Safe Harbors and Careful Planning Make Deferred Exchanges a Valuable Tool

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Bradley T. Borden*

The exchange and like-kind property requirements provide that an exchanger must transfer property in exchange for other like-kind property to obtain Section 1031 nonrecognition treatment. If the exchanger receives cash from the sale of one property and uses it to acquire another piece of property, the transaction will not qualify for Section 1031 nonrecognition. Such transactions are merely sales followed by a purchase. Many exchanges are deferred exchanges (i.e., the exchanger disposes of the relinquished property and later acquires the replacement property) and multiparty exchanges and must be carefully structured to ensure that the exchanger does not receive cash. Because Treasury has provided safe harbors for structuring deferred exchanges, many of them can now be completed with assurance that they will satisfy the exchange and like-kind property requirements.

In planning a deferred exchange, the taxpayer must remember the consequences that will result if the taxpayer actually or constructively receives money or other property that is not of a like kind to the relinquished property (i.e., boot). The regulations reiterate the point that the actual or constructive receipt of cash in a deferred exchange before the taxpayer receives the replacement will be boot or, if it is in full consideration for the relinquished property, it will be full payment for the property.¹ The regulations remind a taxpayer that the actual or constructive receipt of money in lieu of replacement property will disqualify the transaction from like-kind exchange treatment and state that the general rules concerning actual and constructive receipt are used to determine whether the taxpayer has received money, unless the taxpayer uses one of the safe harbors.²

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¹ See Reg. 1.1031(k)-1(f)(1).

² See Reg. 1.1031(k)-1(f)(2).
Deferred Exchanges Under Common Law

*Starker v. U.S.* is perhaps the most famous Section 1031 case. In that case, the Ninth Circuit held that an exchanger could transfer property to an unrelated party and receive replacement property from the same party over a two-year period and still qualify for Section 1031 nonrecognition. The court also held that the transaction qualified for a like-kind exchange treatment even though the taxpayer received a growth factor (interest) based on the unrelated party’s outstanding balance at the end of each year. Because this was a case of first impression, the court invited Congress to enact new legislation if its decision was not consistent with the purposes of Section 1031.

Statutory Rules Governing Deferred Exchanges

Congress responded to the *Starker* decision by enacting Section 1031(a)(3). Although the statute provides that if the timing requirements are not satisfied the property received by the taxpayer will not be treated as like-kind property, the legislative history speaks of a transaction not being an exchange if too much time passes between the time the relinquished property is transferred and the time the replacement property is received. The consequence of not

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3 602 F.2d 1341 (9th Cir. 1979).

4 See H.R. Rep. No. 98-432, pt. 2, at 1233 (1984) (“The committee is also concerned that the like-kind exchange rules significantly expand the ability of taxpayers to avoid recognition of gain on deferred payment sales. Unlike other nonrecognition rules (e.g., the rollover of gain on replacement of a principal residence), the like-kind exchange provisions have no express statutory time limit on the availability of nonrecognition treatment. Decisions such as that in *Starker v. U.S.* suggest that there may, in fact, be no limit on the time for which like-kind exchanges may be kept open. If this is the case, taxpayers, by combining the installment sale rules and the like-kind exchange provisions, may defer taxation on dispositions of property for an indefinite period of time, even if a right to receive cash instead of property is retained. If cash is ultimately received, the installment sale rules will achieve a deferral until the time of receipt, while if like-kind property is received, recognition will be even further delayed. By exercising the right to designate property shortly before death, a taxpayer may conceivably avoid any taxation on the sale. Interaction of the installment sale and like-kind exchange rules also raises serious administrative problems regarding the allocation of liabilities and basis among different properties, problems which may not be resolvable until all exchanges and payments required by the agreement have been completed. Thus the tax consequences of deferred exchanges may not be determined for many years after the transaction is initiated.”).

5 See H.R. Rep. No. 98-432, pt. 2, at 1232 (1984) (“The special treatment of like-kind exchanges has been justified on the grounds that a taxpayer making a like-kind exchange has received property similar to the property relinquished and therefore has not effectively ‘realized’ a profit on the transaction. This rationale is less applicable in the case of deferred exchanges. To the extent that the taxpayer is able to defer completion of the transaction—often retaining the right to designate the property to be received at some future point—the transaction begins to resemble less a like-kind exchange and more a sale of one property followed, at some future point, by a purchase of a second property or properties. This is particularly true when (as was the case in *Starker v. U.S.*) the taxpayer might have received like-kind or non-like-kind property in the future.
satisfying the Section 1031(a)(3) requirements is that the property received in the transaction will not be treated as like-kind property. Section 1031(a)(3) imposes timing requirements for identifying and receiving replacement property. The regulations promulgated under Section 1031(a)(3) also impose specific rules for satisfying the identification requirement and receipt requirements.

**Timing Requirements**

Section 1031(a)(3) imposes three timing requirements. The time period for each requirement begins on the date the taxpayer transfers the relinquished property and ends at midnight on the last day of the time period.\(^6\) The day the taxpayer transfers the property is not counted for this purpose.\(^7\) If, as part of the same deferred exchange, the taxpayer transfers more than one relinquished property, and the relinquished properties are transferred on different dates, the time periods begin running on the earliest date on which any of the properties are transferred.\(^8\) Furthermore, the date the property is deemed to be transferred is the date the exchanger disposes of the property within the meaning of Section 1001(a).\(^9\) The time periods in Section 1031(a)(3) generally are fixed, but in the event of presidentially declared disasters or terrorist or military action, the IRS may extend such time periods.

**Identification Period.** Section 1031(a)(3)(A) provides that the exchanger must identify the replacement property as such on or before the day that is forty-five days after the date on which the exchanger transfers the relinquished property. This is known as the identification period.\(^10\)

**Exchange Period.** Section 1031(a)(3)(B)(i) provides that the exchanger must receive the replacement property on or before the day that is 180 days after the date on which the exchanger transfers the relinquished property, unless the tax return for the year in which the relinquished property is transferred is required to be filed earlier. This is known as the exchange period.\(^11\) If the taxpayer is required to file the tax return (for the taxable year during which the relinquished property was transferred) before the end of the 180-day period, the IRS may extend such time periods.

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The committee believes that like-kind exchange treatment is inappropriate in such situations and that the general rule requiring recognition of gain on sales or exchanges of property should apply to these cases.\(^\)\(^\)\(^1\)\(^2\).

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\(^6\) See Reg. 1.1031(k)-1(b)(2)(i), (ii).
\(^7\) See Reg. 1.1031(k)-1(b)(3).
\(^8\) See Reg. 1.1031(k)-1(b)(2)(iii).
\(^9\) See Reg. 1.1031(k)-1(b)(2)(iv).
\(^10\) See Reg. 1.1031(k)-1(b)(1)(i).
\(^11\) See Reg. 1.1031(k)-1(b)(1)(ii).
period, the replacement property must be received on or before the tax return due date (extensions are taken into account in determining the tax return due date).\textsuperscript{12} To avoid this problem, exchangers may obtain an extension.

**Exchanges Affected by Disasters or Terroristic or Military Action.** For the most part, the identification and exchange periods are fixed. Treasury may, however, extend both of those time periods if an exchanger is affected by presidentially declared disasters or any terroristic or military action.\textsuperscript{13} To qualify for the extended time periods, a disaster event must occur, Treasury must declare that the event is one that affects exchangers, and the exchanger must be a qualifying exchanger. If an exchanger qualifies for the extensions, the extensions may affect the length of time the Reg. 1.1031(k)-1(g)(6) restrictions (Reg. 1.1031(k)-1(g)(6) restrictions) apply. To preserve the safe harbors, exchange documents should identify exchange periods in such a manner that they take into account disaster event extensions.

**Disaster Event.** A disaster event is a presidentially declared disaster or any terroristic or military action. A presidentially declared disaster is “any disaster which, with respect to the area in which the property is located, resulted in a subsequent determination by the President that such area warrants assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.”\textsuperscript{14}

The definition of terroristic or military action is more ambiguous. The Code provides simply that a terroristic activity is “any terroristic activity which a preponderance of the evidence indicates was directed against the United States or any of its allies.”\textsuperscript{15} In similarly succinct language, it provides military action is “any military action involving the Armed Forces of the United States and resulting from violence or aggression against the United States or any of its allies (or threat thereof).”\textsuperscript{16} The general language in this definition means that some events will not fall neatly within the definition. For exchangers, that concern is not too significant, however, because Treasury must determine that the event justifies the extension of time periods.

\textsuperscript{12} See Section 1031(a)(3)(B)(ii).
\textsuperscript{13} See Section 7508A(a)(1) (granting the Treasury Secretary the authority to postpone deadlines for certain required acts described in Section 7508(a)(1) up to one year in the case of a taxpayer affected by a presidentially declared disaster, terroristic action, or military action); Section 7508(a)(1)(K) (granting the Treasury Secretary the authority to identify acts that may be postponed); Rev. Proc. 2005-27, §§ 5.20, 5.21, 2005-1 CB 1050 (identifying the identification and exchange periods as periods eligible for postponement under Section 7805A).
\textsuperscript{14} Section 1033(h)(3).
\textsuperscript{15} Section 692(c)(2)(A).
\textsuperscript{16} Section 692(c)(2)(B) (2006). For the purposes of the definition, the term “military action” does not include training exercises. Section 692(c)(2).
Treasury Declaration. The extension of time periods is not automatic. For each disaster event, the IRS must provide notice that it has extended the time periods.\textsuperscript{17}

If the IRS publishes guidance with respect to a specific presidentially declared disaster area, exchangers may use the Section 1031 postponement rules in Rev. Proc. 2005-27, in lieu of the general extension dates provided in the guidance.\textsuperscript{18} If an IRS News Release or other guidance announces tax relief for victims of a specific presidentially declared disaster and provides relief for acts listed in Rev. Proc. 2005-27, exchangers qualify for the longer of the extensions in the Revenue Procedure or the extensions in the specific guidance issued with respect to the disaster.\textsuperscript{19}

For exchangers who qualify for the relief, the Revenue Procedure extends for 120 days (or, if earlier, until the last day of the general disaster extension period authorized by the IRS guidance announcing the tax relief) the deferred exchange identification periods, exchange periods, and Rev. Proc. 2000-37 identification and holding periods that end on or after the date of a presidentially declared disaster.

Example. Assume Earnest’s (a qualifying exchanger as defined below) identification period was originally scheduled to end on March 15, Year 7. A presidentially declared disaster occurs on March 10, Year 7, and IRS guidance regarding that disaster provides a general disaster extension period that ends on June 12, Year 7. Earnest’s identification period would end on June 12, Year 7, because that is earlier than 120 days from March 15, Year 7 (120 days from March 15, Year 7 would be July 13, Year 7). Because Earnest’s exchange period would end after June 12, Year 7,\textsuperscript{20} without any extension, the general disaster extension period would not affect the exchange period.

\textsuperscript{17} Rev. Proc. 2005-27, § 1.02, 2005-2 CB 1050 (“This revenue procedure does not, by itself, provide any postponements under section 7805A. In order for taxpayers to be entitled to a postponement of any act listed in this revenue procedure, the IRS generally will publish a Notice or issue other guidance (including an IRS News Release) providing relief with respect to a Presidentially declared disaster, or a terroristic or military action.”). See, e.g., Notice 2001-61, 2001-2 CB 305 (granting relief to taxpayers affected by the September 11, 2001, terrorist attacks); Notice 2001-68, 2001-2 CB 504 (extending the Notice 2001-61 relief to Section 1031 exchanges); IRS News Release, IRS Grants Tax Relief for Florida Storm, Tornado Victims, NFL-2007-21 (February 6, 2007), available at www.irs.gov/newsroom/article/0,,id=167606,00.html (granting relief to Florida taxpayers affected by the Presidential Disaster Area that was struck by severe storms and tornadoes on February 1-2, 2007).


\textsuperscript{20} 25 Based on the date the identification period ends, which is forty-five days after the transfer of the relinquished property, the exchange period would end on July 28, Year 7, or 135 days after the identification period ends.
If a presidentially declared disaster substantially damages identified replacement property, Rev. Proc. 2005-27 will postpone an identification period that ends before the date of a presidentially declared disaster. The extension applies to identification periods of both deferred and reverse exchanges, but the extension period may not apply to other exchange deadlines, such as the tax return due date.

**Example.** Assume that Earnest identified Apartment Complex as replacement property, and the identification period ended on March 15, Year 7. On April 1, Year 7, a presidentially declared disaster destroys Apartment Complex, and the IRS provides guidance that provides a general disaster extension period that ends on June 12, Year 7. Because the presidentially declared disaster substantially damages Earnest’s identified replacement property, his identification period will extend to June 12, Year 7, even though the original identification period ended before the date of the presidentially declared disaster.

As stated above, the exchange period ends at the earlier of 180 days after the exchanger transfers relinquished property or the exchanger’s tax return due date for the year of the exchange. The 120-day postponement in Rev. Proc. 2005-27 does not apply to the due date of the exchanger’s tax return. Thus, an exchanger may extend the tax return due date under the regular extension rules, but presidentially declared disaster extensions will not further extend that date.

**Qualifying Exchangers.** The structure of many exchanges distinguishes them from other transactions and distinguishes exchangers from other taxpayers. Therefore, the IRS has created special rules for determining whether an exchanger qualifies for the disaster extension of Section 1031 time periods. These Section 1031 disaster extension rules may apply to an exchanger even though the exchanger is not otherwise treated as an “affected taxpayer” by the IRS guidance and not otherwise eligible for relief under Section 7508A. For an exchanger to qualify for the Section 1031 disaster extension rules, the exchanger must have transferred relinquished property on or before the date of the presidentially declared disaster, or, in the case of a safe harbor title-parking transaction, the exchange accommodation titleholder must have received qualified indicia of ownership on or before the date of

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23 Rev. Proc. 2005-27, § 4.01, 2005-2 CB 1050 (“[T]his revenue procedure expands the categories of taxpayers qualifying for relief and provides additional postponements of deadlines solely with respect to Section 1031 like-kind exchange transactions that are affected by a Presidentially declared disaster.”). Interestingly, the revenue procedure only extends the Section 1031 rules to exchanges affected by presidentially declared disasters, not to those affected by terroristic or military action.
the presidentially declared disaster.\textsuperscript{25} If an exchanger satisfies the transfer requirement, it will qualify for the Section 1031 disaster extension rules if the exchanger either (1) is an “affected taxpayer” as defined in the IRS guidance announcing the tax relief for victims of a presidentially declared disaster,\textsuperscript{26} or (2) has difficulty meeting the deferred exchange identification period, the exchange period, or the Rev. Proc. 2000-37 identification period or holding period for any of several enumerated reasons or something similar to one of the enumerated reasons.\textsuperscript{27} Thus, an exchanger does not have to be an affected taxpayer to qualify for the Section 1031 disaster extension rules.

If an exchanger is not an affected taxpayer, it must have difficulty meeting one of the time periods mentioned for an enumerated reason or something similar to it. The Revenue Procedure lists six reasons that may cause an exchanger difficulty in meeting one of the time periods:

1. Relinquished or replacement property is located in a covered disaster.\textsuperscript{28} 
2. The principal place of business of any party to the exchange is located in the covered disaster area.\textsuperscript{29} 
3. Any party to an exchange (or an employee of such a party who is involved in the Section 1031 transaction) is killed, injured, or missing as a result of the presidentially declared disaster.\textsuperscript{30} 
4. A document prepared in connection with the exchange or a relevant land record is destroyed, damaged, or lost as a result of a presidentially declared disaster.\textsuperscript{31} 
5. A lender refuses to fund a real estate closing or fund a loan because of the presidentially declared disaster or because flood, disaster, or other hazard insurance is not available due to the presidentially declared disaster.\textsuperscript{32} 

\textsuperscript{29} Rev. Proc. 2005-27, § 17.01(2)(b)(ii)(B), 2005-2 CB 1050 (identifying a qualified intermediary, exchange accommodation titleholder, transferee, settlement attorney, lender, financial institution, or title insurance company as examples of parties to an exchange). 
\textsuperscript{31} Rev. Proc. 2005-27, § 17.01(2)(b)(ii)(D), 2005-2 CB 1050 (identifying the agreement between the exchanger and qualified intermediary or the deed to the relinquished property or replacement property as examples of documents prepared in connection with the exchange). 
6. A title insurance company is not able to provide the required title insurance policy to settle or close a real estate transaction because of a presidentially declared disaster.33

If any of these reasons make it difficult for an exchanger to meet the time periods identified above, the exchanger may still qualify for Section 1031 disaster extensions, even though the exchanger is not an affected taxpayer.

Replacement Property Identification

The Section 1031(a)(3) regulations provide rules for properly identifying replacement property within the identification period. With the exception of replacement property received before the end of the identification period, exchangers must properly identify replacement property in writing during the identification period.

Property Received Prior to End of Identification Period. If an exchanger acquires replacement property prior to the end of the exchange period, the identification rules will deem such property as identified prior to the end of the identification period.34

Manner of Identifying Replacement Property. To satisfy the identification requirement, the exchanger must identify replacement property in writing and deliver it to a qualified person before the end of the identification period, and the exchanger must properly describe the replacement property.

Documentation and Delivery Requirements. The exchanger must specifically designate replacement property as replacement property in a written document and sign the designation.35 The IRS does not provide a form for identifying the replacement property. Most professional qualified intermediaries will, however, provide a form on which an exchanger may designate replacement property and satisfy the documentation requirement.

The exchanger must either hand deliver, mail, fax, or otherwise send the signed identification document to a qualified recipient before the end of the identification period.36 A qualified recipient for this purpose is (1) the person obligated to transfer the replacement property or (2) any other person involved in the exchange other than the taxpayer or a disqualified person (such as an intermediary, an escrow agent, and a title company).37 If all parties to an

34 See Reg. 1.1031(k)-1(c)(1).
35 See Reg. 1.1031(k)-1(c)(2).
36 See Reg. 1.1031(k)-1(c)(2).
37 See Reg. 1.1031(k)-1(c)(2)(i), (ii). See also Reg. 1.1031(k)-1(c)(2) (flush language) (providing that if an exchanger identifies replacement property in a document signed by all of the parties to the agreement before the end of the identification period, the exchanger will satisfy the delivery requirement).
exchange sign the identification of replacement property before the end of the identification period, the exchanger will satisfy the delivery requirement.  

**Description Requirement.** To satisfy the identification requirement, an exchanger must unambiguously describe in the document any replacement property not received before the end of the identification period.  

The regulations define what it means to unambiguously identify both replacement real property and replacement personal property.  

**Real Property.** An exchanger generally unambiguously describes real property if it describes the property by a legal description, street address, or distinguishable name (e.g., the Mayfair Apartment Building). Generally, this requirement is not difficult to satisfy. Nonetheless, if the common name of a property is not unique, the exchanger should not use the common name. Furthermore, a street address may not always be sufficient to identify a piece of property. Because the stakes are high when identifying replacement property, exchangers should consider using the legal description if the street address or common name will not definitively identify the replacement property.

If an exchanger intends to acquire a tenancy-in-common interest as replacement property, the exchanger may not be certain of the percent interest to be acquired. Instead, the exchanger may only know the dollar amount to be expended to acquire the interest. In such a situation, identifying the tenancy-in-common interest in a specific property (which the exchanger identifies unambiguously) in terms of dollar value of the interest should satisfy the description requirement. Such a description is unambiguous and clearly identifies the economic unit of property that the exchanger intends to acquire and the nature and character of the identified property that the exchanger would acquire if the value fluctuates after identification would be similar to the property identified. If, however, the replacement property is a condominium, the exchanger probably must specifically identify the unit to be acquired to satisfy the requirement. Condominiums, unlike tenancy-in-common interests, represent a specific part of the property. A tenancy-in-common interest represents an undivided interest in an entire piece of property.

**Personal Property.** An exchanger generally unambiguously describes personal property if it specifically describes the particular type of property. For example, an exchanger unambiguously describes a truck generally if it describes the specific make, model, and year of the truck.  

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38 See Reg. 1.1031(k)-1(c)(2) (flush language).  
39 See Reg. 1.1031(k)-1(c)(3).  
40 See Reg. 1.1031(k)-1(d)(2), Examples 3 and 4 (using a nature and character analysis and comparing the value of identified property to the value of received property to determine whether the exchanger acquired replacement property that was substantially the same as the identified replacement property).  
41 See Reg. 1.1031(k)-1(c)(3).
Identifying Alternative and Multiple Properties. Often, by the end of the identification period, the exchanger does not know which, if any, of multiple properties will be acquired. The regulations provide some leeway in such situations by granting the exchanger the option of identifying alternative or multiple replacement properties. An exchanger may identify alternative or multiple properties under either the three-property rule or the 200% rule. If, at the end of the identification period, an exchanger has identified more properties than allowed by the three-property and 200% rules, the exchanger will be deemed to have identified only those properties received before the end of the exchange period, unless the exchanger can qualify for the 95% rule. Any property that an exchanger fails to identify properly before the end of the exchange period will be treated as property that is not like kind to the relinquished property.

Three-Property Rule. An exchanger may identify up to three replacement properties without regard to the fair market values of the property. Three properties are also the maximum number of replacement properties that an exchanger may identify under the three-property rule, regardless of the number of relinquished properties transferred (i.e., the three-property rule is not a per-relinquished-property rule). Thus, if, as part of a single transaction, the exchanger transfers three relinquished properties, the exchanger may only identify three replacement properties. The exchanger is not allowed to identify nine replacement properties in that situation because the three-property rule applies on a per-exchange basis.

200% Rule. An exchanger may disregard the three-property rule and identify any number of replacement properties as long as the aggregate fair market value of the replacement properties does not exceed 200% of the aggregate fair market value of the relinquished properties. For this purpose, the fair market value of the relinquished properties is measured at the time the exchanger transfers them, and the fair market value of the replacement properties is measured at the end of the identification period.

95% Rule. If an exchanger violates both the three-property rule and the 200% rule, it will be treated as identifying the following properties: (1) any replace-

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42 See Reg. § 1.1031(k)-1(c)(4)(i).
43 See Reg. 1.1031(k)-1(c)(4)(i)(A) and (B).
44 See Reg. 1.1031(k)-1(c)(1).
45 See Reg. 1.1031(k)-1(c)(4)(ii).
46 See Section 1031(a)(3) (2006); Reg. 1.1031(k)-1(c)(1).
47 See Reg. 1.1031(k)-1(c)(4)(i)(A).
48 See Reg. 1.1031(k)-1(c)(4).
49 See Reg. 1.1031(k)-1(c)(4)(i)(B).
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ment property received by the exchanger before the end of the identification period and (2) any replacement property identified before the end of the identification period and received before the end of the exchange period, but only if the fair market value of the property received equals or exceeds the fair market value of 95% of the aggregate fair market value of all identified replacement properties (the value of the replacement properties for this purpose is determined at the earlier of the date the property is received by the taxpayer or the last day of the exchange period).\(^{50}\) Thus, the 95% rule is a fall-back rule that can save an otherwise defective identification.

Because the 95% rule only applies if the exchanger invests additional capital in the exchange, it rarely affects the tax consequences of an exchange. For example, if an exchanger transfers property worth $200,000 and identifies five replacement properties with an aggregate fair market value of $425,000, the exchanger must acquire identified replacement property with an aggregate fair market value equal to 95% of $425,000 or $403,750 of replacement property. Because this amount is significantly greater than the value of the relinquished property, the 95% rule rarely finds applicability.

The 95% rule applies to identified property. Because property acquired within the identification period is deemed to be identified, when computing the value of identified property for purposes of applying the 95% rule, the exchanger must include property received during the identification period.\(^{51}\) This same rule applies when determining identified property for purposes of the three-property rule and the 200% rule.

**Definition of Fair Market Value.** Fair market value of property is determined without regard to any liabilities secured by the property.\(^{52}\) This rule is consistent with the liability-boot rules, which provide that liability relief is treated as cash received, unless offset by liability assumption or additional investment of money. In both situations, Section 1031 ignores the equity in property and focuses on the property standing alone.

To be safe, exchangers should be conservative in estimating the fair market values of properties. The rules do not state whether the fair market value of the relinquished property is the sales price net of closing costs or the total sales price. Erring on the side of caution in such a situation, exchangers should use the sales price net of closing costs to compute the 200% limit. Exchangers should similarly use caution in estimating the fair market value of replacement property. To be safe, exchangers should use a value that will not understate the fair market value of replacement property. If the value used

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\(^{50}\) See Reg. 1.1031(k)-1(c)(4)(ii)(B).

\(^{51}\) See Reg. 1.1031(k)-1(c)(4)(iii).

\(^{52}\) See Reg. 1.1031(k)-1(m).
by the exchanger to apply the 200% rule ends up being lower than the actual fair market value of the property, the exchanger could violate the rule, and any property the exchanger acquires could be deemed to be not like kind to the relinquished property. Another cautionary measure would dictate that the exchanger identify property that is somewhat below the 200% limit.

**Identification of Incidental Property.** An exchanger is not required to identify incidental property. Incidental property is treated as part of a larger item of property for purposes of applying the identification rules.\(^{53}\) Property is incidental to a larger item of property if (1) in standard commercial transactions, the property is typically transferred together with the larger item of property and (2) the aggregate fair market value of all of the incidental property does not exceed 15% of the aggregate fair market value of the larger property.\(^{54}\) Under this rule, incidental property will be deemed to be identified, but, if it is not like kind to relinquished property, it will be boot. For example, an exchanger may identify a hotel as replacement property, and the hotel linens may satisfy the definition of incidental property and therefore be treated as identified. If the exchanger’s relinquished property did not include linens, however, they will be boot in the exchange.

**Revocation of Identification.** An exchanger may revoke an identification prior to the end of the identification period.\(^{55}\) If an exchanger properly revokes an identification, the property is not included in any of the tests mentioned above. For a revocation to be effective, the exchanger must make it in a written document; sign it; and hand deliver, mail, fax, or otherwise deliver it before the end of the identification period to the person to whom the identification was made. If the exchanger identified the replacement property in a written agreement, the revocation must be made either in a written amendment to the agreement or in a written document signed by the taxpayer and properly delivered to all of the parties to the agreement before the end of the identification period.\(^{56}\)

**Receipt of Identified Replacement Property**

The exchanger must acquire identified replacement property before the end of the exchange period to satisfy the rules of Section 1031(a)(3).\(^{57}\) Of course,

\(^{53}\) See Reg. 1.1031(k)-1(c)(5).

\(^{54}\) See Reg. 1.1031(k)-1(c)(5)(A). For example, a spare tire and kit whose aggregate fair market value is $1,500 are incidental to a truck worth $10,000 (see Reg. 1.0131(k)-1(c)(5)(B), Example 1), and furniture, laundry machines, and other miscellaneous items of personal property with an aggregate fair market value of $150,000 are incidental to an apartment building (see Reg. 1.0131(k)-1(c)(5)(B), Example 2).

\(^{55}\) See Reg. 1.1031(k)-1(c)(6).

\(^{56}\) See Reg. 1.1031(k)-1(c)(7), Example 6 (providing an example of a valid written revocation); Reg. 1.1031(k)-1(c)(7), Example 7 (providing an example of an invalid oral revocation).

\(^{57}\) See Reg. 1.1031(k)-1(d)(1).
if the exchanger acquires replacement property within the identification period, the exchanger will be deemed to acquire identified replacement property. If the exchanger acquires replacement property after the end of the exchange period, the property received must be substantially the same property as identified. The regulations provide examples of property that is substantially the same property as identified.

**Substantially-the-Same Requirement.** If the taxpayer identifies unimproved land and following the identification, a fence is constructed on the land so the taxpayer receives the raw land with a fence, the property received will be substantially the same as the property identified. The regulations provide that erecting the fence does not change the nature or character of the land, so the received property is substantially the same as the identified property.

The regulations provide an example of property that is not substantially the same as the property identified. In the example, the exchanger identifies a barn, the property underlying the barn, and two acres as replacement property. The exchanger receives only the barn and the underlying property. The regulations provide that the property received is not substantially the same as the property identified because the property received differed in nature and character from the property transferred. The fact that the value of the two acres was only 25% of the total value of the identified property was not relevant. This example demonstrates that exchangers must consider the nature and character of the property and not merely the value of the property identified and the value of the property received in applying the test to determine whether the property received is substantially the same as the property identified. This example is somewhat confusing, however, because it appears to draw a distinction between improved property and unimproved property, even though elsewhere the regulations provide that whether property is improved or unimproved is immaterial for purposes of determining whether real property is like kind.

The confusion is compounded by another example in the regulations, which provides that an exchanger who identifies unimproved land but acquires only 75% (in terms of both the value and area of the land) of the property identified satisfies the substantially-the-same requirement. The difference between this example and the barn example appears to be the improvements involved in the barn example (since in both situations the exchanger acquired

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58 See Reg. 1.1031(k)-1(d)(1).
59 See Reg. 1.1031(k)-1(d)(2), Example 2.
60 See Reg. 1.1031(k)-1(d)(2), Example 3.
61 See Reg. 1.1031(a)-1(b).
62 See Reg. 1.1031(k)-1(d)(2), Example 4.
75% of the value of the identified property). Apparently, to satisfy the substantially-the-same requirement in situations in which the identified property includes improvements, an exchanger must acquire both the improvements and a significant portion of identified raw land. Acquiring 75% of the value and area of identified raw land would also appear to satisfy the substantially-the-same requirement. The example does not preclude the acquisition of less than 75% of the identified property, but it provides no guidance about how much less can be acquired without violating the substantially-the-same requirement.

**Property to Be Produced.** An exchanger may wish to acquire, as replacement property, property that has not yet been produced at the end of the identification period. The regulations provide rules for identifying such property and whether an exchanger may acquire less than the finished product and still satisfy the substantially-the-same requirement. To satisfy the identification requirement, the exchanger must provide as much detail of the nonexistent property as practicable at the time the identification is made. For purposes of applying the identification rules, the fair market value of property to be produced is its estimated fair market value as of the date it is expected to be received by the taxpayer.

In determining whether an exchanger has met the substantially-the-same requirement with respect to property produced after the exchanger makes the identification, variations due to usual or typical production changes are not taken into account. Personal property must be completed before the date received to be considered substantially the same as the identified property. Real property does not have to be completed when the exchanger receives it if, had the production been completed on or before the date the exchanger receives the property, the property would have been substantially the same as the identified property.

A taxpayer must acquire real property to satisfy the like-kind property standard. Thus, even though the taxpayer may satisfy the substantially-the-same requirement by acquiring unfinished improvements, if the relinquished property was real property, only the portion of the constructed improvements that is real property will satisfy the like-kind property requirement. Prepaid construction costs or acquired materials will not be like kind to other real property and will be boot if paid for using exchange proceeds. Only the

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63 See Reg. 1.1031(k)-1(e)(1) and (e)(2)(i).
64 See Reg. 1.1031(k)-1(e)(2)(ii).
65 See Reg. 1.1031(k)-1(e)(3)(i).
66 See Reg. 1.1031(k)-1(e)(3)(ii).
67 See Reg. 1.1031(k)-1(e)(3)(iii).
portion of the improvements that are finished will be replacement property for purposes of Section 1031(a)(1).

**Fraudulent Identification**

The time requirements in Section 1031(a)(3) are strict. Nonetheless, some exchangers succumb to the temptation to identify property after the end of the identification period. The consequences of doing so are unpleasant and do not justify the risk taken in committing fraud in an attempt to complete a busted exchange. For example, a taxpayer who backdated identification documents (1) was disallowed Section 1031 treatment on the transaction, (2) was treated as having received the funds held by an individual intended to serve as qualified intermediary who assisted the taxpayer in backdating the documents, and (3) was liable for additions to tax for civil fraud under Section 6663(b). Exchange facilitators or others who participate in such fraud may also be subject to strict penalties. For example, an exchange facilitator receiving an identification after the end of the identification period, but date-stamping the identification as received during the identification period, could be guilty of aiding in fraud and could be subject to criminal penalties.

**Section 1031 Deferred Exchange**

**Safe Harbors**

As discussed above, *Starker v. U.S.* opened the door for deferred exchanges. The party who purchased the exchanger’s relinquished property (the exchange partner) was willing to facilitate the acquisition of the replacement property. The exchanger was also comfortable that the exchange partner (a large corporation) would acquire and deliver replacement property. Not all exchanges have such favorable circumstances. Often the party buying the relinquished property has no interest in facilitating an exchange by acquiring replacement property and transferring it to the exchanger. The party selling the replacement property may be equally unwilling to facilitate the exchange. Even if one of the other parties to the exchange is willing to be a facilitator,

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68 Only if an exchange or party to an exchange is within a presidentially declared disaster area may the time requirements extend beyond the limits set forth in Section 1031(a)(3).

69 See Dobrich, 188 F.3d 512 (9th Cir. 1999).

70 See, e.g., Section 7206(2) (2006) (“Any person who . . . willfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document[,] . . . shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation) or imprisoned not more than 3 years, or both, together with the costs of prosecution.”).
the exchanger may not have sufficient confidence that the other party will be financially capable of completing its obligations under the exchange agreement. Thankfully, Treasury has provided several safe harbors that make deferred and multiparty exchanges economically feasible.

The primary concern in deferred and multiparty exchanges is the taxpayer’s actual or constructive receipt of exchange proceeds. Experience has shown that structuring such exchanges without the safe harbors is a significant challenge. Assume that the purchaser of the relinquished property agrees to facilitate the exchange but that the exchanger is not confident that the purchaser will later have the resources needed to acquire replacement property. To protect its interests, the exchanger may request a security interest in the replacement property or require the exchanger to deposit sufficient funds in an escrow or trust to be used to later acquire the replacement property. The concern arises in each of these situations that the exchanger will be in constructive receipt of exchange proceeds.\(^{71}\) If none of the other parties to the exchange are interested in facilitating it, a concern arises that a facilitator will be treated as the agent of the exchanger, and any proceeds the facilitator receives, the exchanger will be deemed to receive. The safe harbors in the regulations help the exchangers overcome each of these obstacles and make Section 1031 exchanges available to a very broad cross-section of property owners.\(^{72}\)

**Security or Guarantee Arrangements**

The first type of safe harbor, the security or guarantee arrangement, allows the exchanger to obtain some comfort that the exchange partner will perform its obligation of transferring replacement property or paying the exchanger an amount of cash equal to the value of the relinquished property. An exchanger would use this safe harbor if the relinquished property buyer agrees to facilitate a multiparty or deferred exchange, and the exchanger wants assurance

\(^{71}\) See, e.g., Halpern v. U.S., 286 F. Supp. 255 (ND Ga. 1968) (holding that an exchanger was in constructive receipt of exchange proceeds held in the exchanger’s attorney trust account because the exchanger could instruct the attorney with respect to the disposition of the proceeds and otherwise had unlimited access to the proceeds). See also Reg. 1.1031(k)-1(f)(2) ("The taxpayer is in actual receipt of money or property at the time the taxpayer actually receives the money or property or receives the economic benefit of the money or property. The taxpayer is in constructive receipt of money or property at the time 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.")

\(^{72}\) See Reg. 1.1031(k)-1(g)(1) (providing that if an exchanger uses one of the safe harbors, the exchanger will not be in actual or constructive receipt of money or other property held in the safe harbor for purposes of Section 1031).
SAFE HARBORS AND CAREFUL PLANNING

that the buyer will perform under the contract. The regulations provide that
the exchanger will not be treated as being in constructive receipt of money
or other property even though the buyer’s obligation to transfer replacement
property is secured by one of the following mechanisms.\textsuperscript{73}

**Security Interest.** The exchanger may take a mortgage, deed of trust, or
other security interest in property (other than cash or a cash equivalent) with-
out being deemed to be in constructive receipt of money or other property.\textsuperscript{74}
This language appears to allow the exchanger to take a security interest in
anything other than cash or its equivalent (which would most likely require
the exchanger to take possession). Thus, the exchanger should be able to take
a security interest in the relinquished property or other property that the buyer
owns.

An exchanger would use this safe harbor if the relinquished property
buyer agreed to acquire replacement property and transfer it to the exchang-
er. The exchanger would transfer the relinquished property to the buyer,
and the buyer would agree to acquire replacement property and transfer it
to the exchanger.\textsuperscript{75} To ensure that the buyer performs under the agreement,
the exchanger could take a security interest in the relinquished property. If
the buyer does not perform under the agreement by failing to deliver replace-
ment property to the exchanger, the exchanger could enforce its security in-
terest and foreclose on the property secured by the security interest. Because
of the difficulties with foreclosure, this may not be an attractive alternative
for the exchanger.

Legal authority does not explain the tax consequences to the exchanger
of foreclosing and receiving back the relinquished property. In such a situ-
ation, since the exchanger’s reacquisition of the relinquished property would
make it whole, the exchanger should be treated as never having sold the re-
linquished property, recognize no gain or loss on the disposition or reacqui-
sition, and take the adjusted basis it had in the property at the time of the
disposition. The exchanger should not, however, be allowed to take depre-
ciation deductions with respect to the property for the period the buyer is
deemed to own it.

**Standby Letter of Credit.** An exchanger may require a standby letter of
credit, which may not be drawn upon in the absence of a default of the
buyer’s obligation to transfer like-kind replacement property, without being

\textsuperscript{73} See Reg. 1.1031(k)-1(g)(2)(i).

\textsuperscript{74} See Reg. 1.1031(k)-1(g)(2)(i)(A).

\textsuperscript{75} Alternatively, if the buyer already owned the replacement property but was unable to
make the transfer immediately, it would agree to transfer the replacement property at some
point in the near future.
deemed to be in constructive receipt of money or other property.\footnote{\text{76}} Because the exchanger does not have to initiate foreclosure proceedings to obtain compensation, this safe harbor provides the exchanger greater flexibility in obtaining compensation in the event that the buyer defaults on its obligation to transfer like-kind replacement property. Because a bank or other financial institution provides the standby letter of credit, the exchanger may feel comfortable that it will be paid for the relinquished property in the event the buyer defaults. If the bank pays under the standby letter of credit in the event the buyer fails to deliver the replacement property, the money that the exchanger receives will be consideration for the relinquished property, and the exchanger will recognize gain or loss on the transaction.

\textbf{Third-Party Guarantee.} An exchanger may obtain a guarantee of the third party that secures the buyer’s obligation to transfer replacement property without being deemed to be in constructive receipt of money or other property.\footnote{\text{77}} Thus, in the event the buyer does not transfer replacement property to the exchanger, the third party would compensate the exchanger for the buyer’s breach. If the exchanger received anything other than like-kind property during the replacement period, the property the exchanger received from the third party would be boot.

\textbf{Cessation of Safe Harbor.} These security interest safe harbors cease to apply as soon as the exchanger has an immediate ability or unrestricted right to receive money or other property pursuant to the security or guarantee arrangement.\footnote{\text{78}} To obtain the maximum time possible to acquire replacement property, most exchangers will structure such arrangements to provide the exchanger the unrestricted right to receive money or other property after the end of the replacement period. The arrangements may provide that in the event the buyer does not deliver replacement property by the end of the exchange period, the exchanger will have the right to receiver money or other property under the arrangement.

\textbf{Qualified Escrow Accounts and Qualified Trusts}

The exchanger will not be deemed to be in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property even though the buyer’s obligation to transfer the replacement property to the taxpayer is, or may be, secured by cash or a cash equivalent held in a qualified escrow or qualified trust.\footnote{\text{79}} Unlike the security interest safe harbors, these safe harbors allow the buyer to actually place

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\text{\textsuperscript{76}} See Reg. 1.1031(k)-1(g)(2)(i)(B) (defining standby letter of credit as one that satisfies all of the requirements of Reg. 15A.453-1(b)(3)(iii)).

\text{\textsuperscript{77}} See Reg. 1.1031(k)-1(g)(2)(i)(C).

\text{\textsuperscript{78}} See Reg. 1.1031(k)-1(g)(2)(ii).

\text{\textsuperscript{79}} See Reg. 1.1031(k)-1(g)(3)(i).}
money in a qualified escrow or qualified trust. Because money is actually on deposit, the exchanger may be confident that it will obtain the funds if the buyer fails to deliver replacement property as agreed.

The regulations provide very specific requirements that must be satisfied to establish a qualified escrow account or qualified trust. An exchanger that uses a qualified escrow account or qualified trust will transfer relinquished property to a buyer. The buyer will deposit the relinquished property proceeds in a qualified escrow account or qualified trust to secure its obligation to acquire replacement property (see Figure 1). The deposited funds will be available only for the acquisition of replacement property to distribute to the exchanger if the exchange fails.

**Qualified Escrow Accounts.** A qualified escrow account is an escrow account that satisfies two requirements: (1) the escrow holder must be a person other than the taxpayer or a disqualified person,80 and (2) the escrow agreement must contain the restrictions set forth in Reg. 1.1031(k)-1(g)(6) ((g)(6) restrictions) restricting the exchanger’s right to receive, pledge, borrow, or otherwise obtain the benefit of money or other property held in the account before the end of the exchange period.81 If an exchanger establishes

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80 See Reg. 1.1031(k)-1(g)(3)(ii)(A).
81 See Reg. 1.1031(k)-1(g)(3)(ii)(B).
a qualified escrow account, it can require the buyer to deposit money equal to the value of the relinquished property in the account to secure the exchange partner’s obligation to transfer replacement property. The escrow documents may provide that in the event the buyer fails to deliver replacement property by the end of the replacement period, the escrow agent may distribute the funds to the exchanger. Of course, any money the exchanger receives from the escrow account will be boot (or consideration for the relinquished property, if the exchanger receives no like-kind property as part of the transaction).

**Qualified Trusts.** A qualified trust is a trust that satisfies two requirements: (1) the trustee must be a person other than the taxpayer or a disqualified person (for this purpose, the relationship between the taxpayer and the trustee created by the qualified trust will not be considered a relationship under Section 267(b)), and (2) the trust agreement must contain the (g)(6) restrictions, restricting the exchanger’s right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held in the trust before the end of the replacement period. Much like the qualified escrow account safe harbor, this safe harbor allows the buyer to deposit money in trust to secure its obligation to acquire replacement property. The trust agreement may provide that in the event the buyer does not deliver replacement property to the exchanger by the end of the replacement period, the money held in trust shall be delivered to the exchanger. Of course, any money that the exchanger receives from the qualified trust will be boot (or consideration for the relinquished property, if the exchanger receives no like-kind property as part of the transaction).

**Cessation of Qualified Escrow Account or Qualified Trust.** A qualified escrow account or qualified trust ceases to be qualified at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account or trust. Rights conferred upon the taxpayer under state law to terminate or dismiss the escrow holder of a qualified escrow account or the trustee of a qualified trust are disregarded for this purpose. Because the (g)(6) restrictions require that the exchanger’s access to money or other property held in a qualified escrow account or a qualified trust be limited for the entire exchange period, it is difficult to imagine a situation where an exchanger would have the immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the funds prior to the end of the replacement period. If the restrictions can be amended after the agreement

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82 See Reg. 1.1031(k)-1(g)(3)(iii)(A).
83 See Reg. 1.1031(k)-1(g)(3)(iii)(B).
84 See Reg. 1.1031(k)-1(g)(3)(iv).
has been executed, this raises the question whether the restrictions are illusory. If the restrictions are illusory, the arrangement would not be a qualified escrow account or a qualified trust.

Although the regulations allow exchangers to terminate or dismiss the escrow holder of a qualified escrow account or the trustee of a qualified trust, they do not discuss the consequences of doing so. Because the escrow holder or trustee merely hold money that secures the buyer’s obligation to transfer replacement property, an exchanger may be able to dismiss an escrow holder or trustee and appoint another so long as the exchanger never has the immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the funds transferred to the new escrow holder or trustee.

**Receipt of Other Property.** The qualified escrow account and qualified trust safe harbors allow exchangers to receive other property directly from a party to the exchange but not from the qualified escrow account or qualified trust, without violating the safe harbors. For example, an exchanger may transfer relinquished property to a buyer and require that the buyer deposit money equal to the value of the relinquished property in a qualified trust to secure the buyer’s obligation to transfer replacement property to the exchanger. If at the closing of the replacement property, the replacement property seller transfers legal title to like-kind real property to the buyer and legal title to non-like-kind personal property directly to the exchanger, the direct transfer of the personal property to the exchanger will not violate the safe harbor.

**Qualified Intermediaries**

By far, the most popular safe harbor is the qualified intermediary. This is because the qualified intermediary allows both the relinquished property buyer and the replacement property seller to participate in the exchange only to the extent of their own personal interests. Thus, a qualified intermediary is used in situations in which neither the relinquished property buyer nor the replacement property seller is willing to facilitate a like-kind exchange. Professional intermediaries also make this an attractive safe harbor. Competent professional intermediaries have spent significant resources preparing documents that satisfy the Section 1031 requirements. They are familiar with the exchange process and provide their services at reasonable prices. For these reasons, Section 1031 advisors generally recommend that exchangers hire a professional qualified intermediary to facilitate their exchanges.

The qualified intermediary safe harbor provides that a qualified intermediary is not treated as the agent of the taxpayer for the purposes of determining whether the taxpayer has actually or constructively received money

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85 See Reg. 1.1031(k)-1(g)(3)(v).
or other property held by the qualified intermediary. Unlike the other safe havens discussed above, this safe harbor is not used to merely secure the obligation of the buyer. By providing that the qualified intermediary will not be deemed to be the exchanger’s agent, this safe harbor allows a qualified intermediary to take possession of money or other property without the exchanger being deemed to be in possession of the money or other property. Therefore, the exchanger may transfer relinquished property to the qualified intermediary, who sells the property to the buyer and receives the exchange proceeds. At the exchanger’s direction, the qualified intermediary uses the exchange proceeds to acquire the replacement property and transfers it to the exchanger (see Figure 2). For this safe harbor to apply, the transaction must satisfy several requirements.

**Qualification Requirement.** The qualified intermediary must be a person other than the exchanger or a disqualified person. As discussed below, a disqualified person is the exchanger’s agent, a person related to the exchanger, or a person related to the exchanger’s agent. Anyone other than a disqualified person may be a qualified intermediary. There is no licensing or certification required for a person to be a qualified intermediary, although some states may have restrictions on who can serve as a qualified intermediary. Some exchangers take this as an opportunity to hire a friend to be a qualified intermediary with the intention of saving the time and expenses involved in hiring a professional intermediary. Because professional intermediaries have developed very efficient means of delivering services and extensive exchange experience, hiring a novice to provide qualified intermediary services generally will not save money or time. It may, however, expose the exchanger to additional risk. For example, an individual who acts as a qualified intermediary may subject exchange proceeds to the individual’s personal liability, which could arise

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86 See Reg. 1.1031(k)-1(g)(4)(i).

87 If the intermediary were deemed to be the exchanger’s agent, the exchanger would be deemed to acquire any money or other property that the intermediary acquired. See Reg. 1.1031(k)-1(f)(2) (“Actual or constructive receipt of money or other property by an agent of the taxpayer (determined without regard to paragraph (k) of this section) is actual or constructive receipt by the taxpayer.”).

88 See Reg. 1.1031(k)-1(g)(4)(iii)(A).

89 See, e.g., Nev. Rev. Stat. 645.6065 (2005) (requiring that a person who acts as a qualified intermediary in Nevada must register with the Real Estate Division); Nev. Rev. Stat. 645.606 (2005) (defining qualified intermediary to include any person who advertises or holds himself out as prepared to facilitate a tax-free exchange of property in Nevada by acting as the custodian of money or other property); Nev. Rev. Stat. 692A.265 (2005) (prohibiting title insurers, title agents, and escrow officers from handling an escrow, settlement, or closing in which a qualified intermediary is involved, unless such person first verifies that the qualified intermediary is registered with the Real Estate Division).
from malfeasance, divorce, negligence, or other acts by the individual. Thus, even though the law allows significant leeway for who can serve as a qualified intermediary, prudence dictates that exchangers choose their qualified intermediary wisely.

**Exchange Agreement Requirement.** The exchanger and the qualified intermediary must enter into a written exchange agreement. The exchange agreement is a contract between the exchanger and the qualified intermediary that establishes the obligations of the exchanger and the qualified intermediary. Pursuant to the exchange agreement, the exchanger transfers relinquished property to the qualified intermediary, the qualified intermediary sells the relinquished property to the relinquished property buyer, the qualified intermediary receives the relinquished property proceeds, and the qualified intermediary holds the proceeds until directed by the exchanger to acquire replacement property and transfer the replacement property to the exchanger. In short, the exchange agreement provides that the qualified intermediary will transfer replacement property to the exchanger in exchange for the relinquished property. Generally, the exchange agreement also contains provisions addressing how the qualified intermediary will hold the proceeds from the sale of the relinquished property.

A key to the qualified intermediary safe harbor is that the exchange agreement must contain the (g)(6) restrictions. Thus, the exchanger and qualified intermediary must contractually agree that the exchanger will not have the right to receive, pledge, borrow, or otherwise obtain the benefits of

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90 See Reg. 1.1031(k)-1(g)(4)(iii)(B).
91 See Reg. 1.1031(k)-1(g)(4)(ii).
money or other property held by the qualified intermediary during the exchange period. As with the qualified escrow account and the qualified trust, these restrictions cannot be illusory for the qualified intermediary safe harbor to be viable. Thus, exchangers should not seek to amend the exchange agreement to remove or modify the (g)(6) restrictions. The qualified intermediary must adhere to the provisions of the exchange agreement and not distribute exchange proceeds until the (g)(6) restrictions lapse.

**Transfer-Through-the-Intermediary Requirement.** The exchange agreement must require the qualified intermediary to (1) acquire the relinquished property from the exchanger, (2) transfer the relinquished property to the buyer, (3) acquire the replacement property, and (4) transfer the replacement property to the exchanger.\(^{92}\) Thus, the qualified intermediary safe harbor requires that the relinquished property and the replacement property transfer through the qualified intermediary. The properties will transfer through the qualified intermediary if the qualified intermediary takes legal title to the properties, the qualified intermediary enters into an agreement to acquire the properties and directs that they be deeded directly from and to the exchanger, or the exchanger assigns its rights in the buy-sell agreements to the qualified intermediary.

**Transfer of Title.** Property is treated as transferred through a qualified intermediary if the qualified intermediary acquires or transfers legal title to the property.\(^{93}\) Although this is a straightforward way to transfer property through the qualified intermediary, the qualified intermediary prefers not to enter the chain of title on property. Avoiding taking title helps shield the qualified intermediary from potential liability that may arise with respect to property, and it simplifies the transfer process by eliminating the documentation that would be required to transfer legal title to and from the qualified intermediary. Therefore, exchanges structures should not require a qualified intermediary to take title to any exchange property.\(^{94}\)

**Intermediary Agreement.** The qualified intermediary safe harbor provides that a qualified intermediary does not have to take title to property to be treated as acquiring the property if the qualified intermediary enters into an agreement to transfer or acquire the property. Thus, if the qualified intermediary enters into an agreement with the buyer of relinquished property for the transfer of the relinquished property to the buyer and pursuant to that agreement, the

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\(^{92}\) See Reg. 1.1031(k)-1(g)(4)(iii)(B).

\(^{93}\) See Reg. 1.1031(k)-1(g)(4)(iv)(A).

\(^{94}\) As discussed in Chapter 5 in the treatise from which this article is adapted, certain title-parking exchange structures require an exchange facilitator to take title to exchange property.
relinquished property is transferred to such person, the relinquished property is treated as passing through the qualified intermediary.\textsuperscript{95} Thus, if the qualified intermediary enters into an agreement with the buyer of the replacement property, the exchanger may transfer legal title to the relinquished property directly to the buyer at the direction of the qualified intermediary.

Similarly, if the qualified intermediary enters into an agreement with the owner of the replacement property for the transfer of the replacement property and, pursuant to that agreement, the owner of the replacement property transfers legal title directly to the exchanger, the qualified intermediary will be treated as acquiring the replacement property and transferring it to the exchanger.\textsuperscript{96} Thus, the qualified intermediary does not have to acquire legal title to property to be treated as acquiring it for Section 1031 purposes.

**Assignment to Intermediary.** The qualified intermediary safe harbor simplifies things further by not requiring the qualified intermediary to enter into the contracts. The regulations treat the qualified intermediary as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary, and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property.\textsuperscript{97} Thus, the taxpayer may enter into an agreement with the buyer of the relinquished property and satisfy this requirement by assigning the rights in that contract to the qualified intermediary. Also, the taxpayer may enter into an agreement to purchase replacement property and satisfy this requirement by assigning the rights in that contract to the qualified intermediary. Indeed, by assigning rights in a contract, exchangers generally satisfy the requirement that property transfer through the qualified intermediary. Although many qualified intermediary companies provide forms that ask for the signature of the buyer of relinquished property or the seller of replacement property, the regulations do not require such signatures. Instead, the regulations merely require that such parties be given notice of the assignment. Exchangers should retain documents showing that the other parties were given notice, if the other parties do not sign the assignment documents.

The regulations merely require that the exchanger assign its rights in the contracts; therefore, the exchanger is not required to assign any obligations to the qualified intermediary. With respect to the relinquished property contract, the exchanger should assign its rights to receive the sale proceeds to the qualified intermediary. The buyer of the relinquished property should transfer the proceeds directly to the qualified intermediary, and the exchanger will directly deed the relinquished property to the buyer (see Figure 3). The qualified

\textsuperscript{95} See Reg. 1.1031(k)-1(g)(4)(iv)(B).
\textsuperscript{96} See Reg. 1.1031(k)-1(g)(4)(iv)(C).
\textsuperscript{97} See Reg. 1.1031(k)-1(g)(4)(v).
intermediary will, however, be treated as acquiring the relinquished property and transferring it to the buyer. With respect to the replacement property, the exchanger must assign to the qualified intermediary its rights to acquire the replacement property. To acquire the replacement property, the exchanger will direct the qualified intermediary to transfer exchange proceeds to the replacement property seller, and the qualified intermediary will direct the seller to transfer title to the replacement property directly to the exchanger. Because of the rules in the regulations, the qualified intermediary will nonetheless be treated as acquiring the replacement property and transferring it to the exchanger. Exchangers prefer to assign rights in contracts to satisfy the requirement that the property pass through the qualified intermediary because (1) assigning rights only requires one extra document (the assignment agreement), (2) the qualified intermediary is not required to enter into agreements with other parties, and (3) the qualified intermediary is not required to take title.

**Receipt of Other Property.** Much like the qualified escrow account and qualified trust account safe harbors, the qualified intermediary safe harbor allows the exchanger to receive money or other property from another party to the exchange without destroying the safe harbor. See Reg. 1.1031(k)-1(g)(vii).
but the exchanger will not be deemed to be in actual or constructive receipt of the money transferred to the qualified intermediary. Thus, the regulations allow exchangers to receive non-like-kind property without destroying the qualified intermediary safe harbor.

**Interest and Growth Factors**

*In Starker v. U.S.*, the exchanger transferred property to a buyer, and the buyer promised to acquire replacement property or pay the taxpayer cash for the relinquished property at the end of five years. The parties also agreed that the buyer would pay interest or a growth factor on the outstanding balance of its obligation to transfer replacement property or cash. The court held that the exchanger’s acquisition of the interest or growth factor did not adversely affect the exchange but that it was income to the taxpayer when received. The regulations codify this rule by providing that a provision in an exchange contract providing for an interest or growth factor will not prevent the transaction from qualifying for like-kind exchange treatment. To benefit from this rule, however, the taxpayer’s right to receive the interest or growth factor must be subject to the (g)(6) restrictions. Thus, the exchanger cannot receive the interest or growth factor until after the end of the exchange period. Any interest or growth factor received by the taxpayer will be income to the taxpayer, as the court held in *Starker*.

**Safe Harbor Combinations**

The regulations allow exchangers to use more than one safe harbor for the same exchange but require the separate safe harbors to separately satisfy their respective terms and conditions. Exchangers would normally use either the qualified escrow account safe harbor or the qualified trust safe harbor in conjunction with the qualified intermediary safe harbor to help ensure that the exchange proceeds are safe. Thus, if, for some reason, the exchanger was concerned that the exchange proceeds may not be safe if held directly by the qualified intermediary, the exchanger may require the relinquished property buyer to deposit the proceeds in a qualified escrow account or a qualified trust to secure the qualified intermediary’s obligation to transfer replacement property (see Figure 4). Also, after the (g)(6) restrictions lapse, the exchanger

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99 129 602 F.2d 1341 (9th Cir. 1979).
100 See Reg. 1.1031(k)-1(g)(5).
101 See Reg. 1.1031(k)-1(g)(1).
102 See Reg. 1.1031(k)-1(g)(8), Example 3 (describing a transaction that involved both a qualified intermediary and qualified escrow account).
may receive interest earned on proceeds while held in one of the safe harbors without adversely affecting the safe harbor.

The (g)(6) Restrictions

As stated above, each safe harbor (with the exception of the security or guarantee safe harbor) requires that the relevant agreement provide that the exchanger has no right to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property held in the safe harbor before the end of the exchange period (including any extensions of time for disaster events).103 These are the (g)(6) restrictions. An exchange agreement, escrow agreement, or trust agreement must contain the (g)(6) restrictions to create a safe harbor.136 The regulations provide three exceptions under which the (g)(6) restrictions may lapse before the end of the exchange period.

Exception for Failure to Identify Replacement Property. The relevant agreement may provide that if the exchanger has not identified replacement property by the end of the identification period, the exchanger may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property at any time after the end of the identification period.104 Thus, the

103 See Reg. 1.1031(k)-1(g)(6)(i).
104 See Reg. 1.1031(k)-1(g)(6)(ii).
end of the identification period presents a decision point for the exchanger. If, at the end of the identification period, the exchanger is certain that it will not acquire any replacement property before the end of the exchange period, and the exchanger wants immediate access to the exchange proceeds, the exchanger should not identify any replacement property. If, at the end of the exchange period, the exchanger has identified replacement property, the exchanger will not have access to the exchange proceeds, except for the purpose of purchasing replacement property, until after the exchange period.

**Exception for Receipt of All Replacement Property.** The regulations allow the exchanger to have the right to receive, pledge, borrow, or otherwise obtain the benefits of the money upon or after the receipt of all of the replacement property to which the exchanger is entitled under the agreement. The exchanger is entitled to receive only identified property under the agreement. Thus, if the exchanger identifies only one property during the identification period, the exchanger is entitled to receive only one property under the agreement. If the exchanger acquires the property after the end of the identification period, the exchanger would have acquired all of the property it was entitled to receive under the agreement. At that point, the exchanger may have access to the money held in the safe harbor.

Apparently no authority addresses several questions that arise with respect to this rule. For example, an exchanger may transfer relinquished property worth $150,000 to a buyer, and the buyer may transfer $150,000 of exchange proceeds to a qualified intermediary. During the identification period, the exchanger may identify two potential replacement properties: Property 1 worth $150,000 and Property 2 worth $135,000. If the exchanger acquires Property 2 after the end of the identification period but before the end of the exchange period, the regulations do not explicitly provide whether the exchanger may receive the remaining $15,000 held by the qualified intermediary before the end of the exchange period.

One argument provides that the exchanger should be able to receive the $15,000 because that amount is insufficient to allow the exchanger to acquire Property 1. The other argument provides that if the exchanger were to invest an additional $135,000, it is entitled to acquire Property 1 under the exchange agreement, and therefore, the (g)(6) restrictions still apply. Although tax advisors may disagree about which argument would prevail, the conservative approach is for the qualified intermediary to not distribute the proceeds. Not only is this approach conservative, it is also prudent.

If a court were to hold that the (g)(6) restrictions still apply after the exchanger acquires Property 2, the distribution of the $15,000 would be evidence that the language in the exchange agreement restricting the exchanger’s

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105 See Reg. 1.1031(k)-1(g)(6)(iii)(A).
rights to the exchange proceeds was illusory. In that case, the arrangement
would not be a safe harbor, the exchanger would likely be deemed to be in
constructive receipt of the exchange proceeds from the date the intermedi-
ary received them, and the transaction would not qualify for nonrecognition
treatment. Furthermore, the same language in exchange agreements between
the intermediary and other exchangers could also be considered illusory, and
those other exchangers would similarly be deemed to be in constructive re-
cceipt of money held by the intermediary, destroying all exchanges the inter-
mediary has facilitated.

Although this may sound like a doomsday scenario, because the issue
has not yet been tested, it could happen. To prevent such a catastrophe, pru-
dence dictates that the intermediary should not distribute exchange proceeds
until it has distributed all identified replacement property or the exchange
period has lapsed.

Exception for Certain Contingencies. The agreement may provide that the
exchanger may have rights to receive, pledge, borrow, or otherwise obtain
the benefits of the money or other property upon 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 exchanger and of any disqualified person, other than
the person obligated to transfer the replacement property to the exchanger.106
For example, if the transfer of replacement property is contingent upon the
replacement property being rezoned, the agreement may contain a provision
that the exchanger will receive rights to receive, pledge, borrow, or otherwise
obtain the benefit of the money or other property held in the safe harbor in
the event the replacement property is not rezoned.107 The destruction of the
replacement property is another acceptable contingency.

The IRS has privately ruled that all property is for sale at the right price.
Therefore, the IRS ruled that the inability to close on a piece of identi-
fied property is not the type of contingency beyond the exchanger’s con-
trol.108 Apparently the IRS believes that in the event negotiations break down,
the exchanger may later be able to make a better offer, or a change in cir-
cumstances may make the property available later. In other words, failure to
close on replacement property is not a material and substantial contingency
referred to in the regulations.

Example. Prasad transfers Nelly’s House as the first leg of a deferred ex-
change on March 1, Year 1. Prasad had a basis in Nelly’s House of $50,000,

106 See Reg. 1.1031(k)-1(g)(6)(iii)(B).
107 See Reg. 1.1031(k)-1(g)(8), Example 2.
108 See PLR 200027028 (July 21, 2000).
and it was worth $200,000. Exchange Co., a qualified intermediary, receives the proceeds from the sale of Nelly’s House. Prasad identifies Properties A, B, and C as replacement property, within the identification period. On June 20, Year 1, Exchange Co. acquires A and B for $170,000 and transfers them to Prasad. Prasad, after a good faith attempt, is unable to reach an agreement with respect to Property C. If the exchange agreement between Prasad and Exchange Co. provides that upon Prasad’s failure to reach an agreement with respect to a property, Exchange Co. may distribute cash to Prasad, the exchange agreement does not satisfy the (g)(6) restrictions. Thus, the safe harbor requirements would not be met. Exchange Co. will likely be treated as Prasad’s agent, and Prasad will be required to recognize all $150,000 of realized gain at the time Exchange Co. received the sales proceeds for Nelly’s House.

Disqualified Persons

As stated above, a qualified intermediary, escrow holder of a qualified escrow account, and a trustee of a qualified trust must be someone other than a disqualified person. The regulations define disqualified person as the exchanger’s agent, a party related to the exchanger, and a party related to the exchanger’s agent.

Exchanger’s Agent. A person who is the agent of the exchanger at the time of the transaction is a disqualified person.\(^{109}\) The regulations list the following as an exchanger’s agent: the exchanger’s (1) employee, (2) attorney, (3) accountant, (4) investment banker or broker, or (5) real estate agent or broker. The regulations provide that for one of the listed persons to come within the definition of agent, the person must have acted in that capacity for the exchanger, within the two-year period ending on the date of the transfer of the first of the relinquished properties.

Exchange-Related Services Disregarded. The regulations also disregard certain services in determining whether a person is the exchanger’s agent for purposes of the Section 1031 definition of disqualified person. First, the regulations provide that services for the exchanger with respect to exchanges of property intended to qualify for like-kind exchange treatment shall not be taken into account in determining whether the service provider is the exchanger’s agent.\(^{110}\) Thus, if an exchanger hires an attorney to represent it only with respect to an exchange, the regulations would not treat that attorney as the exchanger’s agent for purposes of the Section 1031 definition

\(^{109}\) See Reg. 1.1031(k)-1(k)(2).

\(^{110}\) See Reg. 1.1031(k)-1(k)(2)(i).
of disqualified person. Thus, the attorney should be able to also serve as the exchanger’s qualified intermediary on the exchange.\footnote{111}

The language also appears to be broad enough to allow the attorney to perform any legal services related to the exchange without becoming a disqualified person. Even with this broad language, most of the listed parties hesitate to serve as a qualified intermediary, escrow holder for a qualified escrow account, or trustee of a qualified trust. One reason for the hesitancy is the possibility of overlooking prior engagements or other work done for the exchanger. If within the past two years, an attorney had performed any legal services for the exchanger on any matter other than a Section 1031 exchange, regardless of how small, the attorney would be a disqualified person. To avoid this potentiality, most attorneys who practice law prefer not to facilitate exchanges. Others who may be the exchanger’s agent also generally attempt to avoid such service. Some do, however, successfully form affiliated entities to perform the exchange facilitation services.

**Routine Services Disregarded.** In determining whether a person is the exchanger’s agent, the regulations also disregard routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.\footnote{112} Thus, an exchanger’s title insurance company could serve as a qualified intermediary. Normally, title insurance companies would perform such services through an affiliate, which would also be allowed. Indeed, many title companies, escrow companies, and banks have affiliates that serve as qualified intermediaries. As discussed below, the regulations do not specifically provide that affiliates of banks will not be disqualified even though other bank affiliates provide investment banking or brokerage services to the exchanger.

**Person Related to Exchanger.** A person who is related to the exchanger is a disqualified person.\footnote{113} The regulations incorporate the definition of related person in Sections 267(b)\footnote{114} and 707(b)\footnote{115} but broaden the scope of the definition.

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\footnote{111}{Of course, the attorney would have to separately consider rules of professional ethics in deciding whether to act as qualified intermediary. Because the attorney and the exchanger would enter into an exchange agreement, such arrangement may create a conflict of interest for the attorney in some situations.}

\footnote{112}{See Reg. 1.1031(k)-1(k)(2)(ii).}

\footnote{113}{Reg. § 1.1031(k)-1(k)(3).}

\footnote{114}{Related persons under Section 267(b) include members of the same family (e.g., siblings, spouses, ancestors, and lineal descendants); shareholders and corporations if the shareholder owns more than 10% of the outstanding value of the corporation; grantors, trustees, and beneficiaries of a trust.}

\footnote{115}{Related persons under Section 707(b) include partnerships and the persons owning, directly or indirectly, more than 10% of the capital interests or profits interest in such partnership and two partnerships in which the same persons own, directly or indirectly, more than 10% of the capital interests or profits interests.}
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by replacing 50% with 10%. Thus, a corporation, of which the exchanger owns 10%, is related to the exchanger. The purpose of this expanded definition of related party is unclear. The focus does not appear to be on restricting control of the exchange proceeds because the exchanger could become a 5% general partner of a general partnership that serves as the exchanger’s qualified intermediary. In such a situation, the exchanger, even though only a 5% member of the partnership, would control it.

The focus of the definition of related party for this purpose appears to be on restricting the exchanger’s right to receive, pledge, borrow, or otherwise obtain the benefits of the money. The exchange agreement between the exchanger and partnership would limit the partnership’s ability to distribute money to the exchanger. Furthermore, the exchanger, owning only 5% of the partnership, would benefit only nominally from the money held by the partnership as qualified intermediary. The exchanger, as general partner of the qualified intermediary, could, however, otherwise have significant control of the money while held by the partnership, allowing the exchanger to make investment decisions relating to the proceeds. To the extent the exchanger is able to increase the return on the proceeds during the period the partnership holds them, that should not impact the partnership’s qualification, since the regulations allow the exchanger to receive interest or a growth factor on the proceeds.

Person Related to Exchanger’s Agent. A person related to the exchanger’s agent is a disqualified person. Thus, the exchanger’s certified public accountant (CPA) cannot form a corporation to act as the exchanger’s qualified intermediary. The CPA, having prepared the exchanger’s tax returns for several years, is the exchanger’s agent, and the corporation is related to the CPA. Thus, the corporation would be a disqualified person. Nonetheless, if the CPA is one of ten CPAs in town that owns a 10% interest in a corporation that serves as a qualified intermediary, the corporation would not be a disqualified person with respect to the exchanger.

The regulations provide that entities affiliated with banks do not come within the definition of disqualified person, even though the entity may be related to another entity that provides investment banking or brokerage services (i.e., is the exchanger’s agent). As a result of this regulation, many of the large banks are now able to act as a qualified intermediary for many of the clients of affiliated entities, which come within the safe harbors’ definition of related party.

The IRS appears to accept a literal definition of related party for the purposes of determining whether a person is a disqualified person. Thus, the

116 See Reg. 1.1031(k)-1(k)(3).
117 See Reg. 1.1031(k)-1(k)(4).
118 See Reg. 1.1031(k)-1(k)(5), Example 3.
119 See Reg. 1.1031(k)-1(k)(4)(ii).
agent of an exchanger (e.g., attorney or CPA) can control an entity that serves as qualified intermediary, so long as the agent and other entity are not related. The IRS allowed a limited liability company (the intermediary) to serve as an exchanger’s qualified intermediary, even though the law firm of the exchanger’s attorney effectively controlled the intermediary. The son-in-law of one of the attorneys at the law firm was the sole owner of the intermediary. The law firm formed a separate limited liability company to manage the intermediary. That management company entered into a long-term contract with the intermediary, which gave the management company control of the intermediary. Because the son-in-law’s ownership of the intermediary was not imputed to the law firm, the law firm and intermediary did not come within the definition of related parties, and the IRS allowed the intermediary to serve as the exchanger’s qualified intermediary.120

Potential Loss of Safe Harbor Status

If a party intended to be a qualified intermediary (or escrow holder of a qualified escrow account or trustee of a qualified trust) distributes non-like-kind property to the exchanger before the (g)(6) restrictions lapse, the safe harbor status will have no effect with regard to any property it has held.121160 For example, an intermediary may distribute proceeds upon request by an exchanger before the end of the identification period. Such a distribution shows that the exchanger had rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the safe harbor. Therefore, the (g)(6) restrictions would not have been imposed, causing the safe harbor to fail with respect to all cash or other property held within the intended safe harbor.

Conclusion

The rules on like-kind exchanges have been refined to a level that a great deal of certainty is available for taxpayers who take the trouble to conduct transactions under the safe harbors. A number of structures can be used to conduct a deferred like-kind exchange, each with its own intricacies, and provided the rules are given careful attention, the tax benefits for the parties will not be lost.

120 See PLR 200338001 (September 19, 2003); John E. Wagner, II, “Ruling Paves the Way for Professionals to Operate Section 1031 Exchange Intermediaries,” 99 J. Tax’n 349 (December 2003).