ESSENTIALS OF §1031 EXCHANGES IN LOUISIANA

Important 1031 Exchange Issues[1]

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A. Exchanges Between Related Parties

A related party is any individual or entity bearing a prohibited relationship to the Taxpayer. This includes, but is not limited to, members of the taxpayer's family (whole or half-blood siblings, ancestors, spouses, and lineal descendants) corporations owned more than 50% by the taxpayer, two corporations within the same controlled group of corporations, a grantor and any fiduciary of any trust, a fiduciary of a trus and a beneficiary of such trust, a fiduciary of a trust and a corporation in which the trust owns more than 50% of the value of the stock, a corporation and a partnership if each is owned more than 50% by the same person, an S Corporation an a C Corporation if the same person owns more than 50% of each corporation, an executor of an estate and a beneficiary of the estate, and a partnership and a person owning more than a 50% interest in the partnership. (See Code §267(b) and §707(b) for a complete list of disqualifying relationships). Certain ownership attribution rules apply in determining whether the taxpayer meets the more than 50% ownership rule applicable to corporate stock.

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Exchanges between related persons are not automatically disqualified from the tax-deferral of §1031. However, certain restrictions apply to such exchanges. As a general rule, the Taxpayer seeking deferral of tax under §1031 must hold the Replacement Property for at least two years, unless one of the following applies:

1) the Taxpayer or the related person dies;

2) the property is the subject of a compulsory or involuntary conversion under §1033; or

3) the Taxpayer can prove that neither the exchange nor disposition was intended to avoid taxes.

If either the taxpayer or the related party transfers property that was acquired in the exchange within two years from the closing date, the exchange is disqualified under §1031(f)(1)(C). Gain or loss is recognized by both parties to the exchange at the time the property is subsequently transferred.

The §1031(f) related party rule was designed to prevent basis shifting which occurs when high basis property is exchanged for low basis property. If the related party transactions were not regulated, a taxpayer would be able to transfer undesireable low basis property to a related party in exchange for high basis property, shifting the higher basis to the unwanted property, whereupon the taxpayer could then have the related party sell the unwanted property and defer gain recognition. Worthless property which is about to be sold could be exchanged for high basis property allowing the taxpayer to recognize a larger loss.

Rev. Rul. 2002-83, 2002-49 I.R.B. 927, provides that the use of an unrelated qualified

intermediary by related taxpayers to accomplish an exchange will cause the exchange to be denied like-kind treatment. The facts involved included related parties, A and B. A owned Property No. 1 with a fair market value of $150 and an adjusted basis of $50. B owned Property No. 2 with a fair market value of $150 and a basis of $150. A and B engaged a qualified intermediary to accomplish the exchange. Under the exchange agreement, A transferred Property No. 1 to the intermediary, who then transferred it to C for $150. The intermediary then used the $150 to acquire Property No. 2 from B a few days later which the intermediary then transferred to A. Thus, A acquired replacement Property No. 2, C purchased Property No. 1 and B had a cash sale of Property No. 2. The IRS ruled that under §1031(f)(4), if an unrelated third party is used to circumvent the purposes of the related party rule, the nonrecognition provisions of §1031 will not apply. The IRS found that to the case under the facts here.

In Private Letter Ruling 200251008, the taxpayer owned improved/relinquished property and desired to exchange it for a 32 year sublease of land (the unimproved/replacement property) with improvements to be made thereon (the improved/replacement property). The 32 year sublease was held by a related person. The exchange was structured so that: (i) the taxpayer entered into exchange agreements with an EAT and a qualified intermediary; (ii) the related person subleased the unimproved/replacement property at a fair rental rate to the EAT's single member LLC for a term of 32 years (the "unimproved/replacement property lease)"; (iii) the LLC constructed improvements on the unimproved /replacement property creating the improved/replacement property; (iv) the taxpayer sold the improved/relinquished property to

an unrelated buyer through the qualified intermediary (v) the intermediary used the proceeds of the improved/relinquished property to purchase the LLC (which held the improved/replacement property) from the EAT; and (vi) the intermediary transferred the LLC to the taxpayer. The IRS held the transaction to qualify for tax free like-kind treatment under §1031. A critical fact in the outcome was that the related party had not cashed out of its investment in the unimproved/replacement property. By subleasing that property for fair market rental to the LLC, and thus to the taxpayer, the related person never cashed out of its investment in the unimproved/replacement property. The service noted that "since both Taxpayer and the related parties continue to be invested in the exchange properties, and are not otherwise cashing out their interest, Section 1031(f)(1) is not a concern for this transaction unless and until Taxpayer or the related parties dispose of their interests in the exchanged property within two years after the last transfer that is part of the exchange."

In TAM 9748006, the IRS used the substance over form doctrine to rule that the acquisition of replacement property from a related party through an intermediary does not qualify for like-kind exchange treatment. The facts here were as follows: (i) taxpayer transferred relinquished property to a qualified intermediary; (ii) the intermediary sold the relinquished property to an unrelated third party for cash; (iii) the intermediary used the proceeds from the relinquished property to acquire the replacement property from the taxpayer's mother; (iv) the intermediary transferred the replacement property to the taxpayer and the taxpayer paid cash to his mother to make up for the difference in the value of the relinquished property and the replacement property; and (v) the taxpayer's mother sold another

separate property to the unrelated third party for cash. The IRS ruled that the transaction was in substance a transfer of the relinquished property to the taxpayer's mother in exchange for the replacement property followed by the mother's sale of the relinquished property to the unrelated third party for cash. The service then held this was subject to the related party rules and found that the taxpayer used the intermediary for the purpose of avoiding the related party rules, thus prohibiting the transaction from qualifying for tax free exchange treatment.

In TAM 200126007, the taxpayer entered into two transactions involving a related party using a qualified intermediary in an attempt to qualify the transaction for tax free exchange treatment. The service applied an "economic unit" theory in ruling that the related parties were part of a single economic unit and to the extent any portion of the economic unit's investment was cashed out, the exchange did not qualify for tax free exchange treatment. The consequences of the transactions would have (i) shifted the taxpayer's low basis in its relinquished property to the replacement property; and (ii) reduced the controlled group's investment in real property and applied the amounts realized on the transfer of the relinquished property to reduce the controlled group's outstanding debt. The service indicated this is the very type of transaction that §1031(f) was designed to prevent.

Exchanges between related parties are thus extremely risky, and should be structured very carefully. If intended to accomplish the result that §1031(f) was enacted to prevent, extra care should be taken because the IRS will surely target the transaction for attack. Taxpayers should not shy away from engaging in true arms length direct exchanges between related parties where they simply desire a legitimate swap of property for property. In such cases, the parties

should provide for contractual restrictions on disposition of the acquired property for two years and provide for appropriate indemnity and hold harmless obligations in the event of a breach of the contractual restriction on resale within the two year period.

B. Maintain the Same Exchange Entity

1) The same party, parties or entity that initiates an exchange must complete the exchange. For example, if an individual relinquishes property, that same individual, alone, must purchase the Replacement Property. Likewise, if a partnership sells the Relinquished Property an individual partner cannot acquire the Replacement Property and vice versa. Therefore, if an entity initiates an exchange and its members wish to dissolve the entity, the parties should complete the exchange before liquidating, otherwise the gain will be currently taxed. There are a few exceptions where title vests in a different party and the tax-deferred exchange is still successful, such as:

   a. The Exchanger dies and his or her estate completes the exchange.

   b. The Exchanger's *Revocable* (living) Trust may acquire the Replacement Property since title vests in the Exchanger, individually, for income tax purposes. (Proper structure of the Revocable Trust and its treatment for tax purposes is critical to this exception.)

   c. The Exchanger, individually, relinquishes property and his or her *single-member* LLC {which is disregarded for income tax purposes; see Treasury Regulation §301.7701-3(f)(2)} acquires the Replacement Property.

d. A corporation relinquishes property and then merges out of existence in a tax-free reorganization. In this case, the surviving entity can acquire the Replacement Property.

For an example of the potential pitfalls in this area see ***Chase v. Commissioner***, 92 TC 874 (1989). In this case, a partnership was held to be the owner of an apartment complex rather than the partner who held legal title. The partnership received an offer on the apartment complex and accepted the offer. Before the sale was closed, the partnership conveyed an interest in the complex to one of its partners. The deed for the conveyance to the partner was not recorded. The final act of sale provided that the portion of the sales proceeds equal to the value of the partner's interest in the property would be transferred to an escrow agent in accordance with an exchange agreement. The exchange agreement was entered into by the escrow agent an the taxpayer/partner. The taxpayer used his sale proceeds to acquire property which he intended to serve as replacement property for the fractional interest he held in the partnership property. The court held that the partner never held an interest in the apartment complex, individually, notwithstanding the fact that a deed had been executed by the partnership conveying the fractional interest to the taxpayer. The court, upon considering all the facts and circumstances, held the partnership, not the taxpayer, held the apartment complex at the time of sale because: (i) the expenses of operating the apartment complex were paid with funds from the partnership's bank account; (ii) the taxpayer did not pay any of the expenses after the conveyance to him; (iii) rent from the apartments continued to be

paid to the partnership; (iv) the taxpayer's relationship with respect to the apartment complex was in all respects unchanged after the conveyance to him; (v) at no time did the taxpayer act as an owner of the apartment complex other than in a capacity as a limited partner; and (vi) the taxpayer did not negotiate in his individual capacity any of the terms of the sale.

In ***Commissioner v. Court Holding Co.***, 324 U.S. 331 (1945), a corporation that negotiated the sale of its sole asset, a real estate property, was held to be the seller, not the shareholder who transferred legal title. The corporation and the buyer orally agreed on terms of the sale and reduced the agreement to writing. Prior to execution of the documents the corporation learned from its tax attorney that selling the property out of the corporation would result in the imposition of higher income taxes than if the corporation were to liquidate and have the shareholders sell the property. Therefore, the corporation liquidated, distributed the property to the shareholders who then sold the property to the buyer. The Supreme Court held that while the form of the transaction was that of a sale by the individual shareholders, the transaction was in substance a sale by the corporation, and the IRS was entitled to tax the transaction based on the substance of the transaction. This became known as the substance over form doctrine which became, and continues to be, one of the more valuable weapons available to the IRS in attacking transactions where taxpayers attempt to manipulate the facts to avoid taxation.

"Mixed-person transaction" is a term commonly used to refer to transactions

where an exchange is intended, but one person transfers property and another person receives the replacement property. For instance, an individual might transfer legal title to property in the first leg of the transaction, join a partnership, and cause the partnership to receive the conveyance of the replacement property in the second leg of the transaction. This type of transaction does not qualify under §1031 for like kind exchange treatment. In TAM 9818003(May 1, 1998), the IRS ruled that a transaction in which a partnership transferred property and directed that the intended replacement property be conveyed directly to the partners did not satisfy the exchange requirement of §1031(a)(1). In ***Demirijian v. Commissioner***, 457 F.2d 1 (3rd Cir. 1972), the court held that §1033 (the involuntary conversion rule) did not apply to a transaction where a partnership disposed of condemned property and the partners of the partnership used the proceeds to acquire intended replacement property. The result should be no different where an individual transfers property and directs that the replacement property be conveyed to a partnership in which his is a partner.

Querie whether a partnership composed of four partners, three of whom wish to sell the partnership's sole real estate asset for cash and receive the cash in liquidation of their partnership interests, and one of whom prefers not to recognize gain and pay tax on the gain desires to do a §1031 exchange, might use the partnership tax laws which allow partners to make special allocations of individual items of income, gains, losses, deductions and tax credit items under IRC §1031 to satisfy all of the partners' goals? Could the partnership acquire property in an exchange sufficient to

satisfy the exchanging partner's interest in the partnership and receive the balance of the purchase price in cash for distribution to the non-exchanging partners? This may not solve the problem because under §1031 gain is recognized to the extent of the cash received (which might include the gain component attributable to the exchanging partner's interest) and the non-exchanging partners are not likely to be interested in paying tax on the exchanging partner's gain.

Another possible approach to the problem might be that the partners agree to use all the sale proceeds in an exchange to acquire replacement property, distribute undivided interests in the replacement property to the partners with an agreement that the exchanging partner will borrow funds against the replacement property sufficient to buy out the interest of the non-exchanging partners in the property. The problem with this approach is that it might run afoul of the "use requirement". §1031(a)(1) requires that both the relinquished property and the replacement property be held by the exchangor for productive use in a trade or business or for investment. Numerous cases in this area may support the IRS in attacking such a transaction on the basis that the partnership did not acquire the replacement property for investment, but rather, acquired the same with the intent of transferring it to the partners in liquidation of the partnership.

In ***Regals Realty v. Commissioner***, 127 F.2d 931 (2nd Cir. 1942), property was sold soon after its acquisition by the taxpayer in an intended exchange. The court held the taxpayer failed to satisfy the use requirement because less than two weeks after the

corporation/taxpayer acquired the property, the board of directors adopted resolutions to liquidate the corporation by distributing its cash to the shareholders and selling the newly-acquired property.

In ***Click v. Commissioner***, 78 TC 25 (1982), the tax court held that where a taxpayer acquired two residential properties in exchange for farmland and allowed her two adult children to move into the residences immediately after she acquired them and then conveyed the replacement property to the children seven months later, the transaction did not qualify under §1031. During the time the children lived in the residences before receiving the deeds, they made improvements to the property and paid no rent.

In ***Lindsley v. Commissioner***, 47 T.C.M. 540 (1983), the tax court held that property acquired with the intent to donate it to charity was not held for investment. The court found that prior to the exchange, the taxpayer had expressed an intent to transfer the replacement property to a charity. Therefore, the court held that the taxpayer acquired the replacement property with an intent to transfer it and not to hold it for productive use in a trade or business or for investment.

In Rev.Rul. 75-291, 1975-2c.b.332, the IRS ruled that §1031 does not apply to a taxpayer who acquired property solely for the purposes of exchanging it for the like-kind property. The service ruled that the property was not, therefore, held for investment at the time of the exchange. See, however, ***Bolker v. Commissioner***, 760 F.2d 1039 (9th Cir. 1985), in which the court concluded that "the intent to exchange

property for like-kind property satisfies the holding [and use] requirement, because it is not an intent to liquidate the investment or to use it for personal pursuits." In this case, a corporation liquidated. After distribution of the property in liquidation, the sole shareholder conveyed the property in exchange for other property of a like kind. The liquidation occurred under former IRC §333 and was tax-free. The same day the taxpayer received the liquidating distribution, it entered into a contract to transfer the distributed property in exchange for the other like kind property, but the closing on the exchange did not occur until three months later. The court ruled the shareholder held the property for investment and not for the intent to transfer it, noting that although the liquidation was planned before any intention to transfer the property arose, the shareholder intended to use the distributed property in a tax-free exchange at the time he acquired it. The court reasoned that the taxpayer could satisfy the use requirement even though the relinquished property was acquired for the purpose of being exchanged. The court indicated that even though a taxpayer's intended use of the property is determined as of the time it is acquired, the taxpayer is not required to intend to keep the property indefinitely in order to satisfy the use requirement. The court said: "if a taxpayer owns property which he does not intend to liquidate or to use for personal pursuits, he is 'holding' that property 'for productive use in a trade or business or for investment.' within the meaning of §1031. It therefore would seem that under ***Bolker*** a taxpayer who acquires property in a tax-free transaction with the intent to exchange it for like kind property holds such property for investment under §1031.

The only distinction between Rev. Rul. 77-337 and ***Bolker*** appears to be that in the Rev. Rul. the distribution and exchange were part of a single plan. That distinction would appear to be irrelevant considering the reasoning of the court in ***Bolker***. Therefore, even if a distribution is made as a part of a prearranged plan to exchange the property, it would seem that if the transaction is done with proper planning and implementation to avoid application of the substance over form doctrine of ***Court Holding Co.***, acquisition of the relinquished property with the intent to exchange it for another property meets the use requirement.

2) More on Partnership Interests. §1031 like-kind exchange treatment does not apply to any exchange of interests in a partnership. §1031(a)(2)(D). This provision was added to the IRC in 1984 effective for transfers after July 18, 1984. Prior to that time, exchanges of interests in partnerships were considered as falling within the like-kind exchange provisions in some contexts. Under this prior law, some courts held that §1031 could apply to the exchange of certain partnership interests. The tax reform act of 1984 amended the statute to make it clear that the exchange of partnership interests does not qualify as tax free under the statute. IRC. §1031(a)(2)(D).

Although the statute excludes any exchange of "interests in a partnership" from its ambit, the senate committee report indicates that this rule is intended to apply to interests in different partnerships rather than interests in the same partnership. Moreover, an interest in a partnership that has in effect a valid election not to be treated

as a partnership for tax purposes will be treated as an interest in each of the assets of the partnership and not as an interest in a partnership. IRC.§1031(a)(2).

The IRS has issued a ruling spelling out the tax consequences of converting a general partnership to a limited partnership. A, B, C & D, equal partners in a general partnership, converted the partnership to a limited partnership in which A & B became limited partners and C & D became both general and limited partners. Each partner's interests in profits, losses, and capital remained unchanged. No gain or loss was recognized to A, B, C or D as a result of the exchange of their interests in the conversion. However, if as a result of a conversion there were a change in their share of the liabilities of the partnership, the resulting "deemed distribution" of cash to the partners who's liability is reduced could result in the recognition of gain to them. The same results would occur on the conversion of a limited partnership to a general partnership. Rev. Rul. 84-52, 1984-1 C.B.157; see Rev. Rul. 86-101, 1986-2 C.B. 94; Vanoff, "In new Revenue Ruling 84-52, the IRS uses an "exchange" approach to conversions," 61J. Taxation 98 (August 1984).

The regulations provide that the non-recognition provisions do not apply to any exchange of partnership interests, regardless of whether the interests exchanged are general or limited partnership interests or whether the interests are in the same or different partnerships. Reg.§1.1031(a)-1(a)(1). In its discussion of the regulations the service stated this provision is not intended to affect the rule stated in Reg. Ruling 84-52 concerning non-recognition of gain or loss under the partnership provisions of the

code on conversions of partnership interests.

Citing Rev. Rul. 84-52, the service has ruled in a private letter ruling that a partnership may be converted tax-free into a limited liability company (LLC) that qualifies as a partnership for federal income tax purposes. The conversion was made by a contribution by the partners of their interests in the partnership to the LLC in exchange for identical percentage interests of ownership in the LLC. See Priv. Ltr. Rul. 9350013.

A partition of land owned by tenants in common may not rise to the level of an "exchange." The service has ruled privately that the partition into two separate parcels of contiguous acreage used by tenants in common and used exclusively for recreational purposes is not a sale or exchange requiring the recognition of gain. PLR 9327069.

Can a partner avoid tax on a sale of property by a partnership by having the partnership make a preliminary liquidating distribution in kind to the partner of an undivided fractional interest in the property, which the partner then exchanges for like-kind property? In ***Delwin G. Chase***, 92 TC 874, discussed above, the partner set up an elaborate arrangement to implement this strategy, but failed to fully acquire the benefits and burdens of ownership of the undivided interests distributed to him. This failure caused the requisite "exchange" to be lacking for the partner when the partnership subsequently sold the property because upon consideration of all the facts and circumstances, the substance of the transaction was a sale of the relinquished property by the partnership. This case does not stand for the proposition that distribution of an

interest in the partnership property to a partner desiring to effect an exchange can never work. It may suggest a method in which it can be accomplished with proper advance planning.

In ***Mason v. Commissioner***, TC Memo 1988-273, the taxpayer and his partner in two separate partnerships liquidated the partnerships pursuant to an agreement to separate their interests and then proceeded to exchange between one another certain interests in certain properties received from the partnerships. IRC §731(a)(1) provides that no gain will be recognized on a distribution by the partnership to a partner "except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution." IRC §741 provides "in the case of a sale or exchange of an interest in a partnership, gain or loss should be recognized to the transferor partner and ...shall be considered gain or loss from the sale or exchange of a capital asset, except as otherwise provided for in §751." The taxpayer argued that the dissolution of the partnerships was accomplished through distributions of the partnership assets to the partners and thus fell within §731. He argued that because the money that he was deemed to have received pursuant to §752(b) did not exceed his adjusted basis in the partnerships, no gain or loss should be recognized. The IRS argued that the taxpayer and his partner had intended to exchange partnership interests and, consequently, that §741 governed the transaction. Therefore one of the issues before the court was whether the taxpayer and his partner exchanged property owned by them individually following liquidating distributions from the partnerships

or exchanged partnership interests which resulted in the termination of the partnerships. IRC §741 provides that it may be applicable if one of two partners sells his interest to the other partner despite a partnerships termination pursuant to §708(b).

The tax court nevertheless did not feel that the taxpayer's partner had affected a §741 exchange. The court stated:

> "we believe that the transaction between Petitioner and McClure should properly be characterized for federal income tax purposes as a pro rata distribution of partnership assets and liquidation pursuant to §731 followed by like-kind exchange pursuant to §1031(a). The sales contracts language does not support respondents view that the parties to it contemplated an exchange of partnership interest."

The court held that because the exchanges of property occurred between the individuals in their individual capacities and not as partners, that the partnerships terminated prior to the partner level exchanges. It held that §731 and §1031(a) therefore governed the transactions. Interestingly, the court noted that the:

> form of the transaction between the individuals comported with the prior dissolution of the partnership. First, prior to the sales contract the individuals in effect received pro rata liquidated distributions from the partnership pursuant to §731. Second, the properties held individually were exchanged between the former partners. The sales contract, therefore achieved exchanges of like-kind assets between the former partners.

Although the court ultimately found that some gain was recognized by the taxpayer pursuant to the debt relief requirements, the transactions were held to qualify as §1031 exchanges.

The case of ***Mason v. Commissioner*** is interesting from the stand point that the

court essentially allowed the taxpayers to choose their tax treatment by choosing the form of the transaction. Although the IRS argued unsuccessfully that the form of the transaction chosen by the parties was an exchange of partnership interests, the court found that the sales contract nowhere mentioned the sale or conveyance of any partnership interest and, rather, held that the form of the transaction was that of a liquidation and subsequent exchange of properties. It may be important to note in analyzing this case, however, that although the opinion was issued in 1988, it related to a transaction that occurred in 1981 which was prior to the effective date of the amendment to §1031(a)(2) which made §1031 inapplicable to exchange in the partnership interest. But note, also, that the distinction between the facts in ***Mason*** and the facts in ***Delwin G. Chase*** is that in ***Mason***, the form of the transaction matched the substance of the transaction.

It is also noteworthy that the IRS did not argue that the taxpayer failed to satisfy the use requirement such as it had maintained in Rev. Rul. 77-337. Perhaps this was because the service determined it would be fruitless given the 1985 9th Circuit decision in ***Bolker*** .

Bolker and ***Mason*** thus demonstrate that if the transactions are carefully planned and implemented, a distribution followed by an exchange can satisfy the requirements of §1031. This must be done with knowledge of the fact that the IRS and the courts will scrutinize the substance of the transaction to determine what property is actually

exchanged.

In TAM 9645005, a joint venture distributed a property to its two partners a day before a governmental authority closed on a purchase of the property in lieu of condemnation. Thus, the two partners received the distributed property subject to a contract to convey to the governmental authority. One of the partners subsequently attempted to reinvest its shares of sales proceeds in a tax-free reinvestment in a §1033. When presented with these facts, the IRS ruled in TAM 965005 that the partner never owned an economic interest in the property and, therefore, was not eligible to reinvest its share of the sales proceeds under §1033. The court cited ***Court Holding Company***, 324 US 331 (1945), in support of its conclusion that the joint venture, and not the individual partner, sold the property to the governmental authority.

Note that in 1997 the Clinton administration proposed that §1031 be amended to provide that property would not qualify for like-kind exchange treatment unless it was used in the taxpayers trade or business or held for investment for at least one year (except for death or involuntary conversions). See "Administration Proposes Significant Legislative Changes to §1031," (13 Tax Mgt. Real Estate Journal 130, June 1997). The one year holding period would have applied to both the relinquished and replacement properties. Moreover, since the use of §1031 in a partnership "split-ups" often results in one or more of the partners holding a more or less transitory interest in a partnership property, which the partner then exchanges for another property, the administration's proposal would have limited the use of the §1031 in these

circumstances. Fortunately, however, as the 1997 tax bill moved through the legislative process the administration's proposed changes to §1031 were not included in the bill.

In PLR 9818003, the issue was whether there was an exchange that qualified the taxpayer for non-recognition under like-kind exchange §1031 where the taxpayer, a partnership, transferred the relinquished property but titles for the replacement properties were directly deeded to certain partners of the taxpayers in liquidation of their partnership interests. The taxpayer, a partnership, owned the relinquished property and leased it to A, a limited partner of the partnership. After leasing the relinquished property for approximately fourteen years, the partnership and A entered into a contract for the sale of the relinquished property to A. A provision of the partnership agreement provided that upon dissolution and liquidation of the partnership the managing partner could affect one or more like-kind exchanges under §1031 through a qualified intermediary. The provision allowed each partner to designate one or more properties which the partnership would acquire using the respective partners share of the net proceeds from the sale of the property. The agreement provided further that none of the individual partners would be considered agents of the partnership for any purpose related to the deferred like-kind exchange. If the purchase price of the replacement property exceeded that partners share of the proceeds from the property sale that partner was required to provide the additional funds. Shortly before a sale was to occur, the partnership entered into an exchange agreement with an intermediary to act as

intermediary in a deferred exchange of a relinquished property. The intermediary assigned its interests in the exchange agreement to partner A. A purchased the relinquished property and the partnership received the net proceeds. A portion of the proceeds were transferred to an intermediary and distributed by the intermediary to certain partners, including A, in payment for their partnership interests. The intermediary subsequently disbursed funds to closing agents of the other partners to acquire replacement real estate on their behalf which were deeded directly to the individual partners in liquidation of their partnership interests.

In this private letter ruling, the IRS ruled that the partnership had not established that the transaction was an exchange with a reciprocal transfer of property. The partnership transferred the relinquished property but received no reciprocal transfer of replacement property. The IRS relied on ***Carlton v. United States***, 385 Fed.2nd 238 (5th Cir. 1967), in which the taxpayers who had given an option of their ranch property negotiated to acquire other ranch property intending to affect a tax-free exchange. The optionee contracted to buy the other property and assign the contract to the taxpayer at the time of the sale of the taxpayers ranch. The Fifth Circuit held that the transaction did not qualify as a tax-free exchange as title to the replacement property never vested in the optionee. The IRS noted that in order for the taxpayer to qualify for non-recognition treatment in §1031, the transaction must be in the form of an exchange. Because a sale and a purchase may have the same end result as an exchange, in order for the requirement that the transaction qualify as an exchange to have any meaning, the

form of an exchange must be followed. The service noted that in the case of the partnership in PLR9818003, there was no transfer of replacement property to the partnership so as to complete an exchange. Instead, the partnership receives cash and various real properties were transferred to its partners in payment for the relinquished property. The partnership attempted to argue that Rev.Rul. 90-34, 1990-1C.B.154, stood as authority for its proposition that the direct deeding of the replacement properties to partners to the partnership did not affect the status of the transaction as an exchange by the partnership. The IRS noted that Rev. Rul. 90-34 was distinguishable in that in that revenue ruling, X's transfer of property to Y in exchange for property of a like-kind qualified as to X for non-recognition of gain or loss under §1031 even though legal title to the property received by X was never held by Y. In the revenue ruling, Y is the person that receives property and transfers the replacement property to X. The IRS noted that the partners, as recipient of the replacement properties, stand in the same relative position in this transaction as X does in Rev. Rul. 90-34. The partnership stood in the same relative position as Y in that revenue ruling. The relevant inquiry is thus whether the transaction is an exchange in respect to the partnership, not with respect to the partners of the partnership. The IRS also cited Rev.Ruling 77-297, 1977-2 C.B.302 which dealt in part with B, an accommodating buyer that acquired replacement property and then transferred replacement property in exchange for the relinquished property. Rev.Rul. 77-297 held that as to B, the exchange of ranches does not qualify for non-recognition of gain or loss on §1031 because B did not hold

replacement property for productive use for trade or use or for investment property. The IRS also made reference to Rev.Rul. 75-291, 1975-2c.b.332, which held that §1031 does not apply to a taxpayer who acquired property solely for the purposes of exchanging it for the like-kind property.

The IRS noted that it was inappropriate to extend Rev.Ruling 90-34 to the partnership and the partners at issue in PLR 9818003. It stated in order for Rev.Ruling 90-34 to apply, the partners would have to be viewed as exchanging their partnership interests in the partnership for the replacement properties. However, it was the partnership that was seeking non-recognition of gain on the transfer of the relinquished property, not non-recognition of gain on an exchange of the partners partnership interests in the partnership. It stated that it was also clear that the partnership and not the partners of the partnership were transferring the relinquished property. It was noted that even if viewed as an exchange by the partners of the partnership, the exchange would fail to qualify for non-recognition because §1031(a) does not apply to any exchange of an interest in a partnership. §1031(a)2(D).

In PLR 9807013, the IRS determined that a limited partnership which created single asset single member LLCs to receive several parcels of real property as replacement properties in a like-kind exchange would be treated as having directly received those properties for IRC §1031 non-recognition of gain purposes: the single owner non-corporate entities would be disregarded as entities separate from the partnership so the entities' assets were treated as the partnerships assets.

3) Tenancy in Common\Co-Ownership in Indivision Interests - Note that in comparison to real property investments held in a partnership, an owner of an undivided fractional interest in immovable property may readily engage in a tax free like kind exchange of his interest in the property for other real property, whether the acquired property be in full ownership or as co-ownership in indivision. IRC §1031. However, as noted, the tax free like kind exchange is not available for exchanging partnership interests. IRC §1031(a)(2). Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal law and does not depend on whether the entity is recognized as an entity under state law. Treas. Reg. §301.7701-1(a)(1). A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom, but the mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. Treas. Reg. §301.7701-1(a)(2). A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. In ***Bradford v. Commissioner***, 12 F.3d 166 (9th Cir. 1993), the court held that a co-ownership arrangement among 78 investors in computer equipment subject to a 7 year lease managed by a third party manager constituted a partnership for federal tax purposes. See also ***Accord Bussing v. Commissioner***, 88 T.C. 449 (1987), aff'd on reh'g, 89 T.C. 1050 (1987); ***Alhouse v. Commissioner***, T.C. Memo 1991-652; ***Hubert M.Luna***, 42 TC 1067 (1964); ***Commissioner v. Tower***, 327 U.S. 280, 34 AFTR 799

(1946); Rev. Rul. 73-476, 1973-2 CB 300; Rev. Rul. 75-374, 1975-2 CB 261. Among the factors the courts consider are the limitations on the co-owners right to sell, lease, or encumber either the co-ownership interest or the underlying property, and the manager's effective participation in both profits (through a remarketing fee) and losses (through advances).

With the popularity in recent years of the tax free like kind exchange in the real estate investment area, particularly under the deferred exchange rules, a new market has been created for fractional interests in real estate offered by national firms seeking to fill the need for investors who prefer not to get involved in the direct management of the real property or who need a quick deal to comply with the 45 day deadline for identifying replacement property under the deferred exchange rules. These firms offer undivided fractional interests in major real estate properties which are managed under a management contract.

The proliferation of these arrangements and the uncertainty which can surround the determination of whether these interests will be treated as undivided ownership interests in real estate (eligible for tax free like kind exchanges) or partnership interests (not eligible for like kind exchange) resulted in the IRS issuing guidance on the issue. In Rev. Proc. 2000-45, 2002-2 C.B. 438, the Service first indicated that it would not issue advance rulings or determination letters on the issue. The Service came back two years later and issued Rev. Proc. 2002-22 in which it indicated that it will consider ruling requests on the subject if the request satisfies certain conditions.

Among the more significant conditions that must be shown to exist are:

(a) Co-owners must hold title as tenants in common under local law.

(b) The number of co-owners can not exceed 35 persons.

(c) The co-owners may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying the co-owners as partners, shareholders, or members of a business entity or otherwise hold the group out as a partnership or other entity.

(d) Co-owners may enter into a limited co-ownership agreement that may run with the land which may provide for rights of first refusal on sale of an interest in favor of the other co-owners, the sponsor or a lessee, or providing that certain decisions of the co-owners may be made by majority vote of the co-owners (subject to limitations below).

(e) Co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the property, any leases of the property, and the creation of a blanket lien. Any sale, lease, or re-lease of a portion or all of the property, negotiation or renegotiation of indebtedness secured by a blanket lien, hiring of any manager or negotiation of any management contract must be by unanimous approval of the co-owners. For all other actions, the co-owners may agree to be bound by a majority vote of the co-owners. A co-owner who has consented to an action in conformity with these requirements may grant a power of attorney to the manager or other person to execute documents, but may not provide the manager or other person with a global power of attorney.

(f) Each co-owner must have the rights to transfer, partition, and encumber the co-owner's undivided interest in the property without agreement or approval of any person, subject to the right to provide for rights of first refusal.

(g) If property is sold, the proceeds after payment of any blanket lien must be distributed to the co-owners.

(h) Each co-owner must share in all revenues and costs in proportion to their undivided interest in the property.

(i) Co-owners must share in debt secured by a blanket lien in proportion to their undivided interests.

(j) A co-owner may issue an option to purchase the co-owner's interest provided the exercise price is at fair market value as of exercise date. A co-owner may not have a put option to sell his or her interest to the sponsor, lessee, another co-owner or the lender.

(k) Co-owners activities must be limited to those customarily performed in connection with the maintenance and repair of real property.

(l) Co-owners may enter into management or brokerage agreements which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner, but who may not be a lessee. The management agreement may allow for maintenance of a common bank account for collection of rents and payment of expenses, however, the manager must disburse to the co-owners their shares of net revenues within 3 months of the date of receipt of those revenues.

(m) All leasing arrangements must be bona fide leases for federal tax purposes.

(n) The amount of any payment to the sponsor for acquisition of the co-ownership interest must reflect the fair market value of the co-ownership interest (or the services rendered) and may not depend in whole or in part on the income or profits derived by any person from the property.

In its first ruling under Rev. Proc. 2002-22, the IRS ruled in PLR 200327003 that a tenancy in common arrangement satisfied all the conditions of Rev. Proc. 2002-22 and did not create a partnership event though the management agreement involved there was not renewable annually by affirmative consent and the requesting party had yet to acquire the real property or have any co-owners. The management agreement was renewable automatically in the absence of termination by the co-owners. On this issue, the service stated that "although not an affirmative consent, the notice requirement in the Company's management agreement containing the right of any Co-owner to terminate the agreement at any time with just 60 days notice satisfies the conditions in §§6.05 and 6.12 of Rev. Proc. 2002-22 regarding unanimous annual renewals of any management agreement." Even though Rev. Proc. 2002-22 requires a taxpayer requesting a ruling to submit certain information about each co-owner of the property, it is assumed that the service issued a ruling nonetheless because no co-owners existed at the time the ruling was requested.

If a tenancy in common interest does not come within the guidelines of Rev. Proc. 2002-22, the common law test for partnerships must be used to determine whether the TIC interest is actually an interest in a partnership. In ***Commissioner v. Tower***, 327 U.S. 280 (1946), the Supreme Court indicated that whether a partnership has been formed is determined by the court looking to the intention of the parties, "[a]nd their intention in this respect is a question of fact, to be determined from the testimony disclosed by their 'agreement, considered as a whole, and by their conduct in execution of its provisions.' Drennen v. London Assurance Company, 113 U.S. 51, 56 . . ."

In ***Luna v. Commissioner***, 42 TC 1067 (1964), the tax court listed the factors upon which the partnership determination should be based:

> [1] The agreement of the parties and their conduct in executing its terms; [2] the contributions, if any, which each party has made to the venture; [3] the parties' control over income and capital and the right of each to make withdrawals; [4] whether each party was a principal and coproprietorc sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; [5] whether business was conducted in the joint names of the parties; [6] whether the parties filed Federal partnership returns otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; [7] whether separate books of account were maintained for the venture; and [8] whether the parties exercised mutual control over the assumed mutual responsibilities for the enterprise.

IRC §§761(a) and 1031(a)(2) provide a limited refuge for certain ventures seeking to avoid partnership treatment. §1031(a) provides that "for purposes of this

section, an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of Subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership." §761(a) provides that "at the election of all members of an unincorporated organization, [the Secretary may] exclude such organization from the application of all or part of [Subchapter K], if it is availed of" in one of three situations: (1) "for investment purposes only and not for the active conduct of a business;" (2) "for the joint production, extraction, or use of property but not for the purpose of selling services or property produced or extracted;" or (3) "by dealing in securities for a short period for the purpose of underwriting, selling or distributing a particular issue of securities." The election applies only "if the income of the members of the organization may be adequately determined without the computation of partnership taxable income."

The limited availability of this election was demonstrated in ***Madison Gas & Electric Co. v. Commissioner***, 72 TC 521 (1970) where the court held that the venture was a partnership notwithstanding the 761(a) election because the venture was "an unincorporated organization carrying on a business, financial operation, or venture."

4) The Single-member LLC – Because single-member LLCs are disregarded for Federal tax purposes the taxpayer may sell and his or her single-member LLC may acquire the Replacement Property without disqualifying the transaction under Section 1031.

As PLR 9807013 (noted above) indicates, single-member LLCs may be used in §1031 exchanges in a variety of ways. This is available under the so-called

"check-the-box" regulations promulgated by the treasury to deal with the problems of classifying LLCs for tax purposes. On January 1, 1997, these so-called "Check the Box" regulations [26 CFR 301.7701-2(b)(1)] became effective which dramatically simplified the determination of whether the LLC and other unincorporated entities and associations are to be taxed as corporations or as partnerships. Essentially, under these regulations the entity may simply elect to be taxed as either a corporation or a partnership without regard to the corporate characteristics. Thus an LLC is treated similar to a corporation for liability purposes but as a partnership for tax purposes under federal law. Under these regulations, the LLC is taxed as a partnership unless it elects to be treated as a corporation for tax purposes. Perhaps one of the most important developments brought about by the Check the Box regulations was the treatment of single member LLC's. The regulations indicate that, for federal tax purposes, an LLC which has a single owner and does not elect to be treated as a corporation is, for federal tax purposes, disregarded as an entity separate from its owner. Under the default provisions of the regulations, if no election is made, the latter classification will apply. Regs. §301.7701-3(b)(1).

A single-member LLC that does not elect corporate classification effectively is treated as a sole proprietorship or a division of a business entity where the entity is the single member. The concept of "disregarding" an entity for federal tax purposes had no counterpoint under the prior classification regulations. This change was prompted in large part by some state LLC statutes which permit the formation of one-member

LLCs. The effect of this rule is to merge all of the tax attributes of the entity into its owner, while maintaining a liability shield between the owner and the entity for state law purposes.

Under these regulations, the following fact pattern should qualify for like-kind exchange treatment: X, a two-member LLC, owns all of the interest in Y, an LLC which owns an apartment building. An individual, A, owns an apartment building. The question raised is whether X could obtain Section 1031treatment on the transfer of its interest in Y to A in exchange for the apartment building owned by A. In some states, structuring a transaction in this manner might avoid transfer taxes that otherwise would be paid on a direct of exchange of the real property. (Absent that concern, Y could distribute the property to X tax-free by virtue of Section 731(a), and X could then exchange the property with A). Practitioners have suggested that, since Y is disregarded for federal income tax purposes, X is deemed to own the assets of Y directly. Thus, the transaction should be eligible for Section 1031treatment. However, one practitioner has questioned whether, notwithstanding the regulations, X's ownership of its interest in Y, which would be characterized as a separate personal property interest under state law, may be disregarded for purposes of Section 1031. The regulations provide that one kind or class of property may not be exchanged for property of a different kind or class. Regs. Section 1.1031(a)-1(b). To the extent the check-the-box regulations indicate the single member LLC is disregarded for all tax purposes, this should not present a problem. A Treasury official who participated in a discussion at a meeting of the Committee on

Partnerships of the ABA Section of Taxation in January 1997, expressed his personal view that Section 1031treatment should be available in the case of the fact pattern described above. PLR 9807013 should be an indication that this view is now held by the service, generally. See "Interaction of Section 761(a) and Section 1031 Where Property Is Owned by Entity," 37 Tax Mgmt. Memo 196 (6/24/96). For a discussion of the "check-the-box" regulations, see 700 T.M., Choice of Entity. For a discussion of limited liability companies, see 725 T.M., Limited Liability Companies.

The IRS has recently ruled that an LLC owned entirely by a husband and wife under community property laws may, at the election of the spouses, be treated either as a disregarded entity or as a partnership. ***Rev. Proc. 2002-69 (IRB 2002-4, Nov. 4, 2002).*** A qualified entity is a business entity that is wholly owned by a husband and wife as community property under the laws of a state, a foreign country, or a possession of the United States and in which no other person would be considered an owner for federal tax purposes and which has not elected to be treated as a corporation under Treas. Reg. §301.7701-2. If the entity and the husband and wife, as community property owners, treat the entity as a disregarded entity for federal tax purposes, the IRS will accept the position that the entity is a disregarded entity for federal tax purposes. If the entity and the husband and wife, as community property owners, treat the entity as a partnership for federal tax purposes and file the appropriate partnership returns, the IRS will accept the position that the entity is a partnership for federal tax purposes. If the parties change their reporting positions, the change will be treated as a conversion of

the entity.

C. Refinancing Prior to or After an Exchange

Pre-Exchange Refinancing

Existing authority indicates that where a pre-exchange refinancing is completed as part of an integrated transaction which includes the exchange, cash received by a taxpayer from a lender will be treated as cash received on disposition of the relinquished property. See, e.g., ***Long v. Commissioner,*** 77 T.C. 1045 (1981), but see ***Fredricks v. Commissioner***, T.C. Memo 1994-27.

According to the American Bar Association Tax Section's Report on Open Issues in Section 1031 Like Kind Exchanges (July 14, 1995), notwithstanding this apparent rule, the Service is likely to assert that one who obtains financing immediately before the exchange has recognized gain of the amount borrowed because the cash received from the refinancing should be viewed as part of the consideration given. This principle is sometimes referred to as the "in anticipation of exchange" concept. The Service attempted formally to include this concept in the Section 1031 regulations by proposing an amendment to Reg. Section 1.1031(b)-1(c) in 1990 and referring to this as a clarification of existing law. However, protests from practitioners and the public led the Service to conclude the proposal was withdrawn in the final regulations adopted in 1991. Although the proposal was withdrawn, the Service has not formally stated whether it still adheres to the proposition. This was its position in ***Fredricks***, cited above.

In ***Garcia V. Commissioner***, 80 T.C. 491, acq'd 1984-1 C.B. 1, before entry into the exchange escrow, the other parties to the exchange were required by the escrow agreement to obtain additional mortgage indebtedness in order to even up the assumed liabilities and thereby avoid recognition of gain. The Tax Court held that this was still a valid 1031 exchange and there was no boot.

However, where a pre-exchange refinancing is clearly part of the exchange, doctrines such as step-transaction and substance over form might allow the Service to prevent taxpayers from receiving cash upon transfer of relinquished properties without having the cash treated as non-like kind property.

In ***Fredericks v. Commissioner***, TC Memo 1994-27 (which was litigated after the multiple properties regulations were finalized), the IRS asserted that a taxpayer realized disguised boot income when it refinanced its relinquished property shortly before the exchange. The taxpayer had attempted to refinance the loan on the relinquished property for at least two years before the exchange transaction and, therefore, the refinancing appeared to be motivated by factors totally independent of the exchange.

In Fredericks the IRS argued that by refinancing the relinquished property one week after entering into a sales contract with a party desiring to purchase the property the approximate $2,000,000.00 in refinancing proceeds represented "other property or money" within the meaning of IRC§1031(b) thus constituting boot which should be recognized as gain in the transaction. The court rejected the argument noting that the

$2,000,000.00 was received from the lender as a result of refinancing the relinquished property and not from a party to the exchange. The court also disagreed with the IRS's argument that "if the petitioners sale of the [relinquished property] and his acquisition of the [replacement property] were to be construed as integrated events, his refinancing of the [relinquished property mortgage] should likewise be construed as a part of that plan." The court noted that the taxpayer had reasons for refinancing the mortgage that were unrelated to the exchange. The taxpayer had begun attempt to refinance the property two years earlier immediately upon the acquisition of the property. The court noted that in the event the exchange or sale failed the taxpayer would nonetheless be in need of the refinancing of the relinquished property. Accordingly, the court held that the taxpayer did not received other property or money in the exchange and was not required to recognize boot pursuant to IRC§1031(b).

Post-Exchange Refinancing

Post-exchange refinancing should be less of a problem from a tax perspective than pre-exchange refinancing. Where a new loan is obtained immediately following a taxpayer's acquisition of replacement property in an exchange, receipt of cash by the taxpayer should not be treated as boot. However, there appears to be no authority addressing this issue.

When considering competing options of a pre-exchange financing on the relinquished property or a post-exchange financing on the replacement property, a taxpayer is well advised to elect the latter transaction, since the post exchange liability,

when viewed from the perspective of the taxpayer making the exchange, survives the transaction and remains as a liability of the taxpayer and a lien against the replacement property.

D. Treatment of Selling Expenses in an Exchange

Closing costs (such as real estate commissions, title insurance, recording or legal fees) are generally treated as an increase to the cost basis of the Replacement Property (and accordingly, reduce recognized gain on the sale of the Relinquished Property). Treasury Regulation §1.1031(k)-1(g)(7)(ii). Additionally, costs which are required as part of the sale, such as a Termite Inspection, <u>if required by the Purchase Agreement</u>, may not be treated as taxable boot. However, if the Termite inspection is required for the loan but not required in the Purchase Agreement, then it is likely to be considered taxable boot rather than a cost of the exchange.

Other closing costs (such as loan fees, points, prorated mortgage insurance premiums, and property taxes, etc.), may be treated as taxable boot. The general rule of thumb with respect to closing costs is whether such costs are "non-recurring" costs of the sale (non-taxable) or costs associated with obtaining a loan (taxable boot).

E. The Tax Implications of an Exchange

1) <u>Reporting</u> The transaction is reported upon IRS Form 8824 (Like-Kind Exchanges) attached to Form 1040 for the year in which the exchange is initiated. If the Relinquished Property was used in business or depreciated, IRS Form 4797 should also be filed to report recognized gain. For investment

properties, Schedule D should be used.

2) Challenges The Service generally has three years (from the later of the due date or date of filing) within which to challenge the reported treatment of a transaction. Code §6501(a). If the Taxpayer "omits" more than 25% of the gross income from the income tax return, the period for examination is extended to six years. Code §6501(e). If the exchange is not properly structured to qualify for deferral, the "omitted" income will frequently exceed 25% of the "reported" income, therefore triggering the six-year statute of limitations.

3) Basis of Property Acquired

a. Generally: In a §1031 exchange, the Taxpayer receives a "*carryover*" tax basis in the Replacement Property. The Taxpayer's basis in the Replacement Property is his/her basis in the Relinquished Property, adjusted for factors which ultimately impact the purchase price, such as additional consideration and mortgages, as well as any recognized gain or loss in the transaction. Calculation of basis of the Replacement Property may be illustrated by the following formula:

The basis in the Relinquished Property;

PLUS

i) the fair market value of additional consideration *given* by the Taxpayer (cash and property);

ii) the amount of any liabilities incurred or *assumed* by the Taxpayer;

iii) the amount of gain *recognized* in the exchange;

LESS

i) the amount of any liabilities of the Taxpayer *assumed*[2] by other parties;

ii) the amount of additional consideration *received* by the Taxpayer;

iii) the amount of loss recognized in the exchange.

Example provided in Treasury Regulation §1.1031(d)-2: B, an individual, owns an apartment house which has an adjusted basis in his hands of $500,000, but which is subject to a mortgage of $150,000. He transfers the apartment house to C, receiving in exchange therefor $50,000 in cash and another apartment house with a fair market value on that date of $600,000. The transfer to C is made subject to the $150,000 mortgage. B realizes a gain of $300,000 on the exchange, computed as follows:

Value of property received	$ 600,000
Cash	50,000
Liabilities subject to which old property was transferred	150,000
Total consideration received	800,000
Less: Adjusted basis of property transferred	500,000
Gain realized	300,000

Under section 1031(b), $200,000 of the $300,000 gain is recognized (equivalent to the $50,000 cash received, plus the $150,000 mortgage

2 A recourse liability is treated as assumed if the Transferee is expected, under the facts and circumstances, to satisfy the liability. Code §357(d).

debt from which B was "relieved"). The basis of the apartment house acquired by B upon the exchange is $500,000, computed as follows:

Adjusted basis of property transferred . . . . $	500,000
Less: Amount of money received:	
Cash	50,000
Amount of liabilities subject to which property was transferred	150,000
Total boot received	200,000
Difference	300,000
Plus: Amount of gain recognized upon the exchange	200,000
Basis of property acquired upon the exchange	500,000

b. Allocation of basis among multiple properties: If the Taxpayer acquires two or more like-kind properties, the basis is allocated among them in accordance with their relative fair market values. However, if the Taxpayer acquires non-like-kind property, basis is *first* allocated to the non-like-kind property, up to its fair market value and *then* to the like-kind property.

Example provided in Treasury Regulation §1.1031(d)-1: A, who is not a dealer in real estate, transfers real estate held for investment which he purchased for $10,000 in exchange for other real estate (to be held for investment) which has a fair market value of $9,000, an automobile which has a fair market value of $2,000, and $1,500 in cash. A realizes a gain of $2,500, all of which is recognized under section 1031(b). The basis of the property received in the exchange is the basis of the real estate A transfers ($10,000) decreased by the amount of money received ($1,500) and increased in the amount of gain that was recognized ($2,500), which results in a basis for the property received of $11,000. This basis of $11,000 is allocated between the automobile and the real estate received by A, the basis of the automobile being its fair market value at the date of the exchange, $2,000, and the basis of the real estate received being the

remainder, $9,000.

c. Allocation of basis between land and improvements: This is important, obviously, for purposes of calculating depreciation. There are two methods to allocate basis between land and improvements. The first is to allocate according to the relative fair market values. The second method is to allocate the "carryover" basis to the depreciating improvement first, and then allocate the remaining basis (residue) according to the relative fair market values.

Example: Taxpayer relinquishes residential property (used for investment) valued at $4,000,000 with a $1,000,000 land basis and $1,000,000 remaining building basis with a remaining recovery period of 10 years. Taxpayer's Replacement Property is a commercial property valued at $6,000,000 (land of $1,000,000 and building of $5,000,000). Taxpayer pays boot of $2 million. Basis in the Replacement Property to be allocated is $4,000,000 ($2,000,000 "carryover" basis, plus the $2,000,000 additional consideration paid).

Method 1: Allocation based on fair market values: Land ($^1/_6$) = $666,667 and building ($^5/_6$) = $3,333,333. The first $1,000,000 ("carryover" basis) will be depreciated over the remaining 10 year life, with the remainder ($2,333,333) being depreciated as new MACRS property.

Method 2: Allocate the $1,000,000 "carryover" basis first to the depreciable building. Allocate the remaining $3,000,000 basis according to relative fair market values; Land ($^1/_6$) = $500,000 and building ($^5/_6$) = $2,500,000. Note: the total building basis using this method is $3,500,000, compared to $3,333,333 using Method 1.

d. Depreciating the Exchange Property: Assuming that MACRS

Relinquished Property is exchanged for like-kind MACRS Replacement Property, there are two methods for depreciating the Replacement Property. Under the first option the Taxpayer may treat the new asset as newly-acquired MACRS property, with a "new" recovery period and method. Under the second option, the Taxpayer utilizes the remaining recovery period and the same depreciation method as was used for the Relinquished Property ***for the "carryover" basis*** (insofar as the Taxpayer's basis in the Replacement Property does not exceed the basis in the Relinquished Property). Any remaining basis (the new investment) is depreciated as newly-acquired MACRS property. For property placed in service after January 3, 2000, the Taxpayer must use the second option. (IRS Notice 2000-4.)

F. Installment Sales in Exchanges – Problems and Solutions

A deferred exchange will often take place over two tax years on account of the 180-day exchange period provided to complete a deferred exchange. If, on termination of the 180 day exchange period, cash remains to be transferred to the taxpayer by the qualified intermediary, such termination occurs in the tax year subsequent to the year in which the taxpayer parted with title to the relinquished property, and the installment sale method of reporting gain from the sale is otherwise available, the gain allocable to the cash payment can be reported in the subsequent tax year under the installment sale rules, thereby deferring the payment of taxes attributable to that gain for up to one

year.

The installment sale rules are provided in IRC §453 and generally permit a taxpayer selling non-dealer property pursuant to an agreement where the purchase price is paid in installments over more than one tax year to report the gain from the sale allocable to payments received in subsequent tax years in those subsequent years rather than in the year of the sale. Under the safe harbor rules in Reg. §1.1031(k)-1(g), a taxpayer may qualify for like kind exchange treatment by structuring the exchange through the use of a "qualified intermediary" and the obligation to transfer like-kind property to the taxpayer to complete the exchange may be secured by a "qualified trust" or "qualified escrow" which holds the sale proceeds pending acquisition of the replacement property.

The provisions of IRC §453 specifically contemplate that the installment sale rules and the like-kind exchange rules of IRC §1031 may apply to the same transaction. §453(f)(6) provides that in the case of an exchange which only partly satisfies the non-recognition of gain rules under §1031 because of the receipt of boot, the taxpayer's ability to use installment sale treatment with respect to the boot is determined by excluding from the installment sale computations (i) any qualifying like-kind property received by the taxpayer and (ii) the gain not recognized as a result of such like-kind property.

These installment sale rules may help to ease the burden of a blown or failed deferred exchange where the taxpayer either (i) acquires the like-kind property outside

the allowed 180 day period for closing on the acquisition of the replacement property and the transaction is ultimately found not to have qualified for like kind exchange treatment, or (ii) pursuant to the exchange agreement with the intermediary is required to distribute cash if the closing on the replacement property has not occurred as of the expiration of the 180 day period, and the expiration of the 180 day period occurs in a separate tax year from the year in which the taxpayer parted with title to the relinquished property.

In 1994, the Treasury Department promulgated regulations to coordinate the safe harbor provisions on deferred exchanges with the installment sale rules of §453. See Treas. Reg. §1.1031(k)-1(j)(2). These regulations essentially address the issue of the extent to which the safe harbor regulations for use of qualified intermediaries, qualified trusts, and qualified escrow arrangements apply for purposes of the installment sale rules under §453. The regulations provide that, subject to certain limitations, in the case of a taxpayer's transfer of relinquished property in which the obligations of the taxpayer's transferee to transfer replacement property to the taxpayer is or may be secured by cash or a cash equivalent, the determination of whether the taxpayer has received a payment for purposes of §453 and Temp. Reg. §15a.453-1(b)(3)(i) will be made without regard to the fact that the obligation is or may be so secured if the cash or cash equivalent is held in a qualified escrow account or a qualified trust.

The importance of the regulation under §1031 is revealed in the installment sale

rules. An installment sale is defined under §453(b)(1) as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. Under Temp. Reg. §15A.453-1(b)(3)(1), "receipt of an evidence of indebtedness which is secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, will be treated as the receipt of payment." Therefore, absent the exceptions carved out in the §1031 regulations, as those regulations recognized, the use of a qualified trust or qualified escrow arrangement to secure the transferee's promise to acquire replacement property and transfer it to the taxpayer would be treated as a payment in the year of the transfer of the relinquished property. Similar concerns would be present in the use of a qualified intermediary where, although the safe harbor regulations make clear that the qualified intermediary is not the agent of the taxpayer for purposes of §1031(a), absent the provisions coordinating with §453 installment sale treatment, the qualified intermediary could be treated as the taxpayer's agent for other tax purposes such as §453.

The §1031 safe harbor regulations for deferred exchanges thus take the position that, provided the taxpayer has a bona fide intent to enter into a deferred exchange, the safe harbor rules for qualified intermediaries, qualified trust and qualified escrow arrangements will apply for installment sale reporting purposes. The application of this safe harbor applies for installment sale purposes until the earlier of (i) the time the safe harbor would otherwise cease to apply for purposes of §1031 (e.g.,when the taxpayer

has the immediate right to receive the funds held in the qualified escrow account), or (ii) the end of the exchange period. These rules apply even if the transaction ultimately fails to qualify as a like-kind exchange under §1031 (the "failed exchange"). The person who otherwise satisfies the definition of a qualified intermediary is treated as such even if such intermediary ultimately fails to acquire identified replacement property and transfer it to the taxpayer.

The regulations provide that the taxpayer will be treated as having a bona fide intent only if it is reasonable to believe, based on all the facts and circumstances, as of the beginning of the exchange period, that the like-kind replacement property will be acquired before the end of the exchange period. Two examples are provided in which this bona fide intent requirement is deemed to have been satisfied.[3] In ***Smalley v. Commissioner***, 116 TC 29 (June 14, 2001), the Tax Court looked to the following factors to determine that the taxpayer had met the bona fide intent requirement of Reg. §1.1031(k)-1(j)(2)(iv):

(1) The replacement property identified by the taxpayer was of a like kind to the relinquished property;
(2) The purchase agreement for the relinquished property was conditioned on "reasonable cooperation and a tax free exchange qualifying under Section 1031;"
(3) The taxpayer used a qualified escrow account and a proper escrow agent;
(4) The taxpayer identified replacement property within the identification period and received the replacement property within the exchange period;

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[3] The examples in the regulations do not represent either the minimum steps required to establish a bona fide intent or safe harbors pursuant to which a bona fide intent will in other contexts be assumed to exist. See the preamble to the regulations.

(5) The taxpayer testified credibly that he intended to enter into a like kind exchange; and

(6) The taxpayer relied on advice from a well-known expert and from his long-time accountant in planning the exchange.

In addition to the bona fide intent requirement, the regulations provide that they are inapplicable if the relinquished property is not qualified property for purposes of the §1031 like-kind exchange rules (i.e., property that is not held for productive use in a trade or business or for investment, or it is property described in §1031(a)(2) such as stock in trade or a partnership interest). See Examples (5) and (6) of Reg. §1.1031(k)-1(j)(2)(vi), copies of which are found at the end of this outline.

See Reg. §1.1031(k)-1(j) for the other examples of the application of the regulation. Note that none of the examples in the regulations provide guidance for a transaction involving encumbered exchange property. For example, assume that (i) a taxpayer transfers to a qualified intermediary in December 1999, exchange property with a FMV of $100,000, an adjusted basis of $60,000, and liabilities of $80,000, and (ii) the taxpayer is unable to identify suitable replacement property by the end of the identification period with the result that the taxpayer receives in year 2000 the $20,000 of cash equity obtained when the intermediary sold the exchange property to a third party in December 1999. Does the taxpayer defer recognition of the entire $40,000 of gain to 2000 as a result of the involvement of the qualified intermediary? Under Temp. Regs. §15A.453-1(b)(3)(i) a taxpayer must treat as payment in the year of the sale the amount of liabilities in excess of the taxpayer's basis in the property (assuming

a wrap around note is not used). Since the year of sale in this example is 1999, the taxpayer might be required to recognize $20,000 gain in 1999 on account of the existence of the $20,000 of liabilities in excess of basis. The regulations do not indicate which result will obtain, but it would seem that the correct result would be that the income would be realized in 1999. Use of a wrap around mortgage might avoid this result.

Another issue not directly addressed by the regulations is how the gain recognition will be determined and taxed where the relinquished property which is the subject of a failed deferred exchange has §1245 or §1250 recapture income. §453(i) provides that §1245 and §1250 recapture income is recognized in the year of sale, notwithstanding that the gain on the sale is otherwise deferred in full under the installment sale method. Because the IRS has indicated that all rules otherwise applicable to the installment sale method apply to gain reportable under the installment sale method, these rules would appear to require recognition of the recapture income in the year the relinquished property is disposed of, rather than the subsequent tax year when the cash from the failed exchange is received by the taxpayer.

Can a failed exchange involving a qualified intermediary or another safe harbor be restructured, prior to the end of the 180 day period for acquiring the replacement property, into a long-term installment sale for purposes of §453? This issue is not addressed by the regulations. Assume that the taxpayer's exchange agreement with the qualified intermediary authorizes the intermediary, at the point that the deferred

exchange becomes impossible to complete, to return the cash paid by the purchaser of the taxpayer's property in exchange for the purchaser's long-term installment note. Such a restructuring would obviously require a cooperative purchaser, and would not be undertaken unless the purchaser's note is adequately secured (e.g., with a mortgage on the relinquished property or a standby letter of credit[4]). Thus, when the exchange period terminates, the taxpayer will receive, not cash, but an installment obligation technically qualifying for installment method reporting. Reg. §1.1031(k)-1(j)(2)(iii) treats the taxpayer as having received the installment note directly from the purchaser for installment sale method purposes.

This restructuring would likely be subject to challenge on grounds that the taxpayer's original installment obligation with the qualified intermediary, namely, the contractual obligation to deliver either qualifying exchange property during the 180 day period or cash at the end of the period, has been materially modified and, therefore, disposed of for the purposes of the §453B installment obligation disposition rules. Interestingly, the rulings issued by the IRS under those rules have generally been somewhat favorable to taxpayers. In Rev. Rul. 68-419, 1968-2 C.B. 196, the IRS ruled that a note had not been disposed of where the interest rate was increased and the payment term was extended by five years. In Rev. Rul. 74-157, 1974-1 C.B. 115, different security was substituted and the note was not found to have been disposed of

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4 The standby letter of credit would not be treated as payment for §453 purposes as this is allowed by Temp. Reg. §15A.453-1(b)(3).

for purposes of §453B. In Rev. Rul. 75-457, 1975-2 C.B. 196, a different obligor was substituted and this was not found to have resulted in a disposition of the installment obligation.

Under a special rule for deferred exchanges involving qualified intermediaries, a taxpayer in receipt of an evidence of indebtedness of the qualified intermediary's transferee is treated as receiving an evidence of indebtedness of the transferee of the property relinquished, notwithstanding that the regulations generally treat the intermediary as having acquired and transferred the relinquished property for other purposes. Thus, for IRC §453 and Temp. Reg. §15a.453-1(b)(3)(i) purposes, the receipt by the taxpayer of such an evidence of indebtedness is treated as the receipt of an evidence of indebtedness of the person acquiring the relinquished property from the taxpayer, and isn't considered a payment. This rule applies beyond the end of the exchange period. See Reg. §1.1031(k)-1(j)(2)(iii). Note that receipt of a note payable on demand or that is readily tradeable is equivalent to receipt of cash for §453 purposes.

Given these coordinating rules, consider the planning possibilities if the buyer of the relinquished property plans to finance the acquisition through a bank loan payable in installments. The taxpayer might negotiate with the buyer's bank to serve as qualified intermediary for an exchange transaction, as many banks are now doing through their trust departments. The exchange agreement might be negotiated to provide that the intermediary would be allowed to transfer the relinquished property to the buyer in

return for buyer's note payable in installments, secured by a mortgage on the property, which note would be held by the bank as intermediary in lieu of cash from a cash sale by the intermediary/bank to the buyer pending the taxpayer's identification and closing on replacement property. At the time of closing, intermediary/bank might transfer the mortgage note from the trust side to the lending side of the bank for cash which would be used to fund the acquisition of the replacement property. The exchange agreement would provide that if the taxpayer fails to identify the replacement property timely or fails to close on the acquisition of the replacement property timely, the bank would be obligated to distribute the mortgage note to the taxpayer who would then report payments on the note under the installment sale method. This writer has yet to be confronted with the opportunity to negotiate such an agreement in practice, but it would seem that the safe harbor rules for deferred exchanges and the coordination provisions in Reg. §1.1031(k)-1(j) would facilitate such a transaction.

G. More on Reverse Exchanges

A "reverse exchange" refers to a transaction in which the replacement property is received before the relinquished property is transferred.

Example (1) A and C agree to exchange properties. On November 1, 1999, C transfers property X to A. On December 1, 1999, A transfers property Y to C. The exchange is a deferred exchange for C and a reverse exchange for A.

Example (2) A owns property X and wants property Y. C, owner of property Y requires a transfer date before X can be transferred. C transfers Y to A, takes back a promissory note to represent the purchase value. Later, A transfers X to B, who pays off the note

given by A to C as purchase price. Neither B nor C have an exchange but A may have reverse exchange.

In the pure reverse exchange, the taxpayer owns both the relinquished and the replacement properties concurrently during the period between receipt of replacement property and transfer of the relinquished property. Reverse exchanges are not literally covered by IRC§1031(a)(3). They are specifically omitted from coverage under new regulations governing deferred exchanges. The safe harbor regulations define a deferred exchange as one in which the taxpayer transfers property and **subsequently** receives qualifying property in exchange. Comments were solicited in the proposed regulations on whether a "reverse-Starker" transaction should qualify for tax-free exchange treatment under Section 1031. See Preamble to proposed regulations, 1990-1 C.B. 633, 634. The Treasury indicated that the comments it received ranged from advocating the application of the deferred exchange provisions of Section 1031(a)(3) to reverse-Starker exchanges, to advising that neither Section 1031(a)(1) nor (a)(3) applies to these exchanges. See Preamble to final regulations, 56 Fed. Reg. 19933 (5/1/91). At the time, the Treasury settled on a determination that both the deferred exchange rules of Section 1031(a)(3) and the final deferred exchange regulations do not apply to reverse-Starker transactions. It indicated in the preamble to the regulations, however, that it would "continue to study" the applicability of the general rule of Section 1031(a)(1) to these transactions. See "Report on the Application of §1031 to Reverse Exchanges," 21 Journal of Real Estate Taxation 44 (Fall 1993).

In 2000, the IRS issued Revenue Procedure 2000-37 providing the safe harbor rules for reverse exchanges using a qualified Exchange Accommodation Titleholder that were discussed earlier in the program. However, to the extent taxpayers find themselves unable to meet the requirements of the safe harbor, one needs to be aware of the law outside of those rules.

The pure reverse exchange was apparently approved in the case of ***Ruthford v. Commissioner***, TC Memo 1978-505, relating to the exchange of cattle. More recent taxpayer attempts to report similar transactions as exchanges under §1031 have failed. See, eg. ***Bezdjian v. Commissioner***, 845 Fed.2nd 217 (9th Circuit 1988); ***Edwards C. Lee***, TC Memo 1986-294; and ***Julius Dibsy***, TC Memo 1995-277.

In ***Bezdjian***, the taxpayers wanted to purchase a gas station which they operated under a lease. Taxpayer indicated to the seller that they wish to exchange the gas station for rental property which they owned. The contract stated their desire to utilize a like-kind exchange but the seller would not accept the rental property. The taxpayers acquired the gas station and three weeks after the acquiring title to the gas station, sold the rental property to an unrelated party in an independent transaction. The court rejected the taxpayers characterization of the transaction as a like-kind exchange and the ninth circuit affirmed.

In ***Lee***, the taxpayers purchased a farm in November 1998. In June 1979, they sold five parcels of property to five different purchasers, specifying that sale proceeds

be paid to the seller of the farm to retire purchase money incurred by the Lees. Tax Court held that the sale of the five parcels did not qualify as an exchange for the farm because there was no evidence of any interdependence between purchase and sales transactions.

In ***Dibsy***, a purchase followed by sale involved liquor stores. None of the transaction documents for acquisition on this position mentioned an exchange and taxpayers owned and operated the replacement and the relinquished properties for six months before selling the old store and using the proceeds to retire debt incurred to purchase the new store. Relying on ***Bezdjian***, the Tax Court rejected the taxpayers contention that an intent to exchange was sufficient despite lack of interdependence.

A reverse exchange succeeded in ***In Re Exchanged Titles***, 159 BANKR.303 (Bankr. C. D. CA 1993) but the context of the case was a bit unusual. The taxpayer had structured an exchange with an a professional intermediary. The taxpayer provided funds to the intermediary to purchase replacement property. The intermediary acquired title to the replacement property, immediately transferred it to the taxpayer and the taxpayer transferred title to the relinquished property to the intermediary. The parties intended that the intermediary would sell the relinquished property and pay the proceed to the taxpayer. Following the closing, the taxpayer maintained control over the relinquished property, collected rents, paid taxes, maintenance and insurance and mortgage payments and even refinanced the property. Before it could sell the relinquished property, the intermediary ceased doing business and was the subject of

an involuntary Chapter 7 bankruptcy petition. The intermediary's bankruptcy trustee claimed the relinquished property was an asset of the estate and any claim of the taxpayer to the proceeds from its sale was an unsecured claim. The taxpayer asserted that only legal, not equitable title, had been conveyed to the intermediary, that this was all that was required to complete a valid like-kind exchange under §1031 and that the taxpayer's equitable claim on the property survived any attempt by the trustee to cut off the interest and the trustee's "strong arm" powers. The court held that the taxpayer had retained equitable title to the relinquished property and that the trustee was not able to avoid the taxpayer's equitable claim because the trustee had constructive notice of the claim and therefore was not a bonafide purchaser. However, the court concluded that this didn't prejudice the exchange. Taxpayer thus preserved its ability to recover the equity value of the relinquished property while preserving, at least as far as the bankruptcy judge was concerned, their like-kind exchange.

Prior to the issuance of Rev Proc 2000-37, most parties confronted with the reverse exchange situation attempted to use an intermediary to hold the replacement property until the relinquished property could be transferred whereupon a simultaneous exchange of the two would occur.

Example A has property X and wants property Y which must be acquired before property X is ready to be sold. Intermediary D purchases property Y, holds it until X is ready to close, then transfers Y to A in exchange for X, simultaneously selling X to buyer B.

In JH Baird Publishing Company v. Commissioner, 39 TC 608 (1962), an

intermediary acquired replacement property and began to construct improvements on it. During the course of construction the intermediary received title to the relinquished property and transferred the same to the buyer of the relinquished property. Because the exchanger retained the use of the relinquished property until the completion of the construction and transfer of the replacement property to it, the court held the exchanger did not dispose of the relinquished property until that point, creating a simultaneous exchange.

In ***Coastal Terminals, Inc. v. U.S.***, 320 Fed. 2nd 333 (4th Cir. 1963), a party desiring to purchase the taxpayers deepwater port was directed to buy an inland site and construct a facility on it. An exchange occurred following completion of the new facility. The 4th Circuit upheld the exchange treatment, emphasizing the buyers use of its own funds and undertaking of obligations to buy and build the facility for trade with the taxpayer.

In considering the structure of a reverse exchange, one must avoid the application of §1031(f) related party rules. Gain realized on a like-kind exchange between "related parties" must be recognized if within two years of the exchange either of the parties disposes of the properties acquired in the exchange. Lacking regulations to the contrary, it must be assumed that if the taxpayer and the reverse exchange intermediary are "related " in §1031(f) terms, this may result in a deemed disposition.

The deferred exchange regulations do not specify whether a "qualified

intermediary" must acquire and transfer the relinquished property prior to acquiring and transferring replacement property. The qualified intermediary must perform both functions. Since the regulations provide the same safe harbor from constructive receipt of proceeds where a qualified intermediary is used in a simultaneous exchange, there seems no reason why the safe harbor shouldn't apply to a reverse exchange except for the intermediaries actual ownership of property during a gap period, rather than performance of a conduit role with respect to both the replacement and relinquished properties, and not be a "disqualified person" under regulation §1.1031(k)-1(k)(3).

H. More on Replacement Property to Be Built

In ***JH Baird Publishing Company v. Commissioner***, 39 TC 608, 615 (1962) discussed above, the court approved the exchange treatment where the taxpayer oversaw the construction of improvements on the land to be acquired.

In ***Coastal Terminals, Inc. v. United States***, 320 Fed.2nd 333 (4th Cir.1963), also discussed above, Delhi-Taylor Oil Corp. (Delhi-Taylor) sought to purchase property owned by the taxpayer. Prior to this, the taxpayer had acquired options to purchase real property and had entered into commitments to purchase steel for the construction of terminal facilities. As part of an exchange, the taxpayer assigned the options and commitments to Delhi-Taylor. In the end, Delhi-Taylor conveyed completed terminal facilities to the taxpayer, and the taxpayer conveyed the property desired by Delhi-Taylor. In this case the Court of Appeals for the Fourth Circuit held that the transaction was an exchange.

See also ***Fredericks v. Commissioner***, TC Memo 1994-27 where a party to the transaction had acquired replacement property to be used in an exchange with the taxpayer, thus acquired such property to facilitate the exchange and for the additional purpose for constructing improvements thereon. This was considered a tax-free exchange as to the taxpayer.

Bloomington Coca-Cola Bottling Co. v. Commissioner, 189 F.2d 14 (7th Cir. 1951) held that a taxpayer may not obtain like kind exchange treatment if property is disposed of and proceeds are used to improve property the taxpayer owns. The service has ruled, however, that this objective may be accomplished by an exchange party acquiring a land lease, of at least 32 years, for the land on which the improvement will be constructed, constructing the building, and then transferring the building and land lease to the taxpayer in exchange for the relinquished property. See PLR 8304022 (July 27, 1992), PLR 9243038 (October 22, 1982), and PLR 7823035 (March 9, 1977). An EAT apparently may also lease the property and then pay the taxpayer to construct the building on the leased property. See PLR 200251008 (Dec. 19, 2002) discussed in detail above.

I. More on Deferred Exchanges with an Intermediary

Many of the general rules concerning deferred exchanges using a qualified intermediary were discussed earlier in this program. Often, at the time when the relinquished property is transferred to the buyer, the taxpayer does not yet know what property he or she wants to acquire, or the closing on the replacement property cannot

be accomplished simultaneously with the relinquished property. When such is the case, a deferred exchange is necessary.

(1) The Role of the Qualified Intermediary:

The buyer or the seller is usually not willing to act as an accommodation party. After all, there is always the possibility that the exchange might fall through and that he or she will wind up owning an unwanted property. Therefore, most simultaneous and deferred exchanges are structured with an intermediary – a party whose sole purpose in the transaction is to facilitate the exchange. The Regulations provide that the qualified intermediary in a simultaneous exchange will not be the taxpayer's agent.[5] The Regulations do not state whether the other provisions that apply to the qualified intermediary safe harbor, such as direct deeding, apply in the case of a simultaneous exchange as well as a deferred exchange. Presumably they would apply. There is some case law authority for direct deeding in a four party, simultaneous exchange.[6]

In a simultaneous exchange with an intermediary, the relinquished property is conveyed to the intermediary. The intermediary then conveys it to the buyer. The buyer pays cash to the intermediary. The intermediary pays cash to the seller who conveys the replacement property to the intermediary. The intermediary conveys the replacement property to the taxpayer. This transaction

5 Reg § 1.1031(b)-2(a).

6 ***WD Haden Co. v. Comm***., 165 F2d 588 (CA5 1948).

may also be accomplished by direct deeding of either or both the relinquished and replacement properties.

The documentation on this type of exchange will usually include the two purchase and sale agreements, which are assigned to the intermediary, followed by the exchange agreement between the taxpayer and the intermediary.

(2) Safe Harbors Rules of a Delayed Exchange:

In General. The Regulations create four safe harbors that provide certainty in participating in a deferred exchange. If the Regulations are followed, the taxpayer is not considered to be in actual or constructive receipt of money or other property for purposes of IRC §1031. The Regulations also provide that more than one safe harbor can be used in the same deferred exchange, but the terms and conditions of each safe harbor must be separately met to qualify the transaction. 1.1031(k)-1(g). We may describe the safe harbors for purposes of this discussion as Safe Harbor Nos. 1, 2, 3 and 4. They refer to the following safe harbors, using the regulation terminology:

§1.1031(k)-1(g)(2). Safe Harbor No. 1 - Security or Guarantee Arrangements.
§1.1031(k)-1(g)(3). Safe Harbor No. 2 - Qualified Escrow Accounts and Qualified Trusts.
§1.1031(k)-1(g)(4). Safe Harbor No. 3 - Qualified Intermediaries.
§1.1031(k)-1(g)(5). Safe Harbor No. 4 - Interest and Growth Factors.

Security or Guarantee Arrangements, Qualified Escrow & Qualified Trusts. Safe harbors No.1 and No.2 allow that a transferee's obligation

to transfer a replacement property to a taxpayer may be secured by cash or a cash equivalent if the cash or a cash equivalent is held in a qualified escrow account or in a qualified trust. Security structured this way will preclude the application of the actual or constructive receipt rules.[7]

A qualified escrow account is an account where the party holding the escrow is not the taxpayer or a disqualified person and the escrow agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or a cash equivalent held in the escrow account as provided in the paragraph (g)(6) limitations.[8] A qualified trust is a trust wherein the trustee is not the taxpayer or a disqualified person, except that for purposes of a qualified trust under Safe Harbor No. 2, the relationship between the taxpayer and the trustee created by a qualified trust will not be considered a relationship under IRC §267(b). The trust agreement must expressly limit a taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or a cash equivalent held by the trustee, as provided in paragraph (g)(6).[9]

The protection of the Safe Harbor No. 2 ends when the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise

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7 Reg § 1.1031(k)-l(g)(3)(i).

8 Reg § 1.1031(k)-l(g)(3)(ii).

9 Reg § 1.1031(k)-l(g)(3)(iii).

obtain the benefits of the cash or the cash equivalent held in the qualified escrow account or qualified trust.[10] The rights of a 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 purposes of this safe harbor.[11] The Regulations also provide that a taxpayer may receive money or other property directly from a party to the exchange, but not from a qualified escrow account or a qualified trust, without affecting the application of the protection of Safe Harbor No. 2.[12]

The use of Safe Harbor No. 2, whether a qualified escrow account or a qualified trust, has increased since the Regulations were first issued. The qualified escrow account or the qualified trust may be used to secure the obligation of a buyer of the relinquished property or the seller of a replacement property in a deferred exchange. It is also used to secure the obligation of a qualified intermediary in an exchange transaction.

Taxpayers should perfect a security interest in the qualified escrow or qualified trust to protect themselves against an intermediary, escrow agent or trustee bankruptcy. The Regulations allow the taxpayer to perfect a security interest in cash or a cash equivalent if the cash or cash equivalent is held in a

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10 Reg § 1.1031(k)-l(g)(3)(iv).

11 Reg § 1.1031(k)-l(g)(3)(iv).

12 Reg § 1.1031(k)-l(g)(3)(v).

qualified escrow or qualified trust.[13] Taxpayers should consult the local law where the qualified escrow or qualified trust are established to determine the method for perfecting the security interest in their state. A security interest in cash or a cash equivalent that is not in a qualified escrow or qualified trust would result in the constructive receipt of the funds under the Regulations.[14]

Although a qualified trust may be established under Safe Harbor No. 2, the trustee cannot be a disqualified person. The relationship between the taxpayer and a trustee created by a qualified trust will not be considered a relationship which will disqualify that trustee. A trustee acting as a qualified trustee under Safe Harbor No. 2 will be a disqualified person, except for purposes of acting as a qualified trustee under Safe Harbor No. 2. This means that a trustee acting as a qualified trustee under Safe Harbor No. 2 cannot be a qualified intermediary, because the trustee is a disqualified person.

Time Requirements

Under the regulations, the taxpayer has 45 days after the transfer of the relinquished property in which to identify his replacement property. He must complete the acquisition of the replacement property within 180 days of the date on which he transfers title to the relinquished property. As it was mentioned earlier in this program, these are strict requirements. *

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[13]Reg § 1.1031(k)-l(g)(3)(i).

[14]Reg § 1.1031(k)-l(g)(2)(i).

Identification of Replacement Property.

Any replacement property in a deferred exchange must be "identified" timely. Replacement property is identified only if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either:

(i) The person obligated to transfer the replacement property to the taxpayer; or

(ii) Any other person involved in the exchange other than the taxpayer or a disqualified person.

Using an Intermediary.

A qualified intermediary is not considered the agent of the taxpayer for purposes of a tax-deferred exchange. To qualify under Safe Harbor No. 3, there are two requirements. (1) the qualified intermediary cannot be the taxpayer or a disqualified person and (2) the taxpayer and the intermediary enter into an agreement. The agreement between the taxpayer and the qualified intermediary must expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. Paragraph (g)(6) provides the limitation that the taxpayer must not "obtain the benefits of money or other property" that are a result of the sale of the relinquished property. The (g)6) limitations are crucial to Safe Harbor Nos.

2, 3, and 4. For purposes of this Safe Harbor, it is immaterial that a qualified intermediary may be an agent of the taxpayer under general agency principles. The qualified intermediary may execute documents in an agency capacity. In the event of direct deeding, for either or both of the relinquished property or the replacement property, the taxpayer may execute all closing documents although the intermediary typically executes the settlement statement and escrow instructions. In the case of the relinquished property, if, pursuant to the terms of the exchange agreement, the intermediary receives the net sales proceeds and/or other property, the exchange is protected under Safe Harbor No. 3 provided that the taxpayer's right to receive the benefits of such money or other property is subject to the paragraph (g)(6) limitations.

The Intermediary.

A qualified intermediary is a person who is not the taxpayer or a disqualified person and enters into a written agreement with the taxpayer, the exchange agreement. As provided in the exchange agreement, the qualified intermediary must acquire the relinquished property from the taxpayer, transfer the relinquished property, acquire the replacement property, and transfer the replacement property to the taxpayer.[15] Regardless of whether an intermediary acquires and transfers property under general tax principles, for purposes of

[15]Reg § 1.1031(k)-l(g)(4)(iii).

Safe Harbor No. 3, an intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property.[16] An intermediary is treated as acquiring and transferring relinquished property if the intermediary enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and the relinquished property is transferred to that person.[17] The intermediary is treated as acquiring and transferring replacement property if the intermediary enters into an agreement with the owner of the replacement property for the transfer of that property and the replacement property is transferred to the taxpayer.[18] For purposes of Safe Harbor No. 3, an intermediary is treated as entering into an agreement if the rights of the taxpayer are assigned to the intermediary and all parties are notified in writing of the assignment on or before the date of the relevant transfer of property. For example, if a taxpayer enters into a purchase agreement for the sale of relinquished property and thereafter assigns its rights in that purchase agreement to an intermediary and all parties to the purchase agreement are notified in writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as entering into the purchase agreement. If the relinquished property is transferred pursuant to

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16 Reg § 1.1031(k)-l(g)(4)(iv)(A).

17 Reg § 1.1031(k)-l(g)(4)(iv)(B).

18 Reg § 1.1031(k)-l(g)(4)(iv)(C).

the purchase agreement, the intermediary is treated as having acquired and transferred the relinquished property.[19]

Safe Harbor No. 3 ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. As with Safe Harbor No. 2, rights of a taxpayer under state law to terminate or dismiss the qualified intermediary are disregarded in determining whether or not a taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by the qualified intermediary.[20]

As with Safe Harbor No. 2 with regard to qualified escrow accounts or qualified trusts, a taxpayer may receive money or other property directly from a party to the transaction other than the qualified intermediary without affecting the application of Safe Harbor No. 3.[21] This means that if the taxpayer wants to receive cash from the exchange proceeds, arrangements should be made by the taxpayer to receive the cash prior to the time that the proceeds are received by the qualified intermediary. Arrangements should be made with the closing agent so that those funds will be paid directly by the closing agent to the taxpayer with

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[19] Reg § 1.1031(k)-l(g)(4)(v).

[20] Reg § 1.1031(k)-l(g)(4)(vi).

[21] Reg § 1.1031(k)-l(g)(vii).

the balance of the net sales proceeds being transferred to the qualified intermediary for the acquisition of replacement property subject to the (g)(6) limitations. The funds to be disbursed to the taxpayer should be referenced in the purchase agreement and the assignment of the purchase agreement to the intermediary. Also, if the taxpayer wants a reimbursement of any deposits paid to the seller of the replacement property, the seller should reimburse the taxpayer directly at the closing of the replacement property, not the intermediary.

Direct Deeding.

Usually in the case of all cash transactions, direct deeding will be utilized on both the disposition of the relinquished property and on the acquisition of the replacement property. The taxpayer assigns his interest in the purchase and sale agreement on either or both properties to the intermediary, and all parties to the purchase and sale agreements are notified in writing of the assignment before the date of the transfer of either or both the relinquished and the replacement property.[22]

Direct deeding is not expressly authorized under the Regulations, but the Regulations encourage the use of direct deeding by providing the framework to effect title transfers by direct deeding. Direct deeding in an exchange where a

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22 Reg § 1.1031(k)-l(g)(vii).

qualified intermediary is used eliminates the strict liability risks associated with a property (hazardous waste, etc.) which may arise from coming into title on either or both the relinquished or the replacement property and reduces the number of title transfers and the additional documentation involved in transferring title more than once. In addition, direct deeding eliminates the risk of non-cooperation on the part of a buyer of the taxpayer's property or a seller of the replacement property. The fact that a seller of replacement property or a buyer of relinquished property is aware of the fact that the taxpayer is engaged in a tax deferred exchange possibly gives the other party to the transaction leverage in his negotiations with the taxpayer. If the seller of the replacement property is not aware that a taxpayer is involved in an exchange, the seller's ability to take advantage of that fact is eliminated. The seller of the replacement property will only become aware that an exchange is involved immediately prior to the transfer of the replacement property. By that time the seller has entered into a binding agreement with the taxpayer which has been assigned to the intermediary, and the seller will not be able to take advantage of the fact that an exchange is involved on the part of a taxpayer.

Definition of Disqualified Person.

For purposes of a deferred exchange:

(1) A disqualified person is the agent of the taxpayer at the time of the transaction. A person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or

broker within the two-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction. However, the following services will not be taken into account:

(A) Services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under IRC § 1031; and
(B) Routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.[23]

(2) A person is a disqualified person if that person and the taxpayer bear a relationship described in either IRC § 267(b) or § 707(b), determined by substituting "10%" for "50%" every time it appears.[24]

(3) A person is a disqualified person if the person and a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two-year period ending on the date of the transfer of the first of the relinquished properties bears a relationship described in either IRC § 267(b) or § 707(b), again, determined by substituting "10%" for "50%" every time it appears.[25]

Identification of Replacement Property.

The (g)(6) limitations which apply to Safe Harbor Nos. 2, 3, and 4 provide that the agreement must limit the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period. The agreement may provide that if the taxpayer has not identified replacement property before the end of the identification period,

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23 Reg § 1.1031(k)-l(k)(2).

24 Reg § 1.1031(k)-l(k)(3).

25 Reg § 1.1031(k)-l(k)(4).

the taxpayer 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.[26]

The agreement typically provides that if the taxpayer has identified replacement property, the taxpayer will have the right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property upon and after:

(1) The receipt by the taxpayer of all of the replacement property to which the taxpayer is entitled under the exchange agreement; or

(2) The occurrence after the end of the identification period of a material and substantial contingency that relates to the deferred exchange, is provided for in writing, and is beyond the control of the taxpayer and of any disqualified person, other than the person obligated to transfer the placement property to the taxpayer.[27]

If a taxpayer has identified replacement property within the identification period, after the expiration of the identification period and prior to the expiration of the exchange period, the taxpayer may not receive the exchange funds even if the taxpayer decides not to complete an exchange because the

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[26] Reg § 1.1031(k)-l(g)(6)(ii).

[27] Reg § 1.1031(k)-l(g)(6)(iii).

replacement property or properties identified have been sold, or taken off the market, or the terms of purchase agreement do not meet the taxpayer's requirements, or for other reasons. Once an identification has been made and the identification period has expired, the (g)(6) limitations preclude the taxpayer from receiving funds from a qualified escrow account, qualified trust or qualified intermediary until the expiration of the exchange period.

The taxpayer may want to add a "material or substantial contingency" to its exchange agreement or identification so that if the contingency is not met, the exchange proceeds can be released to the taxpayer prior to the end of the exchange period. The contingency must meet the following requirements: (1) it must relate to the deferred exchange, (2) be provided for in writing, and (3) be beyond the control of the taxpayer and of any disqualified person (as defined in paragraph (k) of Reg § 1.1031(k)-l(k)).

The Regulations provide the following examples on what constitutes a qualifying "material or substantial contingency": 1) the identified real property is destroyed, seized, requisitioned, or condemned; (2) a determination is made that the regulatory approval necessary for the transfer of the real property cannot be obtained in time for real property to be transferred to the taxpayer before the end of the exchange period; or (3) a requirement that the property be rezoned from residential to commercial use before a certain date, after which

date the taxpayer may demand the exchange funds.[28] The contingency must be beyond the control of the taxpayer.

Contingencies such as "obtaining financing" or "providing that the seller will sell the property" to the taxpayer present problems because financing can probably be obtained by the taxpayer if the interest rate is high enough and the property can probably be obtained from the seller if the price is high enough. The taxpayer specifying a contingency should be careful and detailed enough so that the contingency is material and substantial and beyond the taxpayer's control. If not, the taxpayer will be deemed to have constructively received the exchange funds and the exchange will be taxable even if the taxpayer acquires replacement property.

The Growth Factor.

Under Safe Harbor No. 4, a taxpayer may be entitled to receive any interest or growth factor with respect to the escrowed funds in a deferred exchange, and the taxpayer will not be construed to be in actual or constructive receipt of money or other property provided that the agreement pursuant to which the taxpayer is or may be entitled to the interest or growth factor expressly limits the taxpayer's rights to receive the interest or growth factor as provided in paragraph (g)(6).[29] Whether or not a taxpayer is treated as entitled

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[28]Reg § 1.1031(k)-l(g)(8), Example 2.

[29] Reg § 1.1031(k)-1(g)(5).

to receive the interest or growth factor with respect to a deferred exchange depends upon the amount of money or property the taxpayer is entitled to receive and the length of time elapsed between the transfer of the relinquished property and the receipt of the replacement property.[30]

When the taxpayer receives the interest or growth factor as part of a deferred exchange, the interest or growth factor is treated as interest regardless of whether the interest or growth factor is paid to the taxpayer in cash or in property, including property of a like-kind. It is treated as interest even if the interest or growth factor is applied to the purchase price of the replacement property. This provision requires that the taxpayer report the interest even if it is paid to the intermediary or paid to the taxpayer in property. This is because the taxpayer is still receiving the benefit of the interest, even though the taxpayer is not receiving cash. Any other benefits the taxpayer may receive in lieu of foregone interest, such as a waiver of bank fees or other charges, must be reported, unless these benefits are received in accordance with the limitations of Reg § 1.1031(k)-l(g)(6).[31] The taxpayer must include the interest or growth factor in income according to the taxpayer's method of an accounting.[32] The interest or growth factor must depend upon the length of time

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30 Reg § 1.1031(k)-l(h)(1).

31 Ltr Rul 9448010.

32 Reg § 1.1031(k)-l(h)(2).

elapsed between the relinquished property and receipt of replacement property.

<u>The 180 Day Deadline to Acquire Replacement Property</u>

It has been mentioned earlier in this program that the 180 day deadline is very strict and cannot be extended, even where the 180th day falls on a weekend or legal holiday. This is certainly the position maintained by the IRS and should be followed in every case. However, to the extent that one finds themselves unable to meet that deadline, the taxpayer is not without support in the law to maintain that an acquisition closed on the next available business day is within the 180 day requirement. IRC §7503 provides that:

> When the <u>last day prescribed under authority of the internal revenue laws for performing any act</u> falls on Saturday, Sunday, or a legal holiday, the performance of such act shall be considered timely if it is performed on the next succeeding day which is not a Saturday, Sunday, or a legal holiday. For purposes of this section, the last day for the performance of any act shall be determined by including any authorized extension of time; the term "legal holiday" means a legal holiday in the District of Columbia; and in the case of any return, statement, or other document required to be filed, or any other act required under authority of the internal revenue laws to be performed, at any office of the Secretary or at any other office of the United States or any agency thereof, located outside the District of Columbia but within an internal revenue district, the term "legal holiday" also means a Statewide legal holiday in the State where such office is located.

Section 7503 has been held applicable to extend to the next business day: (1) the

deadline for the IRS to commence a collection proceeding within the statute of limitations as extended by an agreement with the taxpayer ***(U.S. v. Klotter***, 1985 WL 6025 (W.D. Ky. 1985); (2) the deadline for the IRS to assess additional taxes within the statute of limitations as extended by agreement with the taxpayer (***Olsen v. Commissioner***, T.C. Memo 1984-411, 1984 WL 15060 (U.S. Tax Court), 48 T.C.M. (CCH) 765, T.C.M. (P-H) P 84,411, 1984 PH TC); and (3) the last day within which a corporation was required to complete a liquidation under former IRC §337 which required distributions of all assets in liquidation to be completed within 12 months of adoption of a plan of liquidation (***Snyder v. Commissioner***, T.C Memo 1981-216, 1981 WL 10594 (U.S. Tax Court), 41 T.C.M. (CCH) 1416, T.C.M. (P-H) P 81,216, 1981 PH TC Memo 81,216).

The IRS has maintained in Rev.Rul. 72-541 and Rev. Rul. 83-116 that the legislative history of §7503 indicates that it was intended to apply only to extend the deadline for an "act" constituting a "procedural step in connection with the determination, collection or refund of taxes." The service made this argument in ***Snyder v. Commissioner*** but he Tax Court was unimpressed. The Tax Court there stated:

> "We think respondent reads the language of 7503 too narrowly. [footnote omitted]. It may well be that Congress, in enacting section 7503, was thinking primarily of difficulties in filing

> documents with, or in taking action vis-a-vis, the Government in tax matters. See General Lead Batteries Co. v. Commissioner, 20 T.C. 685 (1953). But the fact of the matter is that the statute is not so confined, nor are the primary references in the committee reports. Moreover, we think it significant that section 7503 uses the word "prescribed," which has a broad connotation, and we see no reason not to accord it the usual and ordinary meaning. See Malat v. Riddell, 383 U.S. 569, 571 (1966). Finally, we note that section 7503 was intended to be the exclusive vehicle for dealing with the effect of a time period expiring on a legal holiday."

More recent decisions of the Supreme Court have reinforced the concept that it is not necessary to look beyond the fact of the statute when the plain meaning of the language there is clear. Moreover, as pointed out by the Tax Court in the **Snyder** decision, there is support outside of §7503 for the extension of a deadline falling on a legal holiday. In ***Campbell Chain Company & Manufacturing v. Commissioner***, 16 TC 1402 (1951), the Tax Court found that the last day within the 60 day period within which an employer contribution may be made to a qualified employee profit sharing plan trust was extended when no statue comparable to §7503 was in effect.

Therefore, if one finds oneself in this situation with respect to the 180 day deadline under the deferred exchange rules, and if it is possible to close the acquisition of the replacement property on the next business day, this writer would not hesitate to recommend the taxpayer do so and take the position that

"any act" as used in §7503 means "any act." Knowing the position of the IRS, one should never plan a transaction relying on this argument.