Connecticut imposes taxes on the transfer of a “controlling interest” in an entity that holds title to real property,340 and Florida imposes a documentary stamp tax on the conveyance of ownership interests in entities to whom real property was conveyed without full consideration by a grantor who owns a direct or indirect interest in the entity within three years of the conveyance of such interests.341

II. "Improvement Exchanges"

A. Overview

An Exchangor may want to exchange into a Replacement Property that has not yet been built or requires substantial improvements. An advantage of an Improvement Exchange is that the Exchange Proceeds may be used to improve or repair the Replacement Property. Further, because the Exchange Value of the Replacement Property is determined as of the date that the Exchangor receives title, only the value of any improvements made to the Replacement Property prior to its conveyance to the Exchangor may be included in its Exchange Value.342 Thus, in a properly structured Improvement Exchange, a Replacement Property may be both acquired and improved with Exchange Proceeds, and its Exchange Value increased to match that of the Relinquished Property. Finally, Improvement Exchanges may be accomplished as part of a forward Delayed Exchange or in a parking arrangement.

B. Structures for Improvement Exchanges

1. Forward Improvement Exchange

In a forward Improvement Exchange the Qualified Intermediary, using Exchange Proceeds from the sale of the Relinquished Property, acquires legal title to the Replacement Property in a title-holding entity, usually in a single-member limited liability company or other disregarded entity that is not affiliated with the Exchangor. The title-holding entity, using the Exchange Proceeds and, if necessary, construction financing arranged by the Exchangor, builds the improvements specified by the Exchangor. After the improvements are completed, the title-holding entity sells the Replacement Property to the Exchangor for a purchase price equal to the combined cost of the land and the improvements. The Replacement Property to be improved may also be held in a QEAA subject to the safe

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340 For example, see Conn. Gen. Stat. Chapter 228b, Sections 12-638a & b that imposes a “Controlling Interest Transfer Tax” of 1.11% (which is the same as the real property conveyance tax rate) on the value of an interest in real estate owned by an entity on any transfer of a “controlling interest” in the entity. A “controlling interest” is defined as more than 50% of the voting stock in a corporation, or more than 50% of the capital, profits or beneficial interest in a partnership, association, trust or other entity.

341 Fla. Stat. Section 201.02, as amended by SB 2430 (June 10, 2009).

342 Regs. Section 1.1031(k)-1(e)(4).
harbor rules, in which case the EAT does not necessarily need to be the Qualified Intermediary or an entity controlled by it. If not the same entity, the Qualified Intermediary may loan the exchange proceeds to the EAT to acquire and improve the Parked Property. Note that, in a forward Improvement Exchange, the Replacement Property must be conveyed to the Exchangor within the 180-day Exchange Period, and that only the value of the improvements that are completed as of the day it is received by the Exchangor may be included in the Exchange Value of the Replacement Property.

2. Parking Arrangement-Improvement Exchange

Improvement exchanges may also be structured with the Qualified Intermediary acquiring legal title to the intended Replacement Property in a Parking Arrangement, and making the specified improvements to the Parked Property commencing prior to the sale of the Relinquished Property. Rev. Proc. 2000-37 contemplates that improvements may be made to property held by an EAT in a QEAA, and specifically provides that the Exchangor (or disqualified person) may supervise improvement of the Parked Property or act as a contractor without compromising the QEAA Safe Harbor. Note that Parked Property must be conveyed to the Exchangor within 180 days of its acquisition by the EAT under the QEAA Safe Harbor, and that only improvements which are completed and paid

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343 See PLR 9413006. The I.R.S. has ruled that the general partner of the taxpayer could, in the performance of a construction contract to improve the Replacement Property, draw down on the exchange proceeds held by the Qualified Intermediary and not be in receipt of such proceeds in violation of the constructive receipt provisions of the 1031 Regulations.

344 Regs. Section 1.1031(k)-1(b)(1)(ii) & (b)(2)(ii).

345 Regs. Section 1.1031(k)-1(e)(4).

346 See PLR 200329021. In this ruling the I.R.S. approved a parking arrangement-improvement exchange within the QEAA Safe Harbor. The taxpayer was a subsidiary of a public company that operated the facilities owned by the taxpayer. The taxpayer wanted to sell an existing facility to its parent and acquire a newly constructed facility on land leased by the parent from an unrelated third party at arms-length terms for a term exceeding 30 years. The taxpayer entered into an Exchange Agreement with a professional accommodator to act as the Qualified Intermediary and the EAT, with a disregarded entity holding legal title and constructing the improvements. Under the Exchange Agreement, the taxpayer would assign to the Qualified Intermediary its right to sell the existing facility to a unrelated third party, and its right to take title to the leasehold interest and the improvements within the QEAA deadline. The IRS ruled that the proposed transaction would satisfy the requirements of I.R.C. Section 1031, the delayed exchange regulations and Rev. Proc. 2000-37. Further, the IRS found that the transaction did not violate the related party rules of I.R.C. Section 1031(f) stating, "The proposed transaction involves a related party to Taxpayer (parent) which provides by transfer to QI part of the property that is to become RP [Replacement Property]. 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 Section 1031(f)(4)." See also PLR 200251008.

347 Rev. Proc. 2000-37 Section 4.03(5). Improvements to a parked property held by an EAT are contemplated under the QEAA Safe Harbor, which specifies that "permissible agreements" include arrangements where, "The taxpayer or a disqualified person . . . supervises improvement of the property, [or] acts as a contractor . . . with respect to the property".
for as of such conveyance date may be included in the property's exchange value.\(^{348}\) However, with careful planning, it should be possible to structure a valid Parking Arrangement to hold and make improvements to the Parked Property outside of the QEAA Safe Harbor that would not be subject to such time limits.\(^{349}\)

3. "Holdbacks" Insufficient

A commonly used device to fund improvements to a Replacement Property is to increase the purchase price in the amount of the improvements and have the closing agent withhold sufficient funds from the sales proceeds to pay for such improvements to be made after the sale of the Replacement Property closes. However, the 1031 Regulations provide 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 like-kind."\(^{350}\) This provision precludes an Exchangor from "prepaying" for improvements to be made to the Replacement Property after the title is transferred.

4. Improvement of Land Already Owned By Taxpayer

Sometimes a taxpayer will already own the land it desires to improve prior to commencing an exchange. Under existing case law, the improvement of land already owned by the taxpayer will not qualify for deferral as an exchange under Section 1031.\(^{351}\) More recently, in Rev. Proc. 2004-51 the I.R.S. reaffirmed its position that Section 1031, and specifically the safe harbor provided by Rev. Proc. 2000-37, did not include transactions where improvements were made to land already owned by the taxpayer.\(^{352}\) There are, however, several possible structures for transactions to improve property already owned by the taxpayer.

(a) Conveyance of Taxpayer's Land to a Third Party

One possible, but potentially risky, structure is to have the taxpayer transfer the property to be improved to the other party to the

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\(^{348}\) Regs. Section 1.1031(k)-1(e)(4).

\(^{349}\) See J.H. Baird Publishing Co. v. Comm., 39 TC 608 (1962), acq. 1963-2 CB 4; Coastal Terminals v. Comm., 320 F.2d 333 (4th Cir. 1963); DeCleene v. Comm., 115 TC 34 (2000), discussed in Footnote 332 infra. In all of these cases, the principal issue is whether the party acquiring and improving the property is acting as the taxpayer's agent.

\(^{350}\) Regs. Section 1.1031(k)-1(1)(e)(4).

\(^{351}\) Bloomington Coca-Cola Bottling Co. v. Comm., 189 F.2d 14 (7th Cir. 1951). The conveyance of one property owned by the taxpayer to a person in exchange for the construction of improvements by such person on other property already owned by the taxpayer was found to be the receipt of building services and materials, and not of real property. See also DeCleene v. Comm., 115 TC 34 (2000), discussed in Footnote 332 infra.

\(^{352}\) Rev. Proc. 2004-51 Section 4.05. "An exchange of real estate owned by a taxpayer for improvements on land owned by the same taxpayer does not meet the requirements of code Section 1031. See DeCleene v. Comm., 115 TC 34 (2000); Bloomington Coca-Cola Bottling Co. v. Comm., 189 F.2d 14 (7th Cir. 1951). Moreover, Rev. Rul. 67-255, 1967-2 CB 270, holds that buildings constructed on land owned by a taxpayer is not of a like-kind to involuntarily converted land of the same taxpayer."
exchange prior to the commencement of the exchange, based upon the other party's promise to build the improvements and then convey the improved property to the taxpayer in exchange for other property owned by the taxpayer. In this situation, the key element that the I.R.S. is likely to consider is whether beneficial ownership of the land to be improved is conveyed to the developer for consideration. Therefore, the agreement between the parties should provide for the sale of the property to be improved at a price 332expenses and risk of owning the property, and that the taxpayer will pay the other party the amount that the value of the improved property exceeds the value of the property conveyed to the other party. However, this type of transaction may be vulnerable to application of the step transaction doctrine.

(b) Leaseholds and "Disappearing Leases"
An alternative structure has the taxpayer, or an affiliate of the taxpayer, lease the real property upon which the improvements are to be constructed to a title holding entity or an affiliate of the taxpayer who is not a disqualified person. The ground lease should provide for the payment of a fair market rent and other terms customary between parties dealing at arms-length. Upon completion of the improvements, the lessee transfers the ground lease, with a remaining term of 30 or more years, to the taxpayer as the Replacement Property in a like-kind exchange for a value equal to the cost of the improvements. If the taxpayer was the lessor, then the lease disappears upon the conveyance from the EAT. This structure permits the improvement of the taxpayer's property with exchange proceeds from another property while avoiding a taxable sale of the land and realization of taxable gain by the taxpayer. However, in Rev. Proc. 2004-51, the I.R.S. expressed concern that taxpayers were using Rev. Proc. 2000-37 to build improvements on land already owned by the taxpayer or a related party. Specifically, the I.R.S. stated that it would continue to study "transactions in which a person related to the taxpayer transfer a leasehold interest in the land and the accommodation party makes improvements to".

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353 See PLR 7823035; PLR 8008113 (The exchange of improvements in a shopping center for a fee interest qualified as an exchange under Section 1031); DeCleene v. Comm., 115 TC 34 (2000). Cf. PLR 200921009 wherein the I.R.S. permitted a non-safe harbor reverse exchange on property owned by the taxpayer using an exchange accommodator who was under common ownership and control as the taxpayer, but not technically a "disqualified person". The ruling is notable in that the I.R.S. did not apply the benefits and burdens test articulated in DeCleene or discuss whether the exchange was a step transaction that would result in the taxpayer acquiring improvements on property it owned before the exchange.


355 See PLR 8921058, revoking PLR 8804742; Comm. v. Court Holding Company, 324 U.S. 331 (1945).

356 See PLR 200251008. In this ruling the I.R.S. permitted a reinvestment of exchange proceeds into the cost of a new building built on land leased to an EAT from an affiliate of the taxpayer. See also PLR 200329021; PLR 9243038; PLR 9110007.
the land and transfers the leasehold with the improvements to the taxpayer in exchange for other real estate. Commentators have expressed concern that notwithstanding the "under study" language, Rev. Proc. 2004-51 may have effectively precluded the use of the "leasehold" and "disappearing lease" structures for making improvements to land owned by the taxpayer or a related party all together.

5. Land Not Already Owned By The Taxpayer
The potential problems with improving land already owned by the taxpayer should not be present if the property to be improved is purchased by an EAT or the other party to the exchange (if they are willing to make the improvements) from a third party, and the EAT or other party acquires all the benefits and burdens of ownership of the land.

6. Identification Requirements
To ensure that the Replacement Property received by the Exchangor is properly identified, the 1031 Regulations provide that "property to be produced" is considered to be identified if ". . . as much detail is provided regarding construction of the improvements as is practicable at the time the identification is made."

7. Receipt Requirements
The improved Replacement Property must be “substantially” the same property that was identified by the taxpayer. Variations due to usual or typical production changes (such as changes that commonly occur during the construction process) are not taken into account, but if "substantial changes" are made then the Replacement Property received will not be considered to be substantially the same property as identified. If the identified Replacement Property to be produced is not completed on or before the date the taxpayer receives the property, then the property received will be considered to be substantially the same property as identified only if, had production been completed on or before the date the taxpayer receives the Replacement Property, the property received would have been considered to be substantially the same property as identified. Even so, the property received is considered to be substantially the same property as identified only to the extent the property received constitutes real property under local law. And, only improvements that have been

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357 Rev. Proc. 2004-51 Section 2.06.
359 See DeCleene v. Comm., 115 TC 34 (2000); PLR 8035049; PLR 8217106; PLR 8847042.
360 Regs. Section 1.1031(k)-1(e)(2)(i).
361 Regs. Section 1.1031(k)-1(e)(3)(i).
362 Regs. Section 1.1031(k)-1(e)(3)(iii).
completed as of the date the property is received by the Exchangor may be included in the exchange value of the Replacement Property.\footnote{Regs. Section 1.1031(k)-1(e)(4).}

III. Alternatives to a “Reverse” or “Improvement” Exchanges
Depending on the situation, it may be possible to structure a non-exchange transaction to accomplish the same outcome as a title-holding reverse or improvement exchange.

A. Alternatives to “Reverse” Exchanges

1. Extended Closing Date
In the situation where a title-holding exchange becomes necessary because the sale of a Relinquished Property fails to close, one alternative would be to negotiate an extended closing date for the acquisition of the Replacement Property, allowing the Exchangor additional time to close the sale of the Relinquished Property. Some motivations to obtain the seller’s agreement to an extended closing date could include increasing the amount of the deposit or making some or all of the deposit non-refundable. If when the contract to acquire the Replacement Property is being negotiated the Exchangor believes an extension of the closing date may be necessary, then it would be advisable for the contract to include a buyer’s right to extend the closing date, perhaps with a provision that the deposit would become non-refundable upon the exercise of such right.

2. Lease/Option
In the situation where it is unknown whether a Relinquished Property will close before the Replacement Property, it may be possible to "tie-up" the desired Replacement Property by leasing the Replacement Property with an option to purchase. This structure will give the lessee/optee possession and control of the Replacement Property pending exercise of the option, and will also generate income for the lessor/optionor pending the closing. A potential issue with a lease/option is whether the transaction is an option or a disguised sale of the property. In looking at whether a sale took place, the I.R.S. will consider factors such as the term of the lease/option (lease/options with a longer term tend to be re-characterized more often as a sale), whether the lessee/optee is responsible for payment of taxes, insurance and other expenses of the property pending exercise of the option, whether some or all of the rent payments are credited towards the purchase price, whether the option price remains the same, decreases or increases pending exercise, and whether the lessee/optee has substantial economic exposure if the option is not exercised or the economic terms of the option are such that its exercise is a virtual certainty.
B. Alternatives to "Improvement" Exchanges

1. Build-to-Suit
Where an Exchangor is considering acquiring a property that requires improvements, it may be possible to negotiate for the seller to make improvements to the Replacement Property to the taxpayer's specification prior to the closing in return for an increased purchase price and, possibly, a non-refundable deposit. However, it making such an agreement, it will be necessary to provide that the party constructing the improvements is not acting as the taxpayer's agent and that the transaction is not a disguised sale.  


Chapter Six: Partnerships, Limited Liability Companies, Corporations and Other Entities

I. Partnerships

A. Overview

A partnership, or an entity taxed as a partnership such as a limited liability company, is a common vehicle for the co-ownership of business and investment real property, often as the partnership's only substantial asset. Upon the taxable disposition of a real estate asset with a capital gain by the partnership, generally the partners will realize and recognize capital gain in relation to their respective partnership interests. This result may be avoided if the partnership exchanges its interest in such real estate for other like-kind property under I.R.C. Section 1031.

However, the disposition of the real property held by a partnership is sometimes the result of some or all of the partners' desire to terminate the partnership, and at other times the cause of such termination. For example, sometimes the partners will not agree on the Replacement Property to be acquired in a like-kind exchange. In these situations, sometimes the partners will want to split-up and each go their separate ways, and other times certain partners will wish to continue as partners and others will wish to split off from the partnership. Or, a disposition of the partnership's real estate may, as is common under many partnership agreements, automatically trigger the termination and liquidation of the partnership. In any of these events, each of the partners will suffer adverse tax consequences unless they can somehow structure a like-kind exchange under Section 1031.

Because the exchange of partnership interests do not qualify for non-recognition treatment under Section 1031, several alternative structures for the exchange of a partner's economic interest in the partnership's business or investment real property are discussed below. However, it is important to note that there are a number of potential issues with these types of like-kind exchanges that must be considered by taxpayers and their advisors when undertaking such transactions.366

B. Partnership Split-Ups and Partner Split-Offs

1. Partnership Split-Ups

In the situation where the partners desire to terminate the partnership, the partnership may liquidate its real estate assets in such a manner that each partner may be able to take advantage of I.R.C. Section 1031 by exchanging its respective interest in the partnership's real estate into like-kind property. Two alternative structures to achieve this result are as follows:

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(a) **Liquidation Followed by Exchange**

The most commonly used technique to structure a like-kind exchange of each partner's interest in partnership assets is to have the partnership dissolve and do a tax-free liquidating distribution under I.R.C. Section 731 to each partner of its pro rata share of each real estate asset as a tenant-in-common with the other former partners, followed by each tenant-in-common exchanging its interest for other like-kind property in separate exchanges under I.R.C. Section 1031. This transaction structure is also known as the "drop and swap".

(b) **Exchange Followed By Liquidation**

A less common structure is for the partnership to effect several like-kind exchanges into separate Replacement Properties selected by each of the partners, followed by a dissolution and a tax-free distribution under I.R.C. Section 731 of each Replacement Property to the partner who selected such property in liquidation of that partner's interest, or a partnership division under I.R.C. Section 708(b)(2) with each continuing partnership holding each partner's respective Replacement Property.

2. **Partner Split-Offs**

The situation where certain partners wish to remain partners after disposition of the partnership's real estate assets, and other partners wish to split-off of the partnership, raises more complex issues for the remaining partners who wish to effect an exchange at the partnership level, and for the departing partners each of who wish to effect an exchange as individuals or who wish to "cash out". Partner split-offs have some unique issues discussed below.

3. **Common Tax Issues of Partnership Split-Ups and Partner Split-Offs**

(a) **The Holding Requirement**

As noted, a basic requirement for a like-kind exchange is that both the Relinquished Property and the Replacement property must be "held" for a qualifying purpose. When an exchange is preceded by a distribution of the intended Relinquished Property to the Exchangor from a partnership, or where an exchange will be followed by a contribution of the Replacement Property by the Exchangor to a partnership, then an issue exists whether the Exchangor has satisfied the holding requirement. The I.R.S. has consistently taken the position that distributions out of entities prior to an exchange, or into entities after an exchange, results in the

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Exchange failing to satisfy the requirement that the property be held for a qualified use. In essence, the I.R.S. has refused to "attribute" the holding of the entity to a distributee, and of a contributor to the entity. Further, the risk also exists that the I.R.S. will attempt to apply the "substance over form" doctrine to disallow exchanges preceded by a distribution or followed by a contribution to an entity. Fortunately for taxpayers, the courts have been more favorable to the argument that, notwithstanding a distribution or contribution, the taxpayer is merely continuing its investment in a different form. Although it appeared that in recent years the I.R.S. had become less antagonistic to the "drop and swap" structure, in 2008 I.R.S. Form 1065 was changed to include questions that appear to specifically identify these types of transactions. It is unclear whether this change is a prelude to some form of limitation to the "drop and swap" transaction structure.

(b) Anti-Mixing Bowl Provisions
Under I.R.C. Section 704(c)(1)(B) any distributions of interests in partnership property to retiring partners within 7 years of such property's contribution to the partnership, the contributing partner must recognize and pay tax on the pre-contribution gain as if the property had been sold at fair market value to the retiring partner.

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369 See Rev. Rul. 77-337, 1977-2 CB 305; Rev. Rul. 75-292, 1975-2 CB 333. See also TAM 9645005 (In this ruling under Section 1033, a joint venture distributed a property to its two partners the day before a governmental authority closed on a purchase of the property in lieu of condemnation. One of the partners subsequently attempted to reinvest his proceeds tax-free under Section 1033. Relying on Comm. v. Court Holding Co., 324 U.S. 331 (1945), the I.R.S. ruled that the partner who attempted a reinvestment of his interest under Section 1033 never owned an economic interest in the property, and that it was the partnership, not the individual partner, who sold the property to the governmental entity. This ruling is at odds with the I.R.S.' position in other pre-condemnation sales by partners of former partnership property, and possibly can be explained by the fact the distribution occurred only one day prior to the sale, and the distributed property was subject to a binding contract of sale.); PLR 8527090 and PLR 8041061.

370 See Chase v. Comm., 92 TC 874 (1989). Applying the "substance over form doctrine", the Chase court found that no "exchange" had occurred where a limited partner who received a deed in liquidation of its interest was not treated as the owner of the property when it held the deed for six months and did not record it until shortly prior to closing, and did not negotiate the sale of the property, execute the purchase and sale agreement, pay expenses on the property pending sale, or receive a pro-rata share of the net sales proceeds.

371 See Magneson v. Comm., 81 TC 767 (1983), affd. 753 F.2d 1490 (9th Cir. 1985). In Magneson, both the Tax Court and the appellate court approved the exchange because, "...the new property is substantially a continuation of the old investment still unliquidated (sic)." See also Bolker v. Comm., 81 TC 782 (1983), affd. 760 F.2d 1039 (9th Cir. 1985); Maloney v. Comm., 93 TC 89 (1989).

372 I.R.S. Form 1065, U. S. Return of Partnership Income, Schedule B:
"13. Check this box, if during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (including a disregarded entity).
14. At any time during the taxpayer year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property?"

Representatives of the I.R.S. have indicated that these questions were added at the request of the Treasury Department.
Under I.R.C. Section 737, a contributing partner who receives a distribution of other property from the partnership within 7 years of the contribution must recognize pre-contribution gain to the extent the value of the other property exceeds the partner’s adjusted basis in his partnership interest.

(c) **Special Allocations**

If a retiring partner wants to receive cash upon the disposition of the partnership's property, it may be possible for the partnership to receive cash boot in the exchange and specially allocate the recognized gain to the partner receiving the cash. However, this approach has several potential problems. First, the amount of gain recognized by the partnership may exceed the gain that would be allocable to the retiring partner upon a sale of the partnership property. Second, it is not clear that a special allocation of the gain recognized by a partnership in a partially tax-deferred exchange governed by Section 1031(b) would be respected under I.R.C. Section 704(b), which requires a special allocation to be appropriately reflected in the partners' respective capital accounts and have "substantial economic effect". The Regulations provide for a two-part analysis whether a special allocation has substantial economic effect, requiring that the allocation must have an "economic effect" and that it must be "substantial." It is possible that such a special allocation to the cash-out partner will have substantial economic effect because the allocations must be reflected in the capital accounts of partners and the cash-out partners' adjusted capital account balance will determine the liquidation distributions to the cash-out partners. The economic effect of the allocation made to the cash-out partners will substantial because, as an objective economic matter, the cash-out partners will not participate in the future economic profits or losses attributable to the replacement property after their interest in the partnership is retired. It has also been suggested that the economic effect of the disproportionate allocation of boot gain to cash-out partners will be substantial because the so-called "value equals basis rule." 

(d) **Allocation of Built-In Gain or Loss Under Section 704(c)**

If property contributed to a partnership has a basis to the

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373 Regs. Section 1.704-1(b)(1)(i).
374 Regs. Section 1.704-1(b)(2)(i).
376 See Regs. Section 1.704-1(b)(2)(iii)(c), which provides in the second-to-last sentence that the adjusted basis of partnership property will be presumed to be the fair market value of such property, and adjustments to the adjusted basis of such property will be presumed to be matched by corresponding changes in such property's fair market value.
contributing partner (a "Section 704(c) partner") that is more or less than the fair market value, the property has a built-in gain or loss and such property is referred to as "Section 704(c) property". A partnership that disposes of property with a built-in gain or loss is required to allocate any remaining built-in gain or loss to the Section 704(c) partner in order to prevent the shifting of tax consequences among partners with respect to such built-in gain or loss. Regulation Section 1.704-3 permits the adoption of various methods to allocate for built in gain or loss, including a "traditional method" and "curative methods".

If a partnership disposes of Section 704(c) property in a Section 1031 exchange in which no gain or loss is recognized, Regs. 1.704-3(a)(8) requires that the replacement property be treated as Section 704(c) property and, if gain or loss is recognized in such an exchange, that "appropriate adjustments" are required. The appropriate adjustments contemplated by Section 704(c) should include:

- Treating any gain allocated to the Section 704(c) partner as Section 704(b) gain to the extent there is book gain recognized in the exchange; and
- Treating any taxable gain in excess of the book gain as Section 704(c) gain allocated to the Section 704(c) partner in order to reduce book and tax disparities.

4. Issues Specific to Partner Split-Offs

(a) Exchange By Partnership

If the remaining partners wish to acquire new property as a continuation of the old partnership, then the transaction may be structured as follows:

(i) Distribute Interest As Tenant-In-Common

The partnership distributes to the retiring partner its interest as a tenant-in-common in the property to be sold. The property is then sold and partnership then exchanges its interest into Replacement Property. The retiring partner/tenant-in-common either exchanges its interest for other property or receives cash in a taxable sale.

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377 Regs. Section 1.704-3(a)(3).
378 I.R.C. Section 704(c)(1)(A).
379 Regs. Section 1.704-3(a)(8).
(ii) Distribute Cash Boot
The partnership exchanges the Relinquished Property for a Replacement Property equal in value to the Relinquished Property less the value of the retiring partner's interest, and then distributes cash boot to the retiring partner in liquidation of its interest. This structure may raise the following issues:

(A) Minimum Gain Chargeback
If a retiring partner receives a cash distribution, the retiring partner may have a minimum gain chargeback if such partner has a negative capital account (e.g., if such partner receives cash and is relieved of a partnership debt in a combined amount greater than such partner's capital account).

(B) Allocation Of Gain And Basis
Under the I.R.C. 704(b) regulations, the gain from a sale of partnership property will cause each partner's capital account to be increased by such partner's pro rata share of the gain. If the partnership exchanges the property and receives cash boot, each partner's capital account will be increased by such partner's pro rata share of the boot, even if a retiring partner subsequently receives a cash distribution equal to all of the boot. Therefore, assuming the partners' intention is that the gain be allocated fully to the retiring partner, an alternative may be to have the partnership receive a promissory note from the buyer of the Relinquished Property equal to the retiring partner's interest, and distribute such note to the retiring partner after acquisition of the Replacement Property. Because all of the basis from the Relinquished Property will be allocated to the Replacement Property, this should also resolve any question of whether the partnership's basis in the Relinquished Property is split between the Replacement Property and the cash boot or all allocated to the Replacement Property. Although it seems clear under the 1031 Regulations that the basis should be allocated all to the Replacement Property, some commentators have speculated that a pro rata share of the basis should go with a distribution of cash boot to a retiring partner.

(iii) Buy-Out of Retiring Partner's Interest
Sometimes, a partner may wish to withdraw from a partnership for its own reasons, which may or may not be in connection with a disposition of the partnership's real estate asset.
(A) **Coupled With Sale of Property**

The remaining partners, or a new partner, may purchase a retiring partner's interest in the partnership. Such transaction would be a taxable sale by the retiring partner of its partnership interest and could not be exchanged under I.R.C. Section 1031.\(^{380}\)

(B) **Not Coupled With Sale of Property**

If the remaining partners do not wish to sell the partnership's real property, but the retiring partner wishes to effect an exchange of its interest, the partnership may do a liquidating distribution of a tenancy-in-common interest in the real property for the retiring partner's interest in the partnership, which the remaining partners or the partnership would then purchase from the retired partner. A variation would include having the purchasing partners or the partnership acquire the retiring partner's interest as Replacement Property in an exchange of other Relinquished Property owned by such partners or the partnership.

C. **Exchanges and Partnership Tax Considerations**

1. **Termination of Partnership**

   (a) "Technical Termination"

   A "technical termination" of a partnership occurs upon the sale or exchange of 50% or more of the interests in its capital and profits within a twelve-month period to an outside party or another partner. When such a termination occurs, the assets and liabilities of the terminated partnership are deemed to be contributed by the terminated partnership to a new partnership for the continuation of the business of the terminated partnership by the new partnership, or for its dissolution and winding up of the terminated partnership. Transfers by gift, bequest or inheritance are not considered a sale or exchange of a partnership interest.\(^{381}\) Upon termination, the terminated partnership's assets are deemed contributed to a new partnership, the interests of which are distributed to the new partner and to the remaining partners in proportion to their respective interests in the terminated partnership.\(^{382}\) The issue is whether a like-kind exchange under Section 1031 may be completed by the new partnership if the partnership that transferred the Relinquished Property is terminated under I.R.C. Section 708(b)(1)(B)?

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380 I.R.C. Section 1031 (a)(2)(D).
381 I.R.C. Section 708(b)(1)(B).
382 Regs. Section 1.708-1(b)(1)(4).
(b) **Completion of a Terminated Partnership’s Like-Kind Exchange**

Many professionals believe that the new partnership that arises out of a technical termination can acquire the Replacement Property to complete the Section 1031 exchange for several reasons. First, under I.R.C. Section 704(b), Section 704(c) and Section 737, the effects of a Section 708(b)(1)(B) termination are disregarded. Also, the capital accounts of the partners in the terminated partnership are carried over to the new partnership. 383 Finally, the holding period and the character of the terminated partnership’s assets in the hands of the new partnership are determined under the general rules for contributions of property to a partnership. 384 These commentators have concluded that the overall effect of Regs. Section 1.708-1(b)(1)(iv) and other Regulations has been to minimize or eliminate any artificial adverse effect of a partnership termination caused by Section 708(b)(1)(B). Thus, there is no policy reason why a new partnership should suffer the adverse consequences that would result from being prohibited from completing a like-kind exchange that “straddles” a termination, and that the new partnership should be viewed as a continuation of the old partnership for purposes of Section 1031. 385

2. **Merger, Consolidation and Division of Partnerships**

(a) **Merger and Consolidation**

If two or more partnerships merge or consolidate into one partnership, the resulting partnership is considered a continuation of the merged or consolidated partnership the members of which own an interest of more than 50% in the capital and profits of the resulting partnership. 386 Any other merged or consolidated partnership will be considered as terminated. If none of the members of the resulting partnership owns more than 50% of the capital and profits of the resulting partnership, then all of the merged or consolidated partnerships are deemed to be terminated, and a new partnership results. 387

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383 Regs. Section 1.704-1(b)(2)(iv)(1); Regs. Section 1.704-3(a)(3)(i); Regs. Section 1.737-2(a).
384 Regs. Section 1.708-1(b)(1)(iv).
385 Long v. Comm., 77 TC 1045 (1981). (In dicta, the Long court stated that a technical termination should not invalidate a like-kind exchange.)
386 I.R.C. Section 708(b)(2)(A).
387 Regs. Section 1.708-1(c)(1).
(b) Division

If a partnership divides into two or more partnerships, any resulting partnership shall be considered a continuation of the prior partnership if the members of the resulting partnership had more than 50% of the capital and profits of the prior partnership. Any other resulting partnership will not be considered a continuation of the prior partnership but will be considered a new partnership. If the members of none of the resulting partnerships owned more than 50% of the capital and profits of the prior partnership, then the prior partnership will be considered to have terminated.

3. Contribution of Exchange Property to Partnership

It is not uncommon for several individuals to wish to acquire a real estate asset and form a partnership to own such asset. However, a problem arises if one or more of the partners desire to exchange its interest in Relinquished Property for an interest in the Replacement Property to be owned by the partnership. The principal problem is whether the transaction can be structured to satisfy the "holding" requirement of I.R.C. Section 1031. Three variations to a post-exchange contribution are as follows:

(a) Contribution of Replacement Property After Exchange

One alternative is to have each partner-to-be exchange into the desired Replacement Property as a tenant-in-common. The problem is whether the holding of the property by the partnership will be attributed to the exchanging partner. A possible solution to the "holding" problem would be for each partner to hold its tenancy-in-common interest for a period sufficient to satisfy the holding requirement of Section 1031. Three variations to a post-exchange contribution are as follows:

388 I.R.C. Section 708(b)(2)(B). See also PLR 200921009. In this ruling, the taxpayer, a general partnership owned equally by two general partners, owned property that was acquired under threat of condemnation. The taxpayer made an election under I.R.C. Section 1033 to replace the property, but the two partners could not agree on the property to be acquired. The taxpayer proposed to the I.R.S. to form two new partnerships, one with one of the taxpayer's general partners as the general partner and the other with the other general partner of the taxpayer as the general partner. The taxpayer would then contribute one-half of the condemnation proceeds and the obligation to acquire replacement property under Section 1033 to each of the new partnerships, and receive an interest as a general partner and as a limited partner in each new partnership. Then, each of the taxpayer's general partners would contribute cash to the other general partner's new partnership for a (probably de minimus) limited partner's interest, after which the taxpayer would do a tax-free distribution under Section 731 of its interest to the new partnership to the general partner of such partnership. If either of the new partnerships fail to reinvest the condemnation proceeds, then it will be required to report the income from such failure. The I.R.S. ruled that the new partnerships would be continuing partnership of the taxpayer under the partnership division rules of Section 708(b)(2)(B) andRegs. Section 1.708-1(d)(1) and are entitled to complete the Section 1033 replacement of condemned property, because at least two partners of the taxpayer were partners of the new partnerships and that collectively had more than a 50% interest in the capital and profits of the taxpayer. It has been suggested that this structure may be an alternative to the "drop and swap" structure for a like-kind exchange, if the ruling's analysis under Section 1033 will apply to Section 1031.

389 Regs. Section 1.708-1(d)(1).
holding requirement. Problems with this solution include the questions of what constitutes a sufficient period, whether the co-tenancy may be considered to be a partnership for tax purposes, or whether business considerations may prohibit a tenancy-in-common (e.g., development financing may not be available to a co-tenancy the same as a partnership, or state law considerations may dictate the form of entity).

(b) Contribution of Relinquished Property Prior to Exchange
A second alternative is to have a partner-to-be contribute its interest in such partner's Relinquished Property to the partnership, who then exchanges such interest into the Replacement Property. The problem is whether the contributing partners holding of such property will be attributed to the partnership, so that the partnership can effect an exchange into the Replacement Property without having to recognize the gain.

(c) Section 761 Election
If they qualify, the new "partners" could make an election out of treatment as a partnership for tax purposes. This election could also facilitate a subsequent exchange of the property, because if a partnership makes a Section 761 election, then for the purposes of I.R.C. Section 1031 an exchange of an interest in such partnership is treated as an exchange of an interest in each of the assets of the partnership. However, in practice, it may be difficult to rely on this provision to facilitate the exchange of real property held in a partnership that made an election under Section 761 where title was held in the name of the partnership, or where a co-ownership arrangement may be considered to be a partnership in spite of an election under Section 761.

4. Netting of Liabilities for Partnership Exchanges Over Two Tax Years
Until 2003, the treatment of liabilities when a partnership transfers encumbered property in a Section 1031 exchange has been uncertain because of the coordination between Section 752(b) and Section 1031. Under Section 752(b), a partner is deemed to receive a distribution of money from the partnership to the extent of a decrease in the partner's share of the partnership liabilities. Such distribution is subject to tax to the

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390 I.R.C. Section 761(a).
391 I.R.C. Section 1031(a)(2)(D).
393 See FSA 199951004 (purported exchange of assets found to be an exchange of a partnership interest where the validity of an election under I.R.C. Section 761 found to be questionable); See also PLR 9741017 (co-ownership arrangement which filed an election under I.R.C. Section 761 was a partnership where partnership returns were filed for five consecutive years).
extent it exceeds the adjusted basis of the partner’s interest in the partnership immediately before the distribution. Rev. Rul. 2003-56 clarifies the treatment of exchanges that straddle two tax years. The ruling takes a netting (single transaction) approach as to the liability that encumbers the relinquished property ("relinquished liability") and the liability that encumbers the replacement property ("replacement liability"), such that if the relinquished liability exceeds the replacement liability, the excess (liability reduction) is treated as money or other property received in the first taxable year involved, and if the relinquished liability is less than replacement liability, the difference (liability increase) is taken into account in the second taxable year as a contribution to the partnership by the partners.\(^{394}\)

D. **Limited Liability Companies**

1. **LLCs Taxed As Partnerships**

   Because nearly every state has adopted the Uniform Limited Liability Company Act, and the recognition by the I.R.S. of entities formed in compliance with the provisions of such Act as partnerships for tax purposes, the provisions discussed above regarding partnerships should be equally applicable to limited liability companies.

2. **Single Member LLCs**

   (a) **Disregarded for Tax Purposes**

   A single-owner non-corporate business entity is disregarded as a tax entity separate from the single owner unless an election is made to be taxed as a corporation.\(^{395}\)

   (b) **Use of Single Member LLCs in Exchanges**

   (i) **Receipt of Replacement Property**

   Where title to the Relinquished Property was held by the taxpayer, title to the Replacement Property may be taken in the name of a single member LLC and treated as if received directly by the taxpayer for the purposes of I.R.C. Section 1031.\(^{396}\)

   (ii) **Bankruptcy Remote Entities**

   A two-member LLC may be disregarded for the purposes of I.R.C. Section 1031 where the second member is for the sole limited purpose of preventing the first member/taxpayer from placing the LLC in bankruptcy on its own volition, and


\(^{395}\) Regs. Section 301.7701-2(c)(2).

\(^{396}\) See PLR 9807013.
where the second member has no interest in the LLC’s profits or losses.\textsuperscript{397}

(iii) Post Exchange Transfer of Replacement Property

The transfer of a Replacement Property received by a corporation to a limited liability company with the corporation as its sole member would be disregarded, and that the corporation would still be considered the direct owner of the replacement property for the purpose of determining whether the replacement property was "held" by the taxpayer.\textsuperscript{398}

(iv) Transfer of Interest in Single Member LLC to Avoid Real Estate Transfer Taxes

The transfer of a membership interest in a single member limited liability company that owns real property, rather than conveyance of fee title to the real property, has become a common structure to save the costs of real estate transfer fees and other costs that would be imposed on the real property transfer. For purposes of a 1031 exchange, receipt by an Exchangor of the sole ownership interest in the single member limited liability company which owned legal title to the Replacement Property would be treated the same as the receipt of the Replacement Property directly by the taxpayer.\textsuperscript{399} However, an increasing number of states and local taxing jurisdictions have recognized the possibility of avoiding real estate transfer taxes by conveying the ownership interest in the entity that holds legal title to the real property by imposing taxes on the transfer of a “controlling interest” in an entity which holds title to real property.\textsuperscript{400}

E. Corporations

1. Taxation of Corporate Capital Gains

C corporations do not have the benefit of reduced tax rates on capital gains. Income and losses recognized from the sale or exchange of property is treated the same as ordinary income with one exception: Unused capital losses are only deductible against capital gains.

Structuring like-kind exchanges for C corporations must consider the

\textsuperscript{397} See PLR 199911033.
\textsuperscript{398} See PLR 200131014.
\textsuperscript{399} See PLR 200118023.
\textsuperscript{400} For example, see Conn. Gen. Stat. Chapter 228b, Sections 12-638a & b that imposes a "Controlling Interest Transfer Tax" of 1.11% (which is the same as the real property conveyance tax rate) on the value of an interest in real estate owned by an entity on any transfer of a "controlling interest" in the entity. A "controlling interest" is defined as more than 50% of the voting stock in a corporation, or more than 50% of the capital, profits or beneficial interest in a partnership, association, trust or other entity.
timing of other possibly expiring tax attributes (e.g. net operating losses, credits, capital loss carryovers, etc.). Additional tax concerns in the disposition of property held in a corporation include review of the AMT issues and limitations, interest charges on large installment sales and unique property including intangibles (franchises, government licenses, fleet or portfolio, synthetic leases, etc.).

2. **Section 1031 Exchanges by Corporations**

If a corporation does engage in a like-kind exchange, then the following issues may be applicable:

(a) **Corporation as Exchangor**
If a corporation owns the Relinquished Property at the time of the exchange, the corporation, and not its shareholders, must acquire the Replacement Property. Similarly, if the shareholders own the Relinquished Property at the time of the exchange, the corporation cannot acquire the Replacement Property because it is a different taxpayer.

(b) **Merger or Reorganization During Exchange**
If the corporation undergoes a merger or other tax-free reorganization during the exchange period, however, the successor corporation may acquire replacement property because there is a carryover of Section 1031 attributes following the reorganization.\(^{401}\)

(c) **Change of Shareholders During Exchange**
Changes in the ownership of the stock of a corporation (either a C or an S corporation) during the exchange period should not affect the exchange because the corporation remains a separate entity for tax purposes.

(d) **Exchange by Qsub Corporation**
A qualified Subchapter S subsidiary ("Qsub") is not treated as a separate corporation for tax purposes and the receipt of replacement property by the Qsub should be treated as receipt by the parent S corporation.\(^{402}\)

\(^{401}\) [PLR 200151017](https://www.irs.gov/blinkpl.html). Brother and sister corporations merged under I.R.C Section 368(a)(1)(A) before purchasing Replacement Property. The survivor was permitted to complete the merged corporation's exchange as a permissible tax attribute carryover under Section 381(a). See also [TAM 9252001](https://www.irs.gov/blinkpl.html).

\(^{402}\) See [PLR 99-09054](https://www.irs.gov/blinkpl.html).
(e) Consolidated Groups
An exchange between two members of a consolidated group is ineligible for Section 1031 treatment.\textsuperscript{403} Gain or loss is deferred under the Deferred Intercompany Transaction ("DIT").\textsuperscript{404} Use of a partnership among group members to avoid the prohibition on Section 1031 exchanges is possible but subject to the related party rules of Section 1031(f).\textsuperscript{405}

(f) Conversions to S Corporation Status
C corporations converting to S status are potentially subject to tax on the built-in gain under I.R.C. Section 1374. If a corporation has an open deferred exchange on the date of conversion, then the gain deferred into the replacement property will be exposed to built-in gains tax in accordance with Section 1374 and the regulations thereunder.

3. Trusts

(a) Grantor Trusts
Revocable living trusts and other "grantor" types of trusts created for estate planning purposes are not considered separate entities for income tax purposes, and will usually use the taxpayer identification number of the grantor for the trust. For the purposes of I. R. C. Section 1031, the grantor will be the exchanging party, although either the Relinquished Property, the Replacement Property, or both, may be titled in the name of the trust.\textsuperscript{406}

(b) Land Trusts
Land trusts are a device where the legal title to real property is separated from the beneficial title to such property. Usually, the legal title is conveyed to a trustee under an instrument that reserves the management and control of the property to the beneficiary. The beneficiary exercises all rights of ownership and control over the property except holding or conveying the legal title, which is handled by the trustee at the written direction of the beneficiary. Land trusts exist under the laws of Illinois and other states. For the purposes of a like-kind exchange, for many years the question was whether the beneficiary’s interest is an interest in a trust or other entity that is excluded property under Section 1031, or an interest in real property. However, in 1992 the I.R.S. ruled that a taxpayer’s interest in a land trust has been ruled to be an interest in real property where the trustee has title to real property,

\textsuperscript{403} Regs. Section 1.1502-80(f).
\textsuperscript{404} Regs. Section 1.1502-13.
\textsuperscript{405} See "Related Parties", infra.
the beneficiary has the exclusive right to direct or control the trustee in dealing with title to the property, and the beneficiary has exclusive control of the management of the property, the exclusive right to earnings and proceeds of the property, and the obligation to pay taxes and liabilities relating to the property. 407

4. Tenancy In Common Interests

(a) Tenancy-In-Common Interests

Due to the increase in like-kind exchanges following the issuance of the 1031 Regulations in 1991, interests as a tenant-in-common ("TIC") have become readily available for purchase by investors looking for a Replacement Property to complete a 1031 exchange. The advantages to acquiring such a TIC interest as a Replacement Property, according to their promoters, include the ability to acquire as large or small an interest as the Exchangor needs to acquire to balance the exchange, and the opportunity to acquire an interest in a larger, higher-quality, professionally-managed property. However, there are several issues regarding the qualification of a TIC interest as a viable Replacement Property in a 1031 exchange. These issues include whether such interests are a "security" within the meaning of applicable federal and state securities laws 408 and, as discussed below, whether such interests are a real property interest or an interest in a partnership. In addition, various business issues also exist, including the underlying economics of the properties that are packaged for sale as TIC interests, the market for the resale of TIC interests and the availability of a tax-free exit strategy from TIC properties.

(b) Rev. Proc. 2002-22

In an attempt to get a handle on the tenancy-in-common issue, in 2002 the I.R.S. issued Revenue Procedure 2002-22 providing guidelines for the structuring of such transactions to avoid being deemed to be a partnership. 409 Specifically, the Revenue Procedure provides the guidelines for taxpayers who want to obtain a ruling on whether a tenancy-in-common arrangement is a partnership. Although Revenue Procedure 2002-22 does not provide a safe harbor for structuring tenancies-in-common to avoid partnership status, as a practical matter, the 15 requirements set forth in the Revenue Procedure will be the standard for structuring such transactions and provide a checklist for advisors reviewing

408 See NASD Notice to Members 05-18 "Private Placement of Tenants-in-Common-Interests" (March 2005).
such investments for their clients.\textsuperscript{410} Note that Revenue Procedure 2002-22 is limited in scope to the co-ownership of rental real property (other than mineral interests) in arrangements that are classified under local law as a tenancy-in-common. It is also important to note that individual states may differ from the I.R.S. in the application determination of whether an interest is a TIC interest or an interest in a partnership.\textsuperscript{411}

The 15 requirements set out in Revenue Procedure 2002-22 are:

- **Tenancy In Common Ownership**
  Each owner must hold title to the property as a tenant-in-common under local law, either directly or through a disregarded entity such as single member limited liability company.

- **35 Co-Owners**
  The number of co-owners cannot exceed 35, counting married couples as a single person.

- **No Treatment of Co-Ownership as an Entity**
  The co-owners may not conduct the business as an entity, including filing partnership or corporate tax returns, conduct business under a common name, enter into agreements or refer to themselves as partners, shareholders or members of a business entity, or otherwise hold themselves out as an entity. In addition, the property cannot have been held in an a corporation or partnership immediately prior to holding the property in a tenancy-in-common, a restriction apparently intended to prevent liquidation of partnerships into tenancies-in-common to allow individual partners to effect a 1031 exchange of their interest in reliance on the Revenue Procedure.

\textsuperscript{410} See PLR 200327003. Applying the criteria set forth in Rev. Proc. 2002-22, the IRS issued a ruling favorable to taxpayer that an undivided fractional interest in the property did not constitute an interest in a business entity for purposes of qualifying the interest as a replacement property under I.R.C. Section 1031(a).

\textsuperscript{411} See California Franchise Tax Board Tax News "Like-kind exchange of TIC interest" (November 2007) wherein the FTB stated, " Taxpayers are relying on Revenue Procedure 2002-22 relating to rental real property) to support their position that they hold a TIC interest and are entitled to gain deferral. We will consider this revenue procedure, but will continue to make determinations based on existing law, and the facts and circumstances of each case. The essential question is whether the parties intended to, and did in fact join together for an undertaking or enterprise. Therefore, the substance of the transaction will ultimately determine the type of property interest involved."
- **Co-Ownership Agreement**
  The co-owners may enter into a "limited co-ownership agreement" that may run with the land.

- **Voting**
  The co-owners may agree to be bound by the vote of a majority of the undivided interests, except for decisions to hire a manager, sell or dispose of the property, lease all or a portion of the property, or encumber the property, all of which require the unanimous approval of all co-owners.

- **Restrictions on Alienation**
  Generally, each co-owner must be able to transfer, partition or encumber its interest free of any restrictions, except for customary restrictions required by lenders and the granting of a right of first offer to other co-owners, the sponsor or the lessee at fair market value.

- **Sharing Proceeds and Liabilities Upon Sale of Property**
  If the property is sold, any secured debt on the property must be satisfied and the remaining sales proceeds distributed to the co-owners.

- **Proportionate Sharing of Profits and Losses**
  Each of the co-owners must share in all revenues generated by the Property and costs associated with the Property in proportion to the co-owner's undivided interest.

- **Proportionate Sharing of Debt**
  The co-owners must share in any indebtedness secured by the property in proportion to their respective undivided interests.

- **Options**
  A co-owner may issue a call option for its ownership interest at fair market value at the time of exercise. Put options are not allowed.

- **No Business Activities**
  The co-owners' activities "... must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities)."

- **Management and Brokerage Agreements**
  Such agreements must be renewable no less often than annually, and may provide for a manager to maintain a common bank account, maintain insurance, negotiate leases and loans, all subject to co-owners' approval as required. A manager's fee may not
depend on the income or profits derived from the property and must not exceed the fair market value for such services.

- **Leasing Agreements**
  All leases must be bona fide leases for federal tax purposes, and must be set at fair market value. Rents based on net income, profit, cash flow, increases in equity or similar arrangements are prohibited, although percentage leases bases on receipts or sales are permitted.

- **Loan Agreements**
  Loans from a co-owner, sponsor, manager or lessee to acquire a tenancy-in-common interest in the property are prohibited.

- **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.

(c) **Master Leases**
It appears that most of the restrictions set forth in Rev. Proc. 2002-22 are reasonable and can be used as a basis for structuring tenancy-in-common transactions. Many of the restrictions that may present practical problems in the management of a TIC property can be solved using a long-term Master Lease to an entity that will operate the property and sublease the individual units in the property. For example, a master lease can be used to solve the practical problem of obtaining unanimous consent of all of the tenants-in-common for leasing individual units within the property or entering into management contract. Another example would be to use a master lease to mitigate the prohibition on business activities that effectively prevents operation of the property by the co-owners as anything other than rental property (e.g., a hotel, motel, or a nursing home).
Chapter Seven: Like-Kind Exchanges of Personal Property Under Section 1031

I. Overview

"Personal property", for the purposes of 1031 exchanges, includes any tangible depreciable capital asset, other than real property, which is held for use in a trade or business or investment. In practice, these assets include all types of motor vehicles, aircraft, railroad stock, marine vessels, satellites, equipment and livestock. Certain types of intangible assets may also qualify for non-recognition exchange treatment under Section 1031 including franchise rights, intellectual property rights (patents, trademarks and copyrights) and television and radio licenses. However, the I.R.S. has taken the position that the goodwill of a business and going concern value does not qualify for non-recognition treatment under Section 1031.

II. Defining "Like-Kind" Personal Property

The exchange of personal property assets under Section 1031 may be available for the sale of individual assets (e.g., a computer or vehicle), or the sale of a variety of assets at the same time (such as in a sale of all of the assets of a business). However, in both cases, to qualify for non-recognition treatment under Section 1031, each item of personal property relinquished in the exchange must be determined to be like-kind with the item of personal property received. In a single asset exchange, the like-kind requirement is usually met easily, with both the property relinquished and the property received being in the same "General Asset Class" or the same "Product Class" as of the date of the exchange.

The 1031 Regulations provide for three test of what constitutes "like-kind" personal property:

A. General Asset Classes

The Regulations issued under Section 1031 introduced a "like-class" safe harbor to determine whether items of depreciable tangible personal property were "like-kind" to each other. Items of tangible personal property will be considered to be "like-kind" if they are within the same "General Asset Class" described as follows:

- Office furniture, fixtures and equipment (asset class 00.11)
- Information systems, such as computers and peripheral equipment (00.12)
- Non computer data handling equipment, such as copiers and typewriters (00.13)
- Airplanes (both air frames and engines) except those used in commercial or contract transport of passengers or freight) and all helicopters (both air frames and engines) (00.21)

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412 As noted tax lawyer and exchange commentator Terence Floyd Cuff reportedly stated, "If man can build it, it can be exchanged."
413 Regs. Section 1.1031(a)-2(b)(2)(i)-(xiii).
- Automobiles and taxis (00.22)
- Buses (00.23)
- Light general purpose trucks (00.241)
- Heavy general purpose trucks (00.242)
- Railroad cars and locomotives, except those owned by railroad transportation companies (00.25)
- Over the road truck tractor units (00.26)
- Trailers and trailer mounted containers (00.27)
- Vessels, barges, tugs and marine transportation equipment, except those used in marine construction (00.28)
- Industrial steam and electric generation and distribution systems (00.4)

B. **Product Classes**

As an alternative to the "like class" test, items of depreciable tangible personal property may be like-kind if they are within the same "Product Class" established by the Standard Industrial Classification Codes published by the Office of Management and Budget. Items of property within the same 4-digit Product Class will be considered to be like-kind, except for any "miscellaneous" Product Class (with a Product Class number ending in a 9). For example, all farm and garden machinery is within the same Product Class 3523 and therefore like-kind. An item of personal property may be included in more than one Product Class, it is treated to be in any one of those Product Classes, creating more possibilities for being like-kind with other depreciable tangible personal property.\(^{414}\)

The SIC Codes are complex and, unfortunately, their use to determine whether personal property is within the same Product Class has been confused by their replacement in 1997 with the North American Classification System Manual. The I.R.S. has referred to the SIC Codes rather than the NACS Manual classifications as recently as 2001 to determine product classes, although no official position has been announced which standard will apply in the future.\(^{415}\)

C. **"Nature or Character" Test**

1. **General Rule**

   Tangible personal property may be "like-kind" even if it is not "like class" or within the same Product Class under the safe harbor established by the Regulations. However, the like-kind standard is less broad than for exchanges of real property, and requires properties to be of the same "nature or character", and perhaps with similar use.\(^{416}\) Examples of tangible personal property which has been determined to be like-kind outside of the safe harbor established by the Regulations include:

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\(^{414}\) Regs. Section 1.1031(a)-2(b)(3).
\(^{415}\) PLR 200110902.
\(^{416}\) Regs. Section 1.1031(a)-1(c).
• Major league sports contracts
• Bullion-type (non-currency) gold coins
• Livestock of the same sex and half-blood heifers for three-quarters blood heifers
• Assets of a television station for those of another television station
• FCC television licenses for FCC radio licenses
• FCC licenses for spectrum rights in certain bandwidths for FCC licenses for spectrum rights in other bandwidths
• Emission allowances allocated by the EPA
• Environmental impact mitigation credits
• Cars and "light-duty trucks"

2. Intangible Personal Property

(a) Intangible Assets
Intangible assets that may qualify for non-recognition treatment under Section 1031 include franchise rights, intellectual property rights (patents, trademarks and copyrights) and television and radio licenses. Whether any particular item of intangible property is like-kind to another item, "... generally depends on the nature or character of the rights involved (e.g., a patent or copyright) and also on the nature or character of the underlying property to which the intangible personal property relates." For example, a copyright for a novel would be like-kind to the copyright for a different novel, but not for the copyright for a song.

(b) Goodwill
The 1031 Regulations state that the goodwill or going concern value of a business is never like-kind to that of another business, and do not qualify for non-recognition treatment under Section 1031. The I.R.S. had concluded that the registered trademarks

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417 Rev. Rul. 82-96, 1982-1 CB 113; Rev. Rul. 76-214, 1976-1 CB 218 (Mexican 50-peso bullion-type gold coins for Austrian 100-corona bullion-type gold coins); See also Rev. Rul. 79-143, 1979-1 CB 264 (United States $20 numismatic-type gold coins for Canadian Maple Leaf bullion-type gold coins not of like-kind).
418 See I.R.C. Section 1031(h). (Livestock of different sexes are not property of a like-kind.)
420 TAM 200035005.
421 PLR 200532008.
423 PLR 200912004. (Cars, light general purpose trucks (for use over the road having actual unloaded weight of less than 13,000 pounds) and vehicles that share characteristics of both cars and light general purpose trucks (e.g. crossovers, sport utility vehicles, minivans, cargo vans, and similar vehicles) are of like-kind for purposes of I.R.C. Section 1031.)
424 Regs. Section 1.1031(a)-2(c)(1).
425 Regs. Section 1.1031(a)-2(c)(3).
426 Regs. Section 1.1031(a)-2(c)(2).
and trade names of a business entity could not be of like-kind to the trademarks and trade names of another business entity because they were "closely related to (if not a part of) the goodwill or going concern value of a business."  

However, in March, 2009 the I.R.S. modified its position, stating that intangibles such as trademarks, trade names, mastheads, and customer-based intangibles that can be separately described and valued apart from goodwill can qualify as like-kind property, and if the properties also satisfy the nature and character rules of Regulation Section 1.1031(a)-2(c)(1)) and the other requirements of Section 1031. The I.R.S. also opined that, except in rare and unusual situations, intangibles such as trademarks, trade names, mastheads, and customer-based intangibles can be separately described and valued apart from goodwill.

III. Identification Requirements

In addition to the more specific requirements discussed above, a delayed exchange of personal property must also comply with the general requirements of the Qualified Intermediary "safe harbor" provided by the Regulations, including the use of an independent third party as the Qualified Intermediary, time deadlines for the identification and receipt of replacement property, etc. The Regulations require that the identification of replacement property to be received in an exchange must specifically describe a particular type of personal property. For example, in an exchange of two automobiles, an unambiguous description of the replacement vehicle would describe the specific make, model and year of the automobile. In addition, the "incidental to a larger item" rule applies for personal property identifications, if the incidental item is typically transferred together with the larger item and the fair market value of the item does not exceed 15% of the larger item. The other general rules of identification under Section 1031 also apply to personal property exchanges, including the "3 property rule", "200% rule" and "95% rule" limitations on the number of properties that may be identified, regardless of the number of groups of personal property in the exchange.

IV. Reporting the Personal Property Like-Kind Exchange

A. Single Asset Exchanges

The gain, balancing of equity and debt, and calculation of adjusted basis for a single-asset personal property exchange should be determined as described in Chapter Five, Section I.A, B and C, above.

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427 TAM 200602034; See also FAA 20074401F. (Newspapers' mastheads, advertiser accounts and subscriber accounts were closely related to, if not a part of, the goodwill and going concern value of the newspapers, and therefore were not of like-kind under Regs. Section 1.1031(a)-2(c)(2).)  
428 ILM 200911006. The I.R.S. also stated that it will no longer follow the position set forth in TAM 200602034 and FAA 20074401F on this issue.  
429 Regs. Section 1.1031(k)-1(c)(3).  
430 Regs. Section 1.1031(k)-1(c)(5).
B. Multi-Asset Exchanges

In Multiple Asset Exchanges, the like-class and like product code classifications can be used to group assets to determine the recognition or non-recognition of gain for each group. This approach is different from the property-by-property approach otherwise set forth in the 1031 Regulations. The 1031 Regulations describe a procedure for the grouping of assets and determination of gain and basis for each group:

- **Step One: Group Assets.** Both the properties relinquished and properties received are grouped into like-class (using the General Asset Class or Product Class) or like-kind groups, and a residual group of any "other property" which cannot be included in any other group;

- **Step Two: Balance Liabilities.** The aggregate amount of all liabilities "assumed" by the Exchangor is offset by the aggregate amount of all liabilities released, and the amount by which liabilities exceed liabilities released is allocated among the various groups of Replacement Property on a pro rata basis;

- **Step Three: Determine Surplus or Deficiency.** The aggregate exchange value of the properties in such exchange group relinquished (the aggregate fair market value of each property in the group less the amount of any surplus liabilities allocated to such group) and compared to the aggregate exchange value of each of the properties in each exchange group received; and

- **Step Four: Determine Gain and Basis.** The gain and adjusted basis for each item of Replacement Property is determined, with gain being recognized to the lesser of the exchange value deficiency for such group or the amount of realized gain for such group. The adjusted basis is calculated for each group and allocated pro rata among the individual properties according to their fair market value.

C. Section 1245 Recapture

For a single asset exchange of personal property, gain may be recognized on "Section 1245 Recovery Property" as ordinary income to the extent of taxable boot plus the amount by which the fair market value of Section 1245 Recovery Property relinquished is greater than the fair market value of such property received or of property received that is not Section 1245 Recovery Property. The Regulations do not address how to apply the depreciation recapture rules to multiple asset exchanges. Applying the group approach of the multi-asset exchange regulations (instead of a property-by-property approach), allocation of

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431 Regs. Section 1.1031(j)-1(a) & (e).
432 Regs. Section 1.1031(j)-1(b)(2).
433 I.R.C. Section 1245(a)(3).
recapture on a group-by-group basis may be reasonable with an pro rata allocation among the properties in a group according to their respective fair market values.

V. "LKE Program" Exchanges

Certain industries routinely exchange large numbers of individual items of personal property. For example, companies that lease vehicles will exchange the vehicles that have expiring leases from their fleet, and sold to the lessee and third-party buyers, often on a daily basis. Because each of these exchanges are substantially identical, in 2003 the I.R.S. issued safe harbor rules for "LKE Program" exchanges.\textsuperscript{434} These rules are applicable to programs involving ongoing exchanges of 100 or more items of tangible personal property using a single exchange intermediary under a "master exchange agreement".\textsuperscript{435} The I.R.S. has shown flexibility in the structure of LKE Programs that meet the criteria of the safe harbor.\textsuperscript{436}
Chapter Eight: The Regulation and Operation of Exchange Accommodators

I. Regulation of Exchange Accommodators

A. Introduction

There are a large number of individuals and companies willing to act as a Qualified Intermediary in a like-kind exchange, including attorneys, accountants, real estate brokers, title companies and independent companies that specialize in accommodating exchanges. Notwithstanding the large volume of exchange transactions and funds handled by Exchange Accommodators, until recently the industry has been largely self-regulated. In 1989, the Federation Of Exchange Accommodators ("FEA") was organized as a national trade association organized to establish and promote ethical standards of conduct for those who conduct like-kind exchanges. Although the FEA has no regulatory or other authority, its members are required to adhere to the organization's Code Of Ethics 437 and it does have a program to certify that individuals possess a certain requisite level of knowledge and expertise in handling like-kind exchanges.438

Understandably, in addition to the competence of an Exchange Accommodator and the costs of an exchange property owners and their advisors are concerned about how the funds that are entrusted to the Exchange Accommodator will be handled and invested. Although losses due to instances of mismanagement or malfeasance involving clients' funds by Exchange Accommodators are not something new,439 in recent years such losses have become more commonplace with significant or catastrophic consequences for their clients. In 2007, the FEA reported to the Federal Trade Commission that it was aware of 23 instances, involving $250 million in estimated losses, in which Qualified Intermediaries might not have met their fiduciary responsibilities to their clients.440 One of the more publicized cases alone accounted for $130 million of the estimated losses.441 In 2008, one of the largest Qualified Intermediaries filed for bankruptcy after being unable to fund clients’ acquisitions of Replacement Property due to the loss of liquidity in the Qualified Intermediary’s investment accounts that held

437 See Federation of Exchange Accommodators, Code of Ethics.
438 See Federation of Exchange Accommodators, "About Certified Exchange Specialists". An individual certified by the FEA is known as a "Certified Exchange Specialist" ("CES").
441 In Re The 1031 Tax Group, et. al., Case No. 07-1148 (ALG) (United States Bankruptcy Court Southern District of New York). See "Lavish lifestyle has $130M collapse", South Florida Business Journal (December 7, 2007); The 1031 Tax Group Bankruptcy Trustee.
approximately $400 million in clients’ funds.\footnote{8}{In Re LandAmerica Financial Group, Inc., et al., Case No. 08-35994-KRH (United States Bankruptcy Court Eastern District of Virginia Richmond Division). See “LandAmerica’s Collapse Leaves Investors Looking for Cash”, The Wall Street Journal (December 3, 2008).}

In response to the increasing number of cases involving mismanagement or malfeasance by Exchange Accommodators, a number of states have enacted regulatory regimes with the intent of protecting consumers who entrust their funds to Exchange Accommodators operating within their jurisdiction.

B. Federal Regulation

It has been suggested that the Federal Trade Commission and the I.R.S. take a more active role in the supervision of Exchange Accommodators and alerting taxpayers to potential risks.\footnote{443}{See “Guidance Could Be Enhanced for Deciding to Use a Qualified Intermediary in Like-Kind Exchanges”, Treasury Inspector General for Tax Administration, Report Reference Number 2008-30-154 (August 27, 2008) at page 5.} However, so far neither the I.R.S. nor any other federal agency has indicated an interest in being involved in the regulation of the like-kind exchange industry.

C. State Regulation

The regulatory systems enacted by those states that regulate Exchange Accommodators operating within their jurisdiction may be separated into two categories; those states who have adopted statutes based on the model legislation promoted by the FEA and those who have drafted their own regulatory structure. However, it is important to note that even the states who have adopted statutes based on the FEA's model legislation have individual variations.

1. FEA Model Legislation

The following states have adopted a regulatory structure based on the FEA’s model legislation:

- California\footnote{444}{Cal. Fin. Code Division 20.5, Section 51000 et seq., (effective January 1, 2009).}
- Colorado\footnote{445}{Colo. H.B. 09-1254 (April 16, 2009), Colo. Rev. Code Title 6, Article 1, Part 7 (effective April 16, 2009).}
- Maine\footnote{446}{Me. Pub.L., Chapter 61, LD 165 (April 30, 2009), Me. Rev. Stat. Title 1, part 10, Chapter 212-C, section 1395 et seq., (effective Sept. 12, 2009).}

The common elements of the FEA model legislation are discussed below:
(a) **Definitions**

(i) **“Exchange Facilitator”**
An Exchange Facilitator is anyone who acts as a Qualified Intermediary for any Relinquished Property located within the state adopting the legislation, takes title to property located in the state as an EAT, acts as the trustee of a Qualified Trust or the escrow holder in a Qualified Escrow, or maintains an office in the state or advertises in the state for the purpose of soliciting business as a Qualified Intermediary. Specific exclusions are provided for financial institutions who act merely as a depository for exchange funds, or title or escrow companies that act as the trustee of a Qualified Trust or the escrow holder in a Qualified Escrow, or entities affiliated with an Exchange Facilitator to facilitate exchanges or take title as an EAT to property located in the state, or Qualified Intermediaries who hold funds from the disposition of property located outside of state.

(ii) **“Prudent Investor Standard”**
The Prudent Investor Standard is defined as the standard for a fiduciary in the investment of assets held for the benefit of another person.\(^\text{448}\)

(b) **Requirements**

(i) **Notification of Change in Control**
Exchange Facilitators must give written notification to all customers whose Relinquished Property is located in the state, or who has property located in the state held in an EAT, of any “change of control” (50% of the Exchange Facilitator’s assets or ownership interests), unless the Exchange Facilitator is a publicly traded company or subsidiary before and after the change.

(ii) **Fidelity Bond and Alternatives**
Exchange Facilitators must maintain a fidelity bond of at least $1,000,000, or deposit cash, securities or irrevocable letters of credit in the same amount with a financial institution, or deposit all funds held on behalf of clients into an account maintained under a Qualified Escrow or a Qualified Trust that requires the written authorization of both

\(^{448}\) California incorporates the “prudent investor rule” set forth in Calif. Probate Code Article 2.5, Section 16045 et seq. Washington incorporates the provisions of Wash. Rev. Code Section 11.100.020, which includes specific guidelines for the investment of funds using a “total asset management approach”

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the Exchange Facilitator and the client for any withdrawal. A person who claims to have sustained damages by reason of the fraudulent or dishonest acts of an Exchange Facilitator or its employee may file a claim the fidelity bond or alternative to recover the damages.

(iii) **Errors and Omissions Insurance and Alternatives**
An Exchange Facilitator shall maintain a policy of errors and omissions insurance of at least $250,000, or deposit cash, securities or irrevocable letters of credit in a like amount into an interest-bearing deposit account. A person who claims to have sustained damages by reason of an unintentional error or omission of an Exchange Facilitator or its employee may file a claim the insurance policy or alternative to recover the damages.

(iv) **Holding and Investment of Exchange Funds**
An Exchange Facilitator shall hold exchange funds in a manner that provides liquidity and preserves principal and, if invested, shall also invest the funds in investments that meet the “prudent investor standard.” Prohibited acts and transactions include the knowing commingling of exchange funds with the operating accounts of the Exchange Facilitator, the loan or transfer of exchange funds to any affiliate of the Exchange Facilitator (except to an Exchange Accommodation Titleholder), the investment of Exchange Funds in a manner that does not preserve the principal or provide sufficient liquidity to meet the Exchange Facilitator's contractual obligations to its clients. Finally, the act provides that Exchange Funds are not subject to execution or attachment on any claim against the exchange facilitator.

(v) **Prohibited Acts**
An Exchange Facilitator shall not commit any of the following acts:

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449 The Washington statute provides an exception if the loss of principal or insufficient liquidity results from “events beyond the prediction or control of the Exchange Facilitator” including, but not limited to, the failure of a financial institution, or from an investment specifically requested by the client. Wash. Engrossed Second House Bill 1078, Section 9(c) (April 13, 2009).

450 It is questionable whether this provision, by itself, would be effective to exclude the Exchange Funds from the bankruptcy estate of an Exchange Facilitator under the U. S. Bankruptcy Code.

451 In Washington, commission of any of specified acts are a Class B felony punishable by up to 10 years in jail and a $20,000 fine. Wash. Rev. Code Chapter 9A.20.
Knowingly make a false, deceptive, or material misrepresentation either directly or indirectly, or in advertising or by any other means, concerning a like-kind exchange

Engage in any unfair or deceptive practice

Obtain property by fraud or misrepresentation

Fail to account for money or property belonging to others in the possession or control of the Exchange Facilitator

Commingle exchange funds with the Exchange Facilitator's funds

Loan or transfer funds to an affiliate or related party of the Exchange Facilitator

Keep funds in an account designated as belonging to a particular client unless the funds belong to that client and the client actually entrusted those funds to the Exchange Facilitator

Fail to fulfill its contractual duties to a client to deliver property or funds to a client in a material way unless the failure is due to circumstances beyond the control of the Exchange Facilitator

Commit, including commission by its owners, officers, directors, employees, agents, or independent contractors, any crime involving fraud, misrepresentation, deceit, embezzlement, misappropriation of funds, robbery, or other theft of property

(c) Civil Remedies
A person who violates the act is also subject to civil suit in a court of competent jurisdiction.

(d) State-by-State Variations from the Model Legislation
Some variations in the legislation based on the FEA's model legislation as adopted by each state are noted below. However, the statutes of each state should be consulted by any person who may be subject to their application.

(i) Colorado
If the exchange funds for a particular client exceed $250,000, then the withdrawal of the funds requires the authorization of both the Exchange Facilitator and the client. The client's authorization for withdrawal is also required if exchange funds are held in a Qualified Escrow or Qualified Trust account in lieu of the Exchange Facilitator maintaining a fidelity bond.
• Exchange Facilitator has a fiduciary duty to protect and preserve the exchange funds.

(ii) Maine
• The new law requires annual licensing of any person acting as an Exchange Facilitator for relinquished property in Maine.
• The new law requires a minimum fidelity bond of $250,000 and minimum errors and omissions insurance coverage of $100,000.

(iii) Washington
• An Exchange Facilitator must deposit all Exchange Funds for a particular client or matter of $500,000 or more in a “Separately Identified Account” (as defined in Treasury Regulation Section 1.468B-6(c)(ii)) and the client must receive all the earnings on such account. Exchange Funds of less than $500,000 may be deposited in a pooled interest-bearing trust account if the client agrees to pooling in writing or, if the client does not agree to pooling, in a Separately Identified Account. An Exchange Facilitator must provide the client with written notification of how the client’s Exchange Funds have been invested or deposited.
• An Exchange Facilitator must administer each place of business under the direct management of an officer or an employee who is either an attorney or certified public accountant admitted to practice anywhere in the United States, or a person who has passed a test specific to the subject matter of exchange facilitation.\(^452\)

2. Other Regulatory Structures

(a) Nevada
Nevada was the first state to enact regulations specifically applicable to Exchange Facilitators in 1993 and amended the law on several occasions thereafter. In 2007, responding to the loss of approximately $100 million from the defalcation of a Nevada-based Exchange Accommodator, the Nevada legislature passed a new law\(^453\) that requires (among other things) Exchange Facilitators doing business in Nevada to be licensed annually (including the

\(^{452}\) Although not specified, presumably a person who has received the CES certification from the FEA as would satisfy the requirement to have “passed a test . . .”

licensing of certain owners, directors and officers which includes a background check), must maintain a minimum $1 million fidelity bond and a minimum of $250,000 errors and omissions insurance, must deposit all exchange funds into a Qualified Escrow or Qualified Trust account that requires the signatures of both the Exchange Facilitator and the client to withdraw the funds, imposes fiduciary duty in the investment of exchange funds, must have a designated "exchange facilitator officer" who is an attorney, CPA, CES or has been actively conducting the business for the prior 3 years, and requiring the state banking commission to audit all Exchange Facilitators every 5 years.

(b)  Idaho
Idaho made Exchange Facilitators subject to the Idaho Escrow Act\(^\text{454}\) on July 23, 2007.\(^\text{455}\) The Idaho Escrow Act requires (among other things) that all Exchange Facilitators doing business Idaho (other than just acquiring Replacement Property on behalf of a client) must be licensed annually by the state, must have a designated supervisor with at least 3 years experience, must maintain a fidelity bond of at least $1 million and errors and omissions insurance of at least $250,000, must maintain separate escrow and trust fund accounts at a bank authorized to do business in the state, must preserve and protect exchange funds as a fiduciary including no commingling with operating funds, a new license may be required upon a change in ownership or control, and acting as an Exchange Facilitator without a license is a felony and may result in civil penalties up to $5,000 per violation.

(c)  Minnesota
The Omnibus Public Finance Bill\(^\text{456}\) was signed into law on May 16, 2009 and contains a provision requiring information reporting by Exchange Facilitators upon notice and demand from state regulators.\(^\text{457}\) The effective date is July 1, 2009, and applies to all transactions whether facilitated on, before, or after that date.

\(^{454}\) Id. Code Title 30, Chapter 9, Section 30-901 et seq.
\(^{456}\) Minn. H.F. No. 1298 (May 13, 2009) (effective July 1, 2009).
\(^{457}\) Minn. H.F. No. 1298, Section 2 provides: "Minnesota Statutes 2008, section 289A.12, is amended by adding a subdivision to read: Subd. 16. Qualified intermediaries. The commissioner may by notice and demand require a qualified intermediary to file a return relating to transactions for which the intermediary acted to facilitate exchanges under section 1031 of the Internal Revenue Code. The return must include the name, address, and state or federal tax identification number or Social Security number of each of the parties to the exchange, information relating to the property subject to the exchange, and any other information required by the commissioner. EFFECTIVE DATE. This section is effective July 1, 2009, and applies to all transactions whether facilitated on, before, or after that date."
(d) **Oregon**

Oregon House Bill 3484 will become effective January 1, 2010. The new law requires Exchange Facilitators to have a fidelity bond of $1 million, E&O insurance coverage of $250,000 (or acceptable substitutes), to adhere to the "prudent investor rule" regarding investment of exchange funds, prohibits commingling of exchange funds with operating accounts, and requires ten-day notice of change of control of an Exchange Facilitator.\(^{458}\)

3. **Other States**

Other states that are in the process of adopting legislation to regulate Exchange Facilitators or considering proposals to regulate Exchange Accommodators, include the following:

- Arizona
- Oklahoma
- Texas

II. **Operation of Exchange Accommodators**

A. **Introduction**

Being part of an exchange accommodation service can be one of the most interesting and challenging businesses for professionals with a background in law, accounting, finance and real estate. In the author's experience, few businesses require such a broad range of knowledge including tax, business, real estate and commercial law, finance and investment management, combined with the day-to-day challenges of running a business with scores of transactions and handling millions of dollars on a daily basis.

The operation of a business providing services as a Exchange Accommodator is rapidly becoming a more complex proposition than in years past. Where once an exchange accommodation service needed little more than someone familiar with the procedures for a 1031 exchange, a set of documents and a bank willing to hold the exchange funds, now the increasing complexity of the law and procedure for 1031 exchanges, combined with greater regulation of the industry and an increasingly sophisticated clientele, requires that anybody providing exchange accommodation services be highly knowledgeable, competent and forthright in their business dealings. This Section is intended to alert those who provide exchange accommodation services, or are interested in becoming involved in providing such services, to some of the key issues in the operation of this unique industry.

B. **Client Funds**

The receipt, handling and disbursement of funds held on behalf of clients is

\(^{458}\) Ore. H.B. 3483 (June 5, 2009).
possibly the one function of a Exchange Accommodator most susceptible to honest mistakes and dishonest conduct. The amount of client's funds that may be handled by even a small-volume exchange accommodation service is sometimes disproportionate to the business experience or competence of the operators, who may find themselves suddenly holding millions or tens of millions of dollars with few or no legal or regulatory constraints on how to handle the funds other than an exchange agreement with their client. Accordingly, an overview of the methods and rules applicable to the holding, investment and accounting of client's funds is warranted, which should also be the subject of careful planning with the operator's accounting, legal and investment advisors.

1. Fiduciary Duty

The 1031 Regulations do not specify that an Exchange Accommodator has a fiduciary duty to an Exchangor arising out of the relationship created by the like-kind exchange. A fiduciary duty may exist under applicable state law if created by the express language of the agreements between the parties. For example, the agreement setting up a Qualified Exchange Trust will expressly establish the existence of a fiduciary relationship between the trustee (usually a financial institution) and the beneficiary/Exchangor, and an agreement setting up a Qualified Exchange Escrow may create a fiduciary duty on the part of the escrow holder to the Exchangor depending on the terms and applicable state law. Further, depending on the facts and circumstances of the parties' relationship, courts may find an Exchange Accommodator has a fiduciary duty to its client by establishing a "resulting trust" under applicable state law based on the language of the agreements and conduct of the parties.459

Although many Exchange Accommodators expressly disavow the existence of a fiduciary duty to their clients in their exchange documents, in its Code of Ethics the FEA has recognized the existence of a higher level of responsibility of Exchange Accommodators to their clients than normally exists in commercial dealings.460

2. Accounts

(a) Segregated or Comingled Accounts

With the increased concern about the security of funds held by a Qualified Intermediary, whether from the claims of creditors in bankruptcy or due to the fraud of the Qualified Intermediary, the use of comingled accounts to hold funds for more than one client has become a disfavored business practice. When faced with the bankruptcy or malfeasance of their Qualified Intermediary,

459 See Cash Funds Held By Qualified Intermediary, infra.
460 See Federation of Exchange Accommodators, Code of Ethics, “Preamble”, "Exchange Accommodators recognize that the fiduciary nature of the industry imposes obligations beyond those of ordinary commerce.”
Exchangors and their advisors have found themselves with limited options to recover their funds when they have been commingled with the funds of other clients in one accounted titled in the name of the Qualified Intermediary or an affiliate. In addition, as discussed herein, many states’ regulation of Qualified Intermediaries require the use of segregated accounts, and I.R.S. Regulation requires segregated accounts to avoid the holding of funds by the Qualified Intermediary be considered to be a loan by the Exchangor for income tax purposes.⁴⁶¹

(b) Trust and Escrow Accounts

In light of a recent bankruptcy decision finding that segregated accounts, by themselves, are insufficient to protect Exchangor's funds from becoming part of the bankruptcy estate, to protect its clients a Exchange Accommodator should in its regular course of business hold all client funds in a Qualified Exchange Escrow or Qualified Exchange Trust.⁴⁶² In addition, the agreements and documentation between the Qualified Intermediary and an Exchangor should not contain any language to the effect that the Qualified Intermediary is the owner of the exchange funds, and should state that the Qualified Intermediary holds each client's funds for the benefit of that client and as its agent for all purposes other than Federal income tax law. The agreements and documentation should still expressly provide that the Exchangor is not in control of the funds as required by the restrictions on Constructive Receipt.⁴⁶³

3. Investment of Client Funds

Another area of trouble for Exchange Accommodators has been the investment of funds held on behalf of their clients. Because it is a common business model for an Exchange Accommodator to retain a portion or all of the interest earned on the funds that it holds on behalf of clients, there is a strong motivation to place the monies in investment vehicles that will provide the greatest return. However, the goal of seeking the best return is often at odds with the need to protect the funds from loss of value or liquidity, and has caused some Exchange Accommodators to make investment choices that have resulted in the outright loss of clients' funds⁴⁶⁴ or a lack of liquidity.⁴⁶⁵ In addition, even funds that are invested

⁴⁶¹ Regs. Section 1.468B-6. See Treasury Regulation Section 468B-6, infra.
⁴⁶³ Regs. Section 1.1031(k)-1(g)(6)(i).
⁴⁶⁴ For example, investing in options (See "Former Benistar head charged with misappropriating $9M in client funds", Boston Business Journal (February 6, 2004)); breast implant manufacturing (See "Southwest Exchange Settlement: $91.7 million", Las Vegas Sun (July 10, 2009)), and making real estate loans (See "Bend's Summit 1031 Exchange goes bust", The Oregonian (December 24, 2008)).
prudently may be at risk from the failure of financial institutions if the deposits or other investments are not covered adequate by FDIC, SPIC or private deposit insurance.

(a) Nature of Investments

There should be little disagreement that the most secure manner in which to invest client funds would be in accounts with a financially stable FDIC-insured institution that are covered fully by FDIC deposit insurance, regardless of the rate of return that would be paid on such accounts. Unfortunately, using such an investment strategy would be unlikely to generate much return on the invested funds, and may not be logistically possible for many Exchange Accommodators due to the high volume of clients and amount of funds that pass through their accounts. Fortunately, even in adverse economic conditions it may be possible for Exchange Accommodators to deposit exchange funds with FDIC-insured institutions and still make a reasonable return on the deposits. For example, some insured institutions are willing to pay a preferential rate due to the large sums that are being deposited, or pay some sort of monthly or yearly "bonus" or "marketing fee" based on the average amount of funds deposited with the institution.

The FEA's Code of Ethics requires that its members "... shall invest exchange funds in investments which meet the "Prudent Investor Standard" and satisfy investment goals of liquidity and preservation of principal." Many of the state laws based upon the FEA Model Legislation follow the same or a similar standard for the investment of exchange funds.467

(b) Deposit Insurance

Exchange Accommodators, and their clients and their advisors, are (or should be) sensitive to the issue of protecting the clients' funds from loss due to failure of the financial institution where the funds are deposited. In addition to ongoing due diligence of the financial stability of a financial institution where an Exchange Accommodator hold its clients' funds, deposit insurance covering the funds will provide a measure of protection from loss of the funds due to a failure of the financial institution. However, there are several different kinds of deposit insurance available, each with its own rules, limitations and costs.

(i) FDIC

466 See Federation of Exchange Accommodators, Code of Ethics, Article VI, Section A(a).
467 See FEA Model Legislation, infra.
Deposit accounts at financial institutions insured by the Federal Deposit Insurance Corporation ("FDIC") are automatically insured up to $250,000 per depositor until December 31, 2013, after which, deposit insurance for deposit accounts will return to $100,000 per depositor per insured bank.\textsuperscript{468} In determining the amount of deposits a specific depositor has in an institution, the FDIC aggregates all accounts of that depositor that are maintained in the same right and capacity.\textsuperscript{469} For the purposes of determining the ownership of accounts, the FDIC presumes that the funds are owned in the manner indicated on the institution’s records of its deposit accounts.\textsuperscript{470}

Generally, if a depositor who is a corporation or partnership maintains one or more accounts at an insured institution in its own name, the deposit insurance on all of its accounts will be limited to $250,000, even if funds in those accounts are held on behalf of the depositor’s clients.\textsuperscript{471} However, if the same depositor were to deposit each client’s funds with an insured institution in an account that qualifies as a fiduciary account, then each client’s individual deposit will be insured up to the maximum amount of FDIC insurance.\textsuperscript{472} To be deemed a fiduciary account, the fiduciary relationship between the parties must be expressly disclosed in the deposit account records of the bank, and the name and ownership interest of each owner must be ascertainable from the bank’s deposit account records or from the records maintained by the fiduciary.\textsuperscript{473} If the funds of more than one client are deposited in a comingled account, then the interest of each client may be determined as a fractional or percentage interest in the account.\textsuperscript{474}

Therefore, for each Exchangor with exchange funds on deposit with a insured institution to be covered by the full amount of FDIC deposit insurance, the account where the funds are deposited should be titled in the name of the Exchangor or in the name of the Exchange Accommodator.

\textsuperscript{468} 12 C.F.R. Part 330.1(n) as amended by the "Helping Families Save Their Homes Act", Pub.L. 111-22 Section 204(a) (May 20, 2009).
\textsuperscript{469} 12 C.F.R. Part 330.6(a).
\textsuperscript{470} 12 C.F.R. Part 330.3(a).
\textsuperscript{471} 12 C.F.R. Part 330.11.
\textsuperscript{472} 12 C.F.R. Part 330.7(a).
\textsuperscript{473} 12 C.F.R. Part 330.5(b)(1) & (2).
\textsuperscript{474} 12 C.F.R. Part 330.5(a)(2).
as a fiduciary for the Exchangor.\textsuperscript{475} This should be true whether the account is a "stand-alone" account or a "sub-account" of a master account in the name of the Exchange Accommodator. Exchange funds deposited in a comingled account in the name of the Exchange Accommodator will be subject to the $250,000 deposit insurance limitation for the entire account.

(ii) Temporary Liquidity Guarantee Program
In 2008, the FDIC added the Transaction Account Guarantee Program, which provides full coverage for non-interest bearing transaction deposit accounts at FDIC-insured institutions that agree to participate in the Temporary Liquidity Guarantee Program.\textsuperscript{476} The transaction account guarantee applies to all personal and business checking accounts that do not earn interest at participating institutions.\textsuperscript{477} This unlimited deposit insurance coverage is temporary and is only in effect for depositors at participating institutions through December 31, 2009.\textsuperscript{478} Therefore, investors whose exchange funds exceed the $250,000 maximum coverage may request that their Exchange Accommodator invest the exchange funds in a non-interest bearing transaction account at an institution participating in the FDIC's Temporary Liquidity Guarantee Program. But, because the interest generated on exchange funds, is often an important part of the Exchange Accommodator's business model, an investor who makes such a request may find itself paying more in fees than if the funds earn interest while they are held by the Exchange Accommodator.

(iii) SIPC
The Securities Investor Protection Corporation ("SIPC") was created by the Securities Investor Protection Act.\textsuperscript{479} SIPC is neither a government agency nor a regulatory authority, but a nonprofit, membership corporation, funded by its member securities broker-dealers.\textsuperscript{480} The Securities Investor Protection Corporation either acts as trustee or works with an independent court-appointed trustee in a missing asset

\textsuperscript{475} In both cases, the accounts should use the Exchangor's taxpayer identification number for the purpose of evidencing the Exchangor's interest in the account and for the purpose of avoiding imputed interest under Regulation 486B. See Accounts and Treasury Regulation Section 1.468B-6, infra.

\textsuperscript{476} 12 C.F.R. Part 370.4(a).

\textsuperscript{477} 12 C.F.R. Part 370.2(h).

\textsuperscript{478} 12 C.F.R. Part 370.4(a)(2). The extension of increased coverage limits under FDIC insurance announced on May 20, 2009 does not apply to the Transaction Account Guarantee Program.

\textsuperscript{479} 15 U.S.C. Section 78aaa et seq, (as amended).

\textsuperscript{480} 15 U.S.C. Section 78ccc(1) & (2)(a).
case to recover funds. Funds from the SIPC reserve are available to satisfy the claims of each investor up to a maximum of $500,000 (in excess of the value of any of the investor’s securities that are recovered) and includes a maximum of $100,000 on claims for cash.\textsuperscript{481} Recovered funds are used to pay investors whose claims exceed SIPC’s protection limit of $500,000.

It is not uncommon for Exchange Accommodators to maintain accounts with registered securities broker-dealers, where they may invest funds held on behalf of clients in higher-yielding investments such as accounts whose yields are tied to Treasury bills, a blend of bank certificates of deposit, and overnight repurchase agreements. The SIPC insurance program provides a measure of security for such funds and investments up to the limits of such coverage.

(iv) Private Deposit Insurance
Private deposit insurance has been available for several decades to insure the deposits of state-chartered credit unions, industrial loan companies, and other non-bank financial institutions. In addition, some large broker-dealer securities firms maintain private deposit insurance providing coverage in excess of SIPC coverage, and it is sometime possible to purchase private deposit insurance to provide additional coverage for accounts in FDIC-insured institutions in excess of the FDIC limits.

(v) Letters of Credit, Etc.
Although not a true form of "deposit insurance", the 1031 Regulations provide for three forms of permissible security devices for funds held by an Exchange Accommodator:\textsuperscript{482}

- Letters of credit
- Deeds of trust
- Third party guarantees

With the exception of a third party guarantee (such as a parent bank or title company guaranteeing the obligations of an Exchange Accommodator subsidiary to its clients) in practice, these security devices are often too cumbersome

\textsuperscript{481} 15 U.S.C. Section 78fff-3(a) & (a)(1).
\textsuperscript{482} Regs. Section 1.1031(k)-1(g)(2)(i).
or expensive to be practical for use in everyday business practice.

4. Payment and Reporting of Interest

(a) 1031 Regulations

The 1031 Regulations provide that the Exchangor may receive interest (or a "growth factor") on funds held by a Qualified Intermediary, so long as all interest is handled in the same manner as the Exchange Proceeds to prevent Constructive Receipt of the interest by the Exchangor. The Exchangor is entitled to receive interest with respect to a Delayed Exchange if the amount interest depends upon the length of time elapsed between transfer of the Relinquished Property and receipt of the Replacement Property. The Exchangor must include the interest in income according to the Exchangor's method of accounting, and that the provisions regarding taxation of accounts used during delayed exchanges under I.R.C. Section 1031 are set forth in Treasury Regulation Section 1.486B-6.

(b) Treasury Regulation Section 1.468B-6

Treasury Regulation Section 1.468B-6 establishes rules concerning the taxation of exchange funds. The Regulation provides a general rule (subject to exceptions discussed below) that all "Exchange Funds" held by an "Exchange Facilitator" are treated as an "Exchange Facilitator Loan" from the taxpayer to the Exchange Facilitator who must take into account all items of income, deduction, and credit (including capital gains and losses) attributable to the Exchange Funds. If the deposit of Exchange Funds is treated as an Exchange Facilitator Loan, then interest will be imputed to the taxpayer at the lower of the short-term Applicable Federal Rate or the 13-week Treasury bill investment rate. The correct Treasury bill investment rate to be used is the one with an issue date on or immediately preceding the date of deposit of the Exchange Funds. The AFR may be found at http://www.irs.gov/app/picklist/list/federalRates.html and the Treasury bill rate may be found at www.treasurydirect.gov/RI/OFBills.

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483 Regs. Section 1.1031(k)-1(h), Regs. Section 1.1031(k)-1(g)(5).
484 Regs. Section 1.1031(k)-1(h)(1).
485 Regs. Section 1.1031(k)-1(h)(2).
486 Regs. Section 1.468B-6.
487 Regs. Section 1.486B-6(b)(2). "Exchange funds means relinquished property, cash, or cash equivalent that secures an obligation of a transferee to transfer replacement property, or proceeds from a transfer of relinquished property, held in a qualified escrow account, qualified trust, or other escrow account, trust, or fund in a deferred exchange."
488 Regs. Section 1.486B-6(b)(3). "Exchange facilitator means a qualified intermediary, transferee, escrow holder, trustee, or other party that holds exchange funds for a taxpayer in a deferred exchange pursuant to an escrow agreement, trust agreement or exchange agreement."
489 Regs. Section 1.468B-6(c)(1).
490 Regs. Section 1.7872-5(b)(16)(d). The correct Treasury bill investment rate to be used is the one with an issue date on or immediately preceding the date of deposit of the Exchange Funds. The AFR may be found at http://www.irs.gov/app/picklist/list/federalRates.html and the Treasury bill rate may be found at www.treasurydirect.gov/RI/OFBills.
main exception is if the amount of Exchange Funds does not exceed $2 million and the duration of the deposit is six months or less then the general rule does not apply. Further, even if the general rule does apply, no additional interest will be imputed to the taxpayer if the Exchange Funds are held in one of the methods specified below:

- In a separately identified account with a depository institution and the account is established under the taxpayer’s name and taxpayer identification number; or the Exchange Facilitator has a master account with a depository institution and the depository institution identifies each sub-account with the taxpayer’s name and taxpayer identification number; and all the earnings from the account or sub-account are paid to the taxpayer, as set forth in the exchange agreement.

- In an account where the Exchange Funds are commingled with other funds if all of the earnings attributable to the commingled funds or assets that are allocable on a pro-rata basis (using a reasonable method that takes into account the time that the Exchange Funds are in the commingled account, actual rate or rates of return, and the respective account balances) to the Exchange Funds either are paid to the taxpayer or are treated as paid to the taxpayer.

The main thrust of Regulation Section 486B-6 restricts the ability of an Exchange Facilitator to retain directly some or all of the interest earned on its deposits of Exchange Funds. For example, it is clear that the Exchange Facilitator cannot agree to pay a stated rate of interest on the Exchange Funds to the taxpayer and retain any additional interest earned on the account where those funds are held. However, certain provisions do provide avenues for an Exchange Accommodator to earn additional revenues based on its deposits of clients’ funds, so long as those revenues are not based on the length of time specific Exchange Funds are held. For example, where a master account and sub-accounts are used to hold Exchange Funds, the Exchange Facilitator may receive from the depository institution where the accounts are established “... an additional amount of interest based on the daily balance of all exchange funds held in the master account during the month.”

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491 Regs. Section 1.7872-5(b)(16). It has not been clarified whether the six months may be extended if the time to complete the exchange is extended by the I.R.S., (e.g., in the event of a natural disaster).
492 Regs. Section 1.468B-6(c)(2)(i) & (ii)(A).
493 Regs. Section 1.468B-6(c)(2)(i) & (ii)(B).
494 Regs. Section 1.468B-6(e) Example 8.
Further, the Exchange Facilitator may receive a "marketing fee" from the depository institution where the accounts are established based on the total amount of exchange funds deposited by the QI with the depository institution for the year.  

C. Bankruptcy of Qualified Intermediaries  
The principal question that arises when a Qualified Intermediary files for protection under federal bankruptcy law is whether funds and property held on behalf of clients are property of the bankruptcy estate and subject to claims of all claimants, or are not a part of the bankruptcy estate and should be distributed only to the clients for whose benefit the funds or property are held.  

1. Cash Funds Held By Qualified Intermediary  
In discerning the nature of the relationship between the Exchangor and its Qualified Intermediary is that of a trust or of a creditor and debtor, earlier decisions found either direct evidence of an intent of the Exchangor and Qualified Intermediary to create a trust or that the circumstances supported a decision to impose a resulting trust. However, the commingling of funds held in trust may result in such funds being part of the bankruptcy estate. Further, a recent decision has more narrowly interpreted the written agreements between the Exchangor and the Qualified Intermediary and found that, notwithstanding the fact the funds were deposited in a segregated account, the language of the agreements not only failed to support a conclusion that the parties intended to create a trust relationship, but that the agreements evidenced the parties' intent not to create a trust. In the face of such language the court concluded it was inappropriate to impose a resulting trust and held that the exchange funds would not be excluded from the property of the bankruptcy estate.

495 Regs. Section 1.468B-6(e) Example 6.  
496 Regs. Section 1.468B-6(e) Example 7.  
2. **Property Held By Qualified Intermediary**

At least one bankruptcy court has found that real property held on behalf of a client was not part of the Qualified Intermediary's bankruptcy estate.\(^{501}\)

3. **Loss of Exchange Proceeds May Be Deductible**

The I.R.S. Chief Counsel has stated that a loss of the exchange proceeds not covered by insurance may be a loss incurred in a trade or business and therefore deductible under Section 165(a)(1).\(^{502}\)

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\(^{501}\) See *DeGroot v. Exchange Titles, Inc. (In Re Exchanged Titles, Inc.)*, 59 Bank. Rept. 303 (Bkpt. C.D. Cal. 1993). In this case, a federal Bankruptcy Court judge decided that, in a "title holding" type of exchange using a Qualified Intermediary holding the Relinquished Property, the taxpayer only conveyed "legal" and not "equitable" title to the Qualified Intermediary who subsequently filed for bankruptcy. In holding that the property held by the Qualified Intermediary was not part of the bankruptcy estate, the judge found that the conveyance of equitable title was not required by the Treasury Regulations for a title-holding exchange. Fortunately for the taxpayer in this situation, the effect of the Bankruptcy Court's decision was that their equity was protected from claims of creditors of the Qualified Intermediary, and that their right to complete the exchange was preserved.

\(^{502}\) See *Chief Counsel INFO No. 2008-0021* (June 27, 2008).
Chapter Nine: Appendices

I. Understanding IRS Guidance - A Brief Primer

For anyone not familiar with the inner workings of tax administration, the array of IRS guidance may seem, well, a little puzzling at first glance. To take a little of the mystery away, here’s a brief look at seven of the most common forms of guidance.

In its role in administering the tax laws enacted by the Congress, the IRS must take the specifics of these laws and translate them into detailed regulations, rules and procedures. The Office of Chief Counsel fills this crucial role by producing several different kinds of documents and publications that provide guidance to taxpayers, firms and charitable groups.

Regulation
A regulation is issued by the Internal Revenue Service and Treasury Department to provide guidance for new legislation or to address issues that arise with respect to existing Internal Revenue Code sections. Regulations interpret and give directions on complying with the law. Regulations are published in the Federal Register. Generally, regulations are first published in proposed form in a Notice of Proposed Rulemaking (NPRM). After public input is fully considered through written comments and even a public hearing, a final regulation or a temporary regulation is published as a Treasury Decision (TD), again, in the Federal Register.

Revenue Ruling
A revenue ruling is an official interpretation by the IRS of the Internal Revenue Code, related statutes, tax treaties and regulations. It is the conclusion of the IRS on how the law is applied to a specific set of facts. Revenue rulings are published in the Internal Revenue Bulletin for the information of and guidance to taxpayers, IRS personnel and tax professionals. For example, a revenue ruling may hold that taxpayers can deduct certain automobile expenses.

Revenue Procedure
A revenue procedure is an official statement of a procedure that affects the rights or duties of taxpayers or other members of the public under the Internal Revenue Code, related statutes, tax treaties and regulations and that should be a matter of public knowledge. It is also published in the Internal Revenue Bulletin. While a revenue ruling generally states an IRS position, a revenue procedure provides return filing or other instructions concerning an IRS position. For example, a revenue procedure might specify how those entitled to deduct certain automobile expenses should compute them by applying a certain mileage rate in lieu of calculating actual operating expenses.

Private Letter Ruling
A private letter ruling, or PLR, is a written statement issued to a taxpayer that interprets and applies tax laws to the taxpayer's specific set of facts. A PLR is issued to establish with certainty the federal tax consequences of a particular transaction before the transaction is consummated or before the taxpayer's return is filed. A PLR is issued in response to a written request submitted by a taxpayer and is binding on the IRS if the taxpayer fully and accurately described the proposed transaction in the request and carries out the transaction as described. A PLR may not be relied on as precedent by other taxpayers or IRS personnel. PLRs are generally made public after all information has been removed that could identify the taxpayer to whom it was issued.

Technical Advice Memorandum
A technical advice memorandum, or TAM, is guidance furnished by the Office of Chief Counsel upon the request of an IRS director or an area director, appeals, in response to technical or procedural questions that develop during a proceeding. A request for a TAM generally stems from an examination of a taxpayer's return, a consideration of a taxpayer's claim for a refund or credit, or any other matter involving a specific taxpayer under the jurisdiction of the territory manager or the area director, appeals. Technical
Advice Memoranda are issued only on closed transactions and provide the interpretation of proper application of tax laws, tax treaties, regulations, revenue rulings or other precedents. The advice rendered represents a final determination of the position of the IRS, but only with respect to the specific issue in the specific case in which the advice is issued. Technical Advice Memoranda are generally made public after all information has been removed that could identify the taxpayer whose circumstances triggered a specific memorandum.

Notice
A notice is a public pronouncement that may contain guidance that involves substantive interpretations of the Internal Revenue Code or other provisions of the law. For example, notices can be used to relate what regulations will say in situations where the regulations may not be published in the immediate future.

Announcement
An announcement is a public pronouncement that has only immediate or short-term value. For example, announcements can be used to summarize the law or regulations without making any substantive interpretation; to state what regulations will say when they are certain to be published in the immediate future; or to notify taxpayers of the existence of an approaching deadline.

Page Last Reviewed or Updated: November 07, 2003

II. **Table of Long-Term Capital Gains Tax Rates**

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<th>Long-Term Capital Gains Tax Rate</th>
<th>Qualified 5-Year Capital Gains Tax Rate</th>
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503 See I.R.C. Section 1(h)(1).
504 Except for gain from the sale of "Section 1250 Property" which is taxed at 25%. I.R.C. Section 1250(1)(A). See Section 1250 Depreciation Recapture, infra.
505 I.R.C. Section 1(h)(4)(A)(i); I.R.C. Section 408(m). ("Collectibles" are defined as any work of art, rug or antique, metal (except bullion) or gem, stamp or coin, or alcoholic beverage.)
506 Except for gain from the sale of "Section 1250 Property" taxed at 25%. I.R.C. Section 1250(1)(A). See Section 1250 Depreciation Recapture, infra.
507 The Qualified 5-Year Capital Gains Rate applies to a capital asset acquired on or after January 1, 2001 and held for 5 years thereafter, or a capital asset that was "marked to market" by electing to realize the appreciation as of that date and paying the capital gains tax on such appreciation, in which case the lower rate will apply to all appreciation after such date provided that the property is held for at least 5 years.
508 I.R.C. Section 1(h)(1). The applicable capital gains rate depends on whether the taxpayer's taxable income, including the adjusted net capital gains, is below or above the threshold for the tax bracket and, if above, to what extent.
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## I.R.S. Private Letter Rulings

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