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Tax Deferred Exchanges of Property —Mistakes and Misconceptions

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Gilbert Dukes outlines the common taxpayer misconceptions and mistakes concerning Code Sec. 1031 *exchanges and describes areas of risk in which taxpayers find themselves absent a properly structured exchange.*

Introduction

Given the growing number of investment properties and their significant appreciation in value, more and more sellers are deferring their income tax liability by conducting exchanges under Code Sec. 1031. Unfortunately many exchanges could result in an unexpected tax liability because of incorrect legal and/or tax advice (or in some cases no advice at all). With this in mind, this article focuses primarily on common misconceptions of taxpayers and their advisers concerning Code Sec. 1031 exchanges and the tax consequences thereof, the mistakes commonly made and the areas of risk in which taxpayers may find themselves absent a properly structured exchange.

Definition of "Exchange" and Concept of "Intermediary"

There is no better place to start than with the definition of an "exchange," a simple yet often misunderstood concept that clarifies the necessity of using a qualified intermediary. *An exchange occurs when a taxpayer conveys property ("the relinquished property") to the same party from whom the taxpayer acquires "replacement property."* Contrary to what many taxpayers believe, if a taxpayer conveys relinquished property to a purchaser and acquires replacement property from someone other than the purchaser, an exchange has not occurred even if the sale and purchase close simultaneously. Absent an exchange, Code Sec. 1031 is inapplicable, and the taxpayer must recognize gain for income tax purposes.

Prior to the 1990s, the requirement of an exchange created problems in that a taxpayer desiring tax deferral under Code Sec. 1031 was forced to require that the purchaser become a party to the taxpayer's acquisition of replacement property (as only then would the taxpayer be deemed to have conveyed property to the same party from whom the taxpayer acquired replacement property). The purchaser would get nervous, hire a lawyer (whose fees would often be borne by the taxpayer conducting the exchange) and complex documents would be drafted, *etc.*

Fortunately, these problems were alleviated when IRS regulations authorized the use of a "qualified intermediary" to accommodate a taxpayer's exchange.[1] Pursuant to Code Sec. 1031 regulations, if prior to a sale of relinquished property a taxpayer (1) executes an exchange agreement with an intermediary and (2) assigns to the intermediary his "rights"[2] under a real estate sale agreement (such assignment accompanied by written notice thereof to all parties to the purchase agreement), then for income tax purposes the taxpayer will be "treated as if" he conveyed the relinquished property to the intermediary followed by the intermediary's conveyance of such property to the purchaser (although at the closing the taxpayer simply may deed the relinquished property directly to the purchaser).[3] Likewise, if prior to the taxpayer's acquisition of replacement property the taxpayer assigns to the intermediary his "rights"[4] under a real estate purchase agreement (such assignment accompanied by written notice thereof to all parties to the purchase agreement), then for income tax purposes the taxpayer will be "treated as if" the intermediary acquired the replacement property and conveyed such property to the taxpayer (although at the closing the seller simply may deed the replacement property directly to the taxpayer).[5] In other words, by executing an exchange agreement and assigning to the intermediary rights under real estate sale/purchase agreements (with written notice thereof to all parties to such agreements), the taxpayer is "treated as if" he conveyed relinquished property to the same party (the intermediary) from whom the taxpayer acquired replacement property (*i.e.*, an "exchange"). By following the Code Sec. 1031 regulations, no longer must a taxpayer request that a purchaser become a party to the taxpayer's acquisition of replacement property. Neither the purchaser's cooperation nor participation is required for purposes of the taxpayer's exchange, and for this reason, there generally is no need to insert language in the real estate sale agreement implying otherwise.[6]

Types of Exchanges

Generally, there are three major types of exchanges: a "simultaneous" exchange (taxpayer conveys relinquished property and simultaneously acquires replacement property); a "deferred" exchange (taxpayer conveys relinquished property and subsequently acquires replacement property); and a "reverse" exchange (taxpayer acquires replacement property and thereafter conveys relinquished property). Again, regardless of the type exchange being conducted, in order to use a qualified intermediary, the taxpayer must execute an exchange agreement and assign to the intermediary rights under real estate sale/purchase agreements (generally with written notice of assignment to the purchaser/seller). With respect to deferred exchanges (which have been the most popular type of exchange but now are quickly losing ground to reverse exchanges), the taxpayer must also (1)"identify" replacement property within the 45-day "identification period," (2) acquire replacement property within the "exchange period," and (3)avoid "constructive receipt"[7] of the sales proceeds in the meantime (which is usually accomplished by escrowing the sales proceeds with the intermediary pursuant to an exchange agreement which restricts the taxpayer's ability to receive, pledge, borrow or otherwise obtain the sale proceeds).[8]

Deferred Exchanges

Identification of Replacement Property

The identification rules can be tricky. Within 45 days after the sale,[9] the taxpayer must identify in a writing signed by the taxpayer (usually a letter mailed or faxed to the intermediary)[10] one or more properties as potential replacement properties for the exchange. A taxpayer may identify up to three properties without worrying about any additional restrictions ("the three-property rule"). If a taxpayer identifies more than three properties, then the total value of all identified property may not exceed twice the value of the relinquished property ("the 200-percent rule") unless the taxpayer acquires 95 percent of everything identified ("the 95-percent rule").[11] If an identification rule is violated, the exchange will fail and 100 percent of the gain must be recognized.[12]

Any property acquired during the 45-day period is deemed to be identified.[13] Thus the identification letter need only identify properties that may be acquired after the end of the 45-day period. However, for purposes of the three-property rule and the 200-percent rule, any property acquired during the 45-day period counts. In other words, if a taxpayer acquires one property during the 45-day period and identifies three more properties, then the total value of the four properties cannot exceed twice the value of the relinquished property absent compliance with the 95-percent rule.

The identification must be specific.[14] With respect to condominium units, for example, a taxpayer must identify a specific unit. Stating "a unit in The Dunes" will not suffice. Also, within the exchange period the taxpayer must acquire substantially the same property as identified.[15] If a taxpayer identifies a unit, but acquires only a half-interest in the unit (the other half for example being acquired by a spouse, friend, *etc.*), then the half-interest is not substantially the same property as identified. In this case, regulations indicate that if a taxpayer acquires at least 75 percent (in size and value) of what was identified, then the acquired interest is substantially the same as what was identified.[16] Obviously if a taxpayer intends to acquire merely a half-interest, a half-interest (or at least no more than an undivided 66.67 percent interest) should be identified.

> **Question.** What if a taxpayer identifies a condominium unit during the 45-day period and thereafter the taxpayer's realtor presents a purchase agreement to the owner of such unit indicating that the taxpayer is acquiring such unit as replacement property for an exchange?
>
> **Answer.** A common mistake. An intelligent seller would realize that the taxpayer may suffer an undesired tax liability absent an acquisition of his unit. The taxpayer will have lost most if not all of his negotiating power. Again the taxpayer does not need the seller's participation, cooperation or consent to conduct an exchange, and there no reason to put language in the purchase agreement implying otherwise. The key is to be sure there is no provision in the real estate purchase agreement restricting the taxpayer's ability to assign "rights" under the agreement to another party (as the taxpayer must assign his rights under the purchase agreement to the intermediary generally with written notice to the seller prior to closing).

Exchange Period

The exchange period can be tricky as well. Most taxpayers believe the exchange period is six months beginning with the date of the sale. *Actually, the exchange period ends on the earlier of the 180th day following the sale or the due date for the taxpayer's income tax return for the year in which the sale takes place.*[17] Assume an individual taxpayer conveys relinquished property on December 15, 2001. His exchange period will end on April 15, 2002 (approximately two months earlier than the 180th day), absent an extension (approved by the IRS) of the due date for his 2001 income tax return. Individuals must be cognizant of this rule with respect to any sale occurring after October 15th (as the due date for their income tax return is April 15th of the following year). Corporations using the calendar year (some corporations use a fiscal year) for income tax purposes must be cognizant of this rule with respect to any sale occurring after September 15th (as the due date for their income tax return is March 15th of the following year).

Exchanges That "Straddle" Year-End-Treatment as Code Sec. 453 Installment Sale

Some exchanges "straddle" year end in that funds are escrowed in one tax year, yet some or all of such funds are returned to the taxpayer in the following tax year upon completion of a failed exchange or upon completion of an exchange successfully conducted by the taxpayer.

Question. What if a taxpayer conveys relinquished property during the year 2001, escrows his conveyance proceeds with an intermediary and successfully acquires replacement property, but less than all conveyance proceeds are applied toward such acquisition and the intermediary returns the balance to the taxpayer during the year 2002?

Answer. A portion of the taxpayer's realized gain may be deferred under Code Sec. 1031. Although the taxpayer recognizes gain to the extent of the balance of the conveyance proceeds returned to the taxpayer, the recognized gain may be reported on the taxpayer's year 2002 income tax return using the Code Sec. 453 installment sale method of reporting recognized gain.

Question. What if a taxpayer conveys relinquished property during the year 2001 and escrows his conveyance proceeds with an intermediary with a *bona fide*[18] intent of conducting an exchange, but the taxpayer fails to identify and/or acquire replacement property, and the intermediary returns all conveyance proceeds to the taxpayer during the year 2002 at the end of the identification period or exchange period, as the case may be.

Answer. Although the taxpayer recognizes all gain, the gain may be reported on the taxpayer's year 2002 income tax return using Code Sec. 453 installment sale method of reporting recognized gain.[19] In this regard, Reg. §1.1031(k)-1(j)(2)(vi) includes the following example:

Example(3):

(i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B enters into an exchange agreement with C whereby B retains C as a qualified intermediary to facilitate an exchange with respect to real property X. On December 1, 1994, pursuant to the agreement, B transfers real property X to C who transfers it to D for $100,000 in cash. On that date B has a bona fide intent to enter into a deferred exchange. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash held by C until the earliest of the end of the identification period if B has not identified replacement property, the date the replacement property is delivered to B, or the end of the exchange period. Although B has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period, B does not identify or acquire any replacement property. In 1995, at the end of the identification period, C delivers the entire $100,000 from the sale of real property X to B.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis in real property X ($60,000), or $40,000. Because B has a bona fide intent at the beginning of the exchange period to enter into a deferred exchange, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(ii) of this section inapplicable even though B fails to acquire replacement property. Further, under paragraph (j)(2)(ii) of this section, C is a qualified intermediary even though C does not acquire and transfer replacement property to B. Thus, any agency relationship between B and C is disregarded for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on December 1, 1994, on C's receipt of payment from D for the relinquished property. Instead, B is treated as receiving payment at the end of the identification period in 1995 on receipt of the $100,000 in cash from C. Subject to the other requirements of section 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

Like-Kind

Real Property

Within the exchange period, the taxpayer must acquire replacement property (identified within the 45-day identification period) of "like-kind" to the relinquished property.[20] Generally, any real property is of like-kind to other real property.[21] A taxpayer may convey timberland and acquire a condominium unit. A taxpayer may convey a condominium unit and acquire a commercial building, vacant lot or any other real property.

Question. What if a taxpayer conveys timberland for $300,000 and acquires a furnished condominium unit for $300,000?

Answer. The furnishings are personal property rather than real property. As personalty is not of like-kind to real property, gain must be recognized to the extent of the value of the furnishings.

Personal Property

Under Code Sec. 1031 personal property may be exchanged for other personal property of like-kind (a truck for a truck, an airplane for an airplane, *etc.*). Additionally, depreciable tangible personal property may be exchanged for (1) other depreciable tangible personal property of like-kind or (2) other depreciable tangible personal property of "like-class," meaning of the same "General Asset Class" or the same "Product Class."[22] General Asset Classes are set forth in Reg. §1.1031(a)-2(b)(2) and in Rev. Proc. 87-56.[23] Product Classes are within Division D of the Standard Industrial Classification codes, set forth in the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual ("the SIC Manual").

Question. Can a taxpayer exchange a convenience store (including all gas pumps and other fixtures) for a commercial building?

Answer. Under local real property laws, a deed will convey the land, the building and all fixtures (items which are affixed to the land or building rather than something generally considered "moveable"). However, a characterization as realty under local real property laws does not necessarily mean such property constitutes real property for purposes of Code Sec. 1031. The following definition of "tangible personal property" is found in Reg. §1.48-1(c): "The term 'tangible personal property' means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items that are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses ... and neon and other signs, which is contained in or attached to a building constitutes tangible personal property ... Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property." In sum, an exchange of a convenience store for other property would likely need to be broken down into "exchange groups" under Reg. §1.1031(j)-1. The taxpayer's realty could be exchanged for other realty. The taxpayer's tangible personal property could be exchanged for other tangible personal property of like-kind or like-class. If the taxpayer conveys tangible personal property and acquires no tangible personal property of like-kind or like-class, then the taxpayer would need to recognize any gain realized upon the disposition of such tangible personal property, and a portion if not all of such gain would likely be characterized as ordinary income under the Code Sec. 1245 recapture provisions.

Held for Investment

Not only must the relinquished and replacement properties be of like-kind, but the relinquished property also must have been held "for investment" (or for use in a trade or business) and the replacement property must be acquired with an intent of holding such property "for investment" (or for use in a trade or business).[24]

Question. How long must the relinquished property have been held for investment before a taxpayer may conduct an exchange?

Answer. There is no specific period beyond which an exchange definitely works or short of which an exchange definitely fails.[25] A conservative approach would be to hold property for at least one year (the period which gives rise to long term capital gain treatment) prior to marketing such property for sale.[26] The longer the period, the safer the exchange will be.

Question. Can a second residence held for personal use be converted into investment property prior to the sale?

Answer. Yes, although the taxpayer should hold such property for investment as long as possible prior to marketing such property for sale (often accomplished by putting the property up for rent and limiting personal use by the taxpayer and/or members of his family).

Question. How long must replacement property be held for investment prior to converting such property to a second residence for personal use?

Answer. Wrong question. If on the date the taxpayer acquires replacement property, the taxpayer intends to convert such property to personal use as soon as possible, the exchange should fail, even if the taxpayer holds such property for investment for some period of time to give the appearance of an investment intent on the date of acquisition. The issue is whether on the date of acquisition of replacement property, the taxpayer has an intent (on that date) of holding such property for investment as opposed to personal use. If a taxpayer initially acquires replacement property with an intent of holding such property for investment and *later* decides to hold such property for personal use, the exchange should not be adversely affected. Of course the IRS has at least three years to audit an income tax return, and if the taxpayer is using the replacement property for personal use at the time of the audit, it will be difficult to prove to the IRS that the property was initially acquired with an investment intent.

Question. How often can a taxpayer or members of his family use property for personal use without adversely affecting an exchange?

Answer. With respect to Code Sec. 1031, there is no specific number of days written in stone. A conservative approach would be to limit personal use to a number of days that would allow expense deductions (*i.e.*, the greater of 14 days or 10 percent of the number of days the property is rented as fair rental).[27]

Taxpayer Issues

A related concept involves the taxpayer conducting the exchange. As a general rule, to defer 100 percent of the gain, whoever conveys the relinquished property must acquire the replacement property.

Question. What if H conveys relinquished property for $300,000, and H and W jointly acquire replacement property at a cost of $300,000?

Answer. A common mistake. H conveyed property worth $300,000 yet acquired property (a half-interest) worth $150,000. Up to $150,000 of realized gain should be recognized by H.

Question. What if H and W convey jointly held relinquished property for $300,000, and W acquires replacement property for $300,000?

Answer. Another common mistake. Although W has a clean exchange, H conveyed property worth $150,000 and acquired no replacement property. H's entire gain should be recognized.

Question. What if H and W convey jointly held relinquished property for $300,000, and their family partnership acquires replacement property for $300,000?

Answer. Another common mistake. H and W conveyed property worth $300,000, and acquired no replacement property. Their entire gain should be recognized.

Question. In the preceding question, what if H and W acquired the replacement property but soon thereafter contributed such property to their family partnership?

Answer. Under the step transaction doctrine the IRS would argue that H and W have either (1) exchanged realty for a partnership interest in violation of Code Sec. 1031(a)(2)(D),[28] or (2) acquired replacement property with an intention of conveying such property to another party (their partnership) rather than with an intention of holding such property for investment as required by Code Sec. 1031(a)(1).[29]

Exchanges Involving Partnership Property

I often receive calls from individuals who desire to conduct an exchange, yet soon learn the relinquished property is owned by a partnership or LLC having other owners with no desire to conduct an exchange. In other words, one partner wants to conduct an exchange with "his share" of the sales proceeds while the other partners simply want cash. The problem relates to the basic requirements of Code Sec. 1031(a) discussed above. To conduct an exchange, a taxpayer must convey relinquished property that has been held for investment. Under these facts, the partnership, not its partners, has held the relinquished property. Consider the following conservative options:[30]

Option 1

The partnership could be dissolved with its assets distributed to the individual partners. The individuals (who would then be tenants in common with respect to the distributed property) could then begin holding the relinquished property for investment. After the property has been held for investment, the owners could market the relinquished property for sale. At the closing any owner may conduct an exchange with his share of the net sales proceeds while other individuals simply cash out.

Option 2

The partnership could distribute an undivided interest in the relinquished property to the partner who desires to conduct an exchange. The relinquished property (which would then be owned by the partnership and the distributee as tenants in common) could then be held for investment. After the property has been held for investment, the partnership and the distributee could market the relinquished property for sale. At the closing, the distributee may conduct an exchange with his share of the net sales proceeds while the partnership simply cashes out.

The inevitable problem with either option is that the relinquished property is either already under contract or at least already on the market for sale. In either case, even if the partnership distributes the relinquished property or an interest therein to one or more partners desiring to conduct an exchange and even if such distribution takes place quite some time prior to closing, the IRS would argue that such property was held "for sale" by the distributees rather than having been held for investment as required by Code Sec. 1031. Moreover, take note of lines 3 and 4 of Form 8824:

3. Date like-kind property given up was originally acquired (month, day, year)

4. Date you actually transferred your property to other party (month, day, year)

Why is the IRS asking these questions? Obviously to determine how long the individual held the relinquished property for investment prior to closing. If the closing takes place three weeks after the partnership's distribution, will the answer to line 3 be three weeks prior to the answer to line 4, or will the taxpayer "fudge" and take the position that he has held the property (via his interest in the partnership) since the date the partnership acquired such property? Under current law it appears the proper difference between lines 3 and 4 would be three weeks.[31]

Gain Recognition

An often misunderstood concept involves the amount of gain which must be recognized when less than 100 percent of the net sales proceeds is invested in replacement property. Assume a taxpayer purchases property for $100,000 and therefore has an income tax basis of $100,000 in such property. Further assume the property appreciates in value to $300,000. Two things are clear to most taxpayers. First, if the taxpayer sells the property for $300,000 and does not conduct an exchange, the taxpayer's "realized gain" would be $200,000, all of which must be "recognized" and reported on the taxpayer's income tax return. Second, if the taxpayer conducts an exchange and acquires one or more replacement properties of like-kind at a cost of $300,000 or more, none of the $200,000 realized gain need be recognized as the entire gain is deferred under Code Sec. 1031.[32] What many taxpayers and their advisers do not understand is the amount of realized gain which must be recognized if, in this example, the taxpayer acquires replacement property at a cost of $250,000. The answer —$50,000. Realized gain must be recognized to the extent the net sales proceeds ($300,000) exceed the cost of the replacement property ($250,000).[33] Take this a step further with the following question:

Question. Assuming the taxpayer sells relinquished property for $300,000 (with an income tax basis of

$100,000), how much gain must be recognized if the replacement property costs only $100,000?

Answer. The entire gain of $200,000 must be recognized. *If the taxpayer does not reinvest in replacement property an amount which exceeds his income tax basis in the relinquished property, the tax consequences of an exchange are generally the same as the tax consequences of a sale.* In other words a taxpayer does not start deferring tax under Code Sec. 1031 until he has reinvested in replacement property an amount which exceeds his income tax basis in the relinquished property. Assuming a 25-percent state/federal capital gain tax rate, for every dollar in excess of basis reinvested in replacement property, a taxpayer defers 25 cents of tax.

The preceding rules apply whether or not the relinquished property is encumbered by a mortgage. To defer 100 percent of the realized gain, taxpayers must reinvest in replacement property 100 percent of the net amount realized, not just their "equity" in the relinquished property.

Question. If a taxpayer conveys relinquished property for $300,000, and $200,000 of the sales proceeds is used to satisfy the taxpayer's mortgage on the relinquished property (leaving $100,000 to be escrowed with the intermediary), how much must the taxpayer reinvest in replacement property to defer 100 percent of the gain?

Answer. To defer 100 percent of the gain, the taxpayer must acquire replacement property at a cost of at least $300,000. In other words, the taxpayer must not only reinvest the $100,000 of net sales proceeds but must also either infuse $200,000 of cash or borrow at least $200,000 in connection with the acquisition of replacement property.[34]

Seller Financed Exchanges

A related concept involves financing issues upon the conveyance of relinquished property or acquisition of replacement property. Assume a taxpayer conveys property for $300,000 but finances $200,000 of the sales price for the purchaser. In other words, the purchase price is payable via $100,000 in cash at closing (properly escrowed with an intermediary) with the balance represented by the purchaser's promissory note (properly escrowed with an intermediary) secured by a vendor's lien or mortgage on the relinquished property. In this example, many taxpayers believe they may then acquire replacement property for $300,000, supply to the closing agent the $100,000 of cash initially escrowed with the intermediary, then borrow the balance from a bank and have the intermediary return the purchaser's promissory note initially escrowed with the intermediary. This is incorrect. In such an exchange, the taxpayer would have given up relinquished property worth $300,000 and executed a $200,000 note to the bank in exchange for replacement property worth $300,000 and the purchaser's $200,000 promissory note. The purchaser's promissory note of $200,000 constitutes "boot" (*i.e.*, something other than real estate of like-kind to the relinquished property). Generally taxpayers must recognize gain to the extent of the boot. The question becomes whether the taxpayer may offset the receipt of such boot by executing a note to the bank. The answer is no, leaving the taxpayer with up to $200,000 of realized gain to be recognized.[35] Taxpayers may not offset the receipt of boot by executing a note to a bank.[36] To defer 100 percent of the gain in this example, the taxpayer should consider "infusing" $200,000 into the exchange from a source other than a bank loan secured by the replacement property. If properly structured, a cash infusion of $200,000 should offset the purchaser's promissory note and fully reduce the boot in this example.[37] Another way to salvage the exchange would be to find a seller of replacement property willing to accept the purchaser's promissory note as part of the sales price.[38] I have seen this happen only twice in my career.

Financing Acquisition of Replacement Property

To defer 100 percent of the realized gain, a taxpayer must apply toward the acquisition of replacement property 100 percent of the net cash proceeds derived from the conveyance of relinquished property.

Question. What if a taxpayer conveys relinquished property for $300,000 cash at closing, but upon his acquisition of a $300,000 replacement property he obtains a $200,000 bank loan and pockets $200,000 of the cash derived from the conveyance of relinquished property?

Answer. This doesn't work. In such an exchange, the taxpayer would have conveyed relinquished property worth $300,000 and executed a $200,000 note to the bank in exchange for replacement property worth $300,000 and cash of $200,000. The $200,000 of cash constitutes boot for purposes of computing gain. Again the question is whether the taxpayer may offset the receipt of boot by executing a note to the bank. The answer is no. Taxpayers may not offset the receipt of boot by executing a note to a bank.[39]

Related Party Issues

Most advisers understand that as a general rule taxpayers may conduct a tax deferred exchange with a "related party" (such as the taxpayer's child or a corporation in which the taxpayer owns a majority of the outstanding stock). In other words, a taxpayer may convey relinquished property to a related party in exchange for the related party's conveyance of replacement property to the taxpayer. The kicker is that for a period of two years following an exchange with a related party, both the taxpayer and the related party must refrain from disposing of their property acquired in the exchange. Why is this? Consider the following example:

> **Example 1.** Father owns "Parcel A" worth $100,000 with an income tax basis of $10,000. Son owns "Parcel B" worth $100,000 with an income tax basis of $90,000. Purchaser desires to purchase Parcel A for $100,000. Father realizes that if he sells Parcel A to Purchaser, he must recognize a $90,000 gain. Thus Father instead conveys Parcel A to Son in exchange for Parcel B. Father then owns Parcel B with a substituted income tax basis of $10,000, and Son owns Parcel A with a substituted income tax basis of $90,000. Son then sells Parcel A to Purchaser for $100,000, and recognizes a $10,000 gain.

The proposed outcome is that by conducting a tax deferred exchange prior to the sale and by shifting Son's high income tax basis to Parcel A prior to the sale, Father and Son, as a family unit, have reduced their gain from $90,000 to $10,000. To avoid this "shifting of basis," the Code imposes a two-year holding period subsequent to an exchange between related parties. Generally, if the taxpayer or the related party disposes of his exchange property within two years after the initial exchange, then the taxpayer's exchange with the related party will become taxable.[40]

Straight exchanges between two related parties are quite uncommon. What is common is a taxpayer's desire to convey relinquished property to an unrelated party and acquire replacement property from a related party through the use of an intermediary. Many taxpayers (and many tax advisors) believe that this type of exchange will qualify for tax deferral under Code Sec. 1031, provided the taxpayer holds the replacement property for two years following the exchange. This is incorrect. Consider the following example:

> **Example 2.** Father owns "Parcel A" worth $100,000 with an income tax basis of $10,000. Son owns "Parcel B" worth $100,000 with an income tax basis of $90,000. Purchaser desires to purchase Parcel A for $100,000. Father realizes that if he sells Parcel A to Purchaser, he would need to recognize a $90,000 gain. Thus, as part of an exchange through the use of an intermediary, Father conveys Parcel A to Purchaser for $100,000 and acquires Parcel B from Son for $100,000.

The result of the second example is identical to the result in the first example. Purchaser ends up owning ParcelA. Father ends up owning Parcel B with a substituted income tax basis of $10,000. Son ends up with $100,000 and recognizes a $10,000 gain. For this reason, as a general rule[41] if a taxpayer (using a qualified intermediary) conveys relinquished property to an unrelated party and acquires replacement property from a related party, the IRS will treat the exchange as an immediately taxable "transaction structured to avoid the purposes of the related party rules"[42] (*i.e.*, an immediate violation of the two-year holding period applicable to related party exchanges). Generally, a taxpayer may (using a qualified intermediary) convey relinquished property to a related party and acquire replacement property from an unrelated party, but a taxpayer generally may not convey relinquished property to an unrelated party and acquire replacement property from a related party.

Pre-Construction Acquisitions and Improvement Exchanges

Many taxpayers desire to sell one condominium unit and exchange into another unit on a "pre-construction" basis. This type of improvement exchange usually presents problems in that the replacement unit may not be completed within the taxpayer's exchange period. Unless the taxpayer receives a deed to a completed unit within the exchange period, the exchange will fail. This generally requires that the developer complete the condominium, obtain a certificate of occupancy and close the conveyance to the taxpayer prior to the end of the taxpayer's exchange period.

In an attempt to alleviate this problem, some developers offer to convey to the taxpayer (within the taxpayer's exchange period) an undivided interest in the overall uncompleted condominium project, such conveyance to be followed by a simultaneous exchange of such undivided interest for the actual unit once a certificate of occupancy is obtained. This presents risks. In this case, I assume that within the 45-day identification period the taxpayer would "identify" the undivided interest in the uncompleted project. However, under the "step transaction doctrine" the IRS could argue that the completed unit, not the undivided interest in the uncompleted project, constitutes the replacement property for the initial exchange. The IRS could then point out that the completed unit was neither identified during the 45-day period nor was it acquired during the 180-day period.[43]

Focusing on a more common type of improvement exchange, assume a taxpayer (using an intermediary) conveys relinquished property for $300,000 and desires to acquire a vacant lot for $75,000 and construct improvements thereon at a cost of $225,000. There are three crucial requirements. First, not only must the lot be identified within the 45-day period, the improvements must be identified as well (generally by attaching the plans to the identification letter).[44] Second, amounts must be spent on the improvements prior to the date on which the taxpayer takes title to the replacement property. This is usually accomplished by "parking" the replacement property with the intermediary[45] (*i.e.*, the intermediary takes title to the replacement property either outright or via a single-member LLC) and having the improvements constructed prior to the date on which the intermediary conveys such property to the taxpayer. Third, regardless of whether the improvements are completed, the intermediary must convey the replacement property to the taxpayer prior to the end of the exchange period.

Question. Under the preceding facts, what happens if the intermediary acquires the vacant lot for $75,000 but only $200,000 has been spent on improvements prior to the date on which the replacement property must be conveyed from the intermediary to the taxpayer?

Answer. In this case, $275,000 has been applied toward the investment property, which is $25,000 less than the amount realized from the conveyance of relinquished property. The taxpayer must therefore recognize $25,000 of realized gain. Assuming the improvements are thereafter completed in a manner which substantially conforms to the identification of such improvements, the balance of the taxpayer's realized gain may be deferred under Code Sec. 1031 even though the improvements were not completed within the 180-day exchange period.[46]

Question. What if the remaining $25,000 is spent at the site soon after the taxpayer takes title?

Answer. Amounts spent at the site subsequent to the date on which the taxpayer takes title will be deemed to have been spent on construction "services" (which are not of like-kind to realty) and will not reduce the amount of gain which must be recognized.[47]

Question. Can the intermediary "prepay" for the improvements prior to conveying the replacement property to the taxpayer?

Answer. No. This will not reduce the recognized gain (and could result in the IRS being quite upset with the taxpayer, his advisor and the intermediary).

Reverse Exchanges

Rev. Proc. 2000-37

In September 2000 the IRS issued Rev. Proc. 2000-37,[48] which sets forth a safe harbor for purposes of structuring what may otherwise constitute an invalid "reverse" exchange under Code Sec. 1031. As contemplated by the revenue procedure, I generally have the taxpayer execute a "Qualified Exchange Accommodation Agreement" with an "Exchange Accommodation Titleholder" ("the titleholder"). The replacement property is then "parked" with the titleholder. The taxpayer subsequently executes a real estate sale agreement with a purchaser, assigns his rights under such agreement (with written notice to the purchaser) to a qualified intermediary pursuant to an Exchange Agreement, and "direct deeds" the relinquished property to the purchaser. Once the relinquished property has been conveyed by the taxpayer (yet no more than 180 days after the replacement property is parked with the titleholder), the taxpayer assigns to the qualified intermediary his rights under the Qualified Exchange Accommodation Agreement (with written notice to the titleholder), then acquires the replacement property via direct deed from the titleholder. Assuming the taxpayer's conveyance of relinquished property and acquisition of replacement property occur simultaneously, the transaction is reflected as a simultaneous exchange on the Form 8824.[49] Alternatively, pursuant to an Exchange Agreement with a qualified intermediary the taxpayer may acquire replacement property from a seller and simultaneously park the relinquished property with the titleholder (who would hold such property for no more than 180 days pursuant to a Qualified Exchange Accommodation Agreement), in which case the transaction would again be reflected as a simultaneous exchange on the Form 8824.

The revenue procedure includes the following requirements which should be expressed in the Qualified Exchange Accommodation Agreement:

1. The taxpayer must have a bona fide intent to acquire the replacement property in an exchange intended to qualify for

nonrecognition of gain under Code Sec. 1031.

2. The titleholder must hold the replacement property (or the relinquished property, as the case may be) for the benefit of the taxpayer in order to facilitate the taxpayer's exchange under Code Sec. 1031 and the revenue procedure.

3. The taxpayer and the titleholder must agree to report the acquisition, holding and disposition of the "parked property" as provided in the revenue procedure. In this regard, the titleholder must be treated for income tax purposes as the beneficial owner of the "parked property" until such property is conveyed to another party.

4. The relinquished property must be identified within 45-days after the acquisition of replacement property.

5. The exchange must be completed within 180 days.

With respect to the third requirement set forth above, *understand that "reverse" exchanges have not been authorized by the IRS.* When replacement property is parked with a titleholder pursuant to the requirements of the revenue procedure, the titleholder is treated as the true owner of such property for income tax purposes rather than as the taxpayer's agent. Given this treatment, the taxpayer has yet to acquire the replacement property. The taxpayer later conveys relinquished property to a purchaser (through the use of a qualified intermediary) and simultaneously or subsequently acquires the replacement property from the titleholder (through the use of a qualified intermediary). On the Form 8824, the transaction is reflected as a simultaneous exchange or a deferred exchange, as the case may be, either of which is specifically authorized by the Code and regulations. If the terms of the revenue procedure are not met, the titleholder would be considered the taxpayer's agent, and the titleholder's acquisition of the replacement property would be treated as an acquisition of replacement property by the taxpayer prior to the taxpayer's conveyance of relinquished property —a "reverse" exchange which in the eyes of the IRS is not allowed under Code Sec. 1031.

Advisors must be cognizant of the required income tax consequences to the titleholder, particularly where income producing replacement property is to be parked with the titleholder. Titleholders generally desire to structure the transaction so that income and deductions "zero out" on their income tax return. For example, in a reverse exchange in which I was recently involved, the following steps were taken pursuant to a Qualified Exchange Accommodation Agreement:

1. The taxpayer borrowed $8,500,000 from a bank, signed a note to the bank and mortgaged its property (including the "relinquished property") as collateral.

2. The taxpayer loaned $8,500,000 to the titleholder. The titleholder executed a note to the taxpayer requiring monthly interest payments with a balloon at the end of the 180-day exchange period.

3. The titleholder formed a single member LLC which acquired replacement property for $8,500,000.[50] The single-member LLC executed a triple net lease of the replacement property to the taxpayer requiring monthly rent equal to the titleholder's monthly interest payments to the taxpayer (the monthly rent was simply set off against the monthly interest).

4. Prior to the end of the 180-day exchange period, the taxpayer conveyed approximately $8,500,000 of relinquished property to various purchasers (via direct deeds coupled with assignments of rights under sales agreements to a qualified intermediary), with all net sales proceeds passing to the bank in exchange for the bank's release of its rights as mortgagee.

5. The taxpayer then acquired from the titleholder its 100-percent membership interest in the single member LLC, the acquisition price being satisfied via the taxpayer's cancellation of the titleholder's obligations to the taxpayer under the $8,500,000 note.

Outside the Revenue Procedure —LTR 200111025

The issuance of Rev. Proc. 2000-37 was certainly a surprise. Even more surprising was the release of LTR 200111025 on March 16, 2001. Making a long story short, an "accommodation party" borrowed funds (the repayment of which was guaranteed by the taxpayer for a fee), acquired replacement property, leased the replacement property to the taxpayer and executed agreements under which the taxpayer would later acquire the replacement property from the accommodation party. The accommodation party and the taxpayer reported the transaction as if the accommodation party was not the taxpayer's agent. The arrangement between the taxpayer and the accommodation party made it appear as if the accommodation party had some risk of loss and potential for gain (although I'm confident there was little, if any, such risk or potential).

As to whether the taxpayer's conveyance of relinquished property and acquisition of replacement property from the accommodation party would constitute a tax deferred exchange under Code Sec. 1031, the IRS presented the following three requirements: (1) the taxpayer must demonstrate its intent to achieve an exchange and the properties to be exchanged must be of like-kind and for a qualified use; (2) the steps in the various transfers must be part of an integrated plan to exchange the relinquished property for the replacement property; and (3) *the party holding the replacement property must not be the taxpayer's agent*. Regarding the agency issue, the IRS applied the "National Carbide factors" and stated as follows:

> With respect to the first factor, Accommodation Party has operated and will operate in its own name and for its own account. The Operating Agreement of Accommodation Party states "[a]ll business of Accommodation Party will be conducted in the Accommodation Party name" and that "Accommodation Party will own and hold title to all of its property in the name of Accommodation Party." Consistent with its operating agreement, Accommodation Party entered into the Property Acquisition Agreement, the Taxpayer Acquisition Agreement, the Lease, the Bank Loan, and the Taxpayer Loan each in its own name and each for its own account. Accommodation Party operates its business through its own bank accounts, which are held in its name and for its account. In none of the operative documents is Accommodation Party referred to as Taxpayer's agent. With respect to the second factor, Taxpayer has not contractually authorized Accommodation Party to bind Taxpayer by Accommodation Party's actions. With respect to the third factor, Accommodation Party does not transmit money it receives for its account to Taxpayer. Under the Lease, Taxpayer is obligated to pay Accommodation Party a monthly base rent for Accommodation Party's account. Applying the fourth factor, Accommodation Party's rental income under the Lease is pursuant to its lessor-lessee relationship with Taxpayer and Accommodation Party's ownership of the Property. Taxpayer's rental income from the subtenants under the subleases is pursuant to Accommodation Party's assignment of such subleases to Taxpayer under the assignments of lessor's interests in leases and assumption of liability under the leases. The fifth factor is that "the agency relationship must not be dependent upon the fact that the principal owns it." Accommodation Party and Taxpayer are separate legal entities. Neither Accommodation Party nor Exchange Company is owned by or related to Taxpayer. Furthermore, as demonstrated by the preceding analysis, Accommodation Party is not acting on behalf of Taxpayer, but rather is acting for its own account. Exchange Company, as the sole member of Accommodation Party, will report Accommodation Party's rental income and expenses on its tax returns. With respect to the sixth factor, Accommodation Party's business purpose is not to carry on the normal duties of an agent. As stated in its operating agreement and as demonstrated by its actions, (1) Accommodation Party is engaged in the business of acquiring, owning, holding, leasing, financing, refinancing and disposing of real property and its associated personal property and (2) Accommodation Party will conduct its business and will hold title to all of its property in its own name and for its own account. Further, the Tax Court has consistently held that the fact that an accommodator is used to facilitate a like-kind exchange does not mean that the accommodator is an agent of the taxpayer ... Thus, the fact that Accommodation Party is facilitating Taxpayer's exchange of the Park for the Property does not mean Accommodation Party is Taxpayer's agent. Accordingly, Accommodation Party is not Taxpayer's agent.

Since relying on a private letter ruling has obvious risks,[51] taxpayers should structure reverse exchanges within Rev. Proc. 2000-37 whenever possible. However, in instances where the relinquished property will not be conveyed within 180 days of the initial transfer to the "accommodator," a transaction based on the facts of LTR 200111025 may be explored.

Bifurcation into Reverse and Deferred Exchange

Earlier this year I ran into an interesting fact situation. The taxpayer owned beach property which he hoped to sell for approximately $800,000. He had contracted to acquire a vacant lot for $150,000 and planned to construct an office building on such lot at a cost of approximately $350,000. Since the net sales proceeds from his beach property were anticipated to exceed the cost of the lot and building by $300,000, the taxpayer desired to preserve his right to exchange the $300,000 balance into other replacement property. The taxpayer decided to structure the acquisition of the $150,000 lot as the first leg of a reverse/improvement exchange. We parked the lot with the titleholder, began construction of the improvements and the taxpayer identified as relinquished property an undivided 5/8th interest in the beach property. This freed up an undivided 3/8th interest in the beach property to constitute relinquished property for a separate deferred exchange. Just prior to the end of the 180-day period, the taxpayer conveyed his beach property for $800,000, the closing agent delivered $500,000 to the taxpayer's qualified intermediary (for simultaneous use in acquiring the improved replacement property from the titleholder pursuant to a Simultaneous Exchange Agreement) and the $300,000 balance was delivered to the qualified intermediary to be escrowed pursuant to a Deferred Exchange Agreement. Within 45 days thereafter the taxpayer identified additional replacement property pursuant to the Deferred Exchange Agreement, and within 180 days thereafter the taxpayer acquired additional replacement property in completion of the $300,000 deferred exchange.

Conclusion

An article such as this cannot cover in detail all issues in connection with tax deferred exchanges. This article simply skimmed the surface with respect to issues which were discussed, and many areas which present risks were not discussed at all.[52]

* With this article, Gil honors his father, Gilbert F. Dukes, Jr., a CPA with Smith, Dukes and Buckalew in Mobile, Alabama.

[1] *See* Reg. §§1.1031(k)-1(g)(4)(i), 1.1031(k)-1(g)(4)(iii) and 1.1031(k)-1(k).

[2] Only "rights" need be assigned. There is no requirement that the intermediary assume obligations under the real estate sale agreement.

[3] *See* Reg. §§1.1031(k)-1(g)(4)(iv) and 1.1031(k)-1(g)(4)(v).

[4] Again, only "rights" need be assigned. There is no requirement that the intermediary assume obligations under the real estate purchase agreement.

[5] *See* Reg. §§1.1031(k)-1(g)(4)(iv) and 1.1031(k)-1(g)(4)(v).

[6] We often see real estate purchase agreements which indicate that the seller intends to conduct an exchange, that the purchaser will cooperate in this regard, that the seller will indemnify the purchaser against any loss or expense associated with seller's exchange, etc. This language is left over from the 1980s when there were no regulations authorizing the use of qualified intermediaries (*i.e.*, when taxpayers needed the purchaser to participate in the taxpayer's exchange). There is nothing in Code Sec. 1031 or the regulations thereunder requiring that the real estate purchase agreement address issues associated with the Code Sec. 1031 exchange, and with the advent of intermediaries, today there is no need for such language. One should be sure that there is nothing in the real estate sale agreement restricting the taxpayer's ability to assign rights to another party, as the taxpayer will need to assign rights under the agreement to the intermediary with written notice to the purchaser.

[7] Reg. §1.1031(k)-1(a). *See also* Reg. §1.1031(k)-1(f).

[8] *See* Reg. §§1.1031(k)-1(g)(4)(i) and 1.1031(k)-1(g)(4)(ii).

[9] *See* Reg. §§1.1031(k)-1(b)(2)(i) and 1.1031(k)-1(b)(2)(iii).

[10] *See* Reg. §§1.1031(k)-1(c)(2)(i) and 1.1031(k)-1(c)(2)(ii).

[11] Reg. §1.1031(k)-1(c)(4)(i). For the 95-percent rule, *see* Reg. §1.1031(k)-1(c)(4)(ii).

[12] *See* Reg. §1.1031(k)-1(c)(4)(ii).

[13] *See* Reg. §1.1031(k)-1(c).

[14] *See* Reg. §1.1031(k)-1(c)(3).

[15] *See* Reg. §§1.1031(k)-1(d)(i) and 1.1031(k)-1(d)(ii).

[16] Example 4 of Reg. §1.1031(k)-1(d)(2) states as follows: "(i) In the agreement, B identifies real property R as replacement property. Real property R consists of two acres of unimproved land and has a fair market value of $250,000. As of October 3, 1991, real property R remains unimproved and has a fair market value of $250,000. On that date, at B's direction, C purchases 1 1/2 acres of real property R for $187,500 and transfers it to B, and B pays $87,500. (ii) The portion of real property R that B received does not differ from the basic nature or character of real property R as a whole. Moreover, the fair market value of the portion of real property R that B received ($187,500) is 75 percent of the fair market value of real property R as of the date of receipt. Accordingly, B is considered to have received substantially the same property as

identified." Compare such result to Example 3 of Reg. §1.1031(k)-1(d)(2), which states as follows: "(i) In the agreement, B identifies real property Q as replacement property. Real property Q consists of a barn on two acres of land and has a fair market value of $250,000 ($187,500 for the barn and underlying land and $87,500 for the remaining land). As of July 26, 1991, real property Q remains unchanged and has a fair market value of $250,000. On that date, at B's direction, C purchases the barn and underlying land for $187,500 and transfers it to B, and B pays $87,500 to C. (ii) The barn and underlying land differ in basic nature or character from real property Q as a whole. B is not considered to have received substantially the same property as identified."

[17] *See* Reg. §§1.1031(k)-1(b)(2)(ii) and 1.1031(k)-1(b)(2)(iii).

[18] *See* Reg. §1.1031(k)-1(j)(2)(iv).

[19] *See* Reg. §1.1031(k)-1(j)(2)(ii).

[20] *See* Code Sec. 1031(a).

[21] *See* Reg. §§1.1031(a)-1(b) and 1.1031(a)-1(c). "The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class."

[22] *See* Reg. §1.1031(a)-2(b).

[23] Rev. Rul. 87-56, 1987-2 CB 27.

[24] *See* Code Sec. 1031(a).

[25] *See* Jeremiah M. Long and Mary Foster, Tax Free Exchanges Under 1031, §2:13 (2000).

[26] Once a property is put on the market for sale, it is being held "for sale" rather than held "for investment."

[27] *See* Tax Free Exchanges Under 1031, *supra* note 25, at §2:16.

[28] Reg. §1.1031(a)-1(a)(1).

[29] The American Bar Association has taken the position that replacement property may be contributed to a partnership without violating the requirement that replacement property be acquired with an intent of holding such property for investment. *See* the American Bar Association's *Joint Report on Section 1031 Open Issues Involving Partnerships*, BNA Tax Management Memorandum, Jan. 29, 2001. For holdings consistent with this position, *see B.B. Maloney*, 93 TC 89, Dec. 45,863 (1989), *J.R. Bolker*, 81 TC 782, Dec. 40,558 (1983), aff'd, CA-9, 85-1 USTC ¶9400, 760 F2d 1039; and *N.J. Magneson*, 81 TC 767, Dec. 40,557 (1983), aff'd, CA-9, 85-1 USTC ¶9205, 753 F2d 1490.

[30] For options other than those presented in this article, including the use of special allocations of gain to those who do not conduct an exchange, *see Joint Report on Section 1031 Open Issues Involving Partnerships, id.*

[31] The American Bar Association has taken the position that where an interest in relinquished property is distributed by a partnership (which has been holding such property for investment) to a partner, the partner should be treated as if he has held such interest for investment and should be allowed to thereafter conduct an exchange with his interest in such property. *See Joint Report on Section 1031 Open Issues Involving Partnerships, id.* For holdings consistent with this position, *see Maloney, Bolker* and *Magneson, supra* note 29.

[32] Note that gain is "deferred," not alleviated. Reg. §1.1031(d)-1 states as follows: "(a) If, in an exchange of property solely of the type described in section 1031 ... no part of the gain or loss was recognized under the law applicable to the year in which the exchange was made, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with property adjustments to the date of the exchange. If additional consideration is given by the taxpayer in the exchange, the basis of the property acquired shall be the same as the property transferred increased by the amount of additional consideration given (see section 1016 and the regulations thereunder). (b) If, in an exchange of properties of the type indicated in section 1031 ... gain to the taxpayer was recognized under the provisions of section 1031(b) or a similar

provision of a prior revenue law, on account of the receipt of money in the transaction, the basis of the property acquired is the basis of the property acquired shall be the same as the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized on the exchange."

[33] *See* Reg. §1.1031(b)-1(a).

[34] If the taxpayer were to reinvest only his equity of $100,000, the debt relief of $200,000 would be considered "money received by the taxpayer" for purposes of recognizing gain. *See* Reg. §1.1031(d)-2. In this regard, Reg. §1.1031(b)-1(a) states as follows: "If the taxpayer receives other property (in addition to property permitted to be received without recognition of gain) or money ... in an exchange described in section 1031(a) of property held for investment or productive use in trade or business for property of like-kind to be held either for productive use or for investment ... the gain, if any, to the taxpayer will be recognized under section 1031(b) in an amount not in excess of the sum of the money and the fair market value of the other property ..."

[35] Although the purchaser's note would constitute boot for purposes of recognizing gain, the gain may be reported over time using the Code Sec. 453 installment sale method of reporting gain. In this regard, Reg. §1.1031(k)-1(j)(2)(vi) sets forth the following example: *Example 4*. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange, B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is a qualified intermediary under paragraph (g)(4) of this section. On September 22, 1994, pursuant to the agreement, B transfers real property X to C who then transfers it to D for $80,000 in cash and D's 10-year installment obligation for $20,000. On that date B has a bona fide intent to enter into a deferred exchange. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property held by C until the earlier of the date the replacement property is delivered to B or the end of the exchange period. D's obligation bears adequate stated interest and is not payable on demand or readily tradable. On March 11, 1995, C acquires replacement property having a fair market value of $80,000 and delivers it, along with the $20,000 installment obligation, to B. (ii) Under section 1031(b), $20,000 of B's gain (i.e., the amount of the installment obligation B receives in the exchange) does not qualify for nonrecognition under section 1031(a). Under paragraphs (j)(2)(ii) and (iii) of this section, B's receipt of D's obligation is treated as the receipt of an obligation of the person acquiring the property for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B's receipt of the obligation is not treated as a payment. Subject to the other requirements of sections 453 and 453A, B may report the $20,000 gain under the installment method on receiving payments from D on the obligation.

[36] "The taxpayer cannot offset the receipt of the buyer's note by the assumption of debt on the replacement property or probably even a note from the taxpayer to the seller of the replacement property because the buyer's note is 'cash or other property' for the purposes of the boot offsetting rules and cannot be offset with mortgage liabilities assumed." *See* Tax Free Exchanges Under 1031, *supra* note 25, at §9:15.

[37] Neither case law nor the regulations under Code Sec. 1031 appear to have addressed the issue of offsetting a purchaser's note with a cash infusion for purposes of computing gain. Rev. Rul. 72-456, 1972-2 CB 468, indicates that cash paid in connection with an exchange offsets all money subsequently received for purposes of computing gain, and Reg. §1.1031(d)-2 indicates that cash paid in connection with an exchange offsets boot received in the form of an assumption of a liability or the transfer of property encumbered by a liability. There appears to be no reason why a cash infusion would offset boot in the form of cash subsequently received and boot in the form of debt relief, but not boot in the form of a purchaser's note received subsequent to the cash infusion.

[38] *See* Tax Free Exchanges Under 1031, *supra* note 25, at §9:15.

[39] "Cash received by the taxpayer does not offset debt incurred by the taxpayer. Therefore, the taxpayer cannot take cash out of the exchange at closing by incurring a liability on the replacement property greater than the liability on the relinquished property." *See* Tax Free Exchanges Under 1031, *supra* note 25, at §4:06.

[40] *See* Code Sec. 1031(f).

[41] In my opinion, the primary exception to this general rule is an acquisition from a related party which would result in a taxable gain recognized by the related party which equals or exceeds the amount of gain the taxpayer would have recognized had the related party acquisition not taken place (*i.e.*, an acquisition from a related party whose income tax basis in his property is less than or equal to the taxpayer's income tax basis in the relinquished property). Of course, if this exception was

applicable, the acquisition would result in the same or more tax being payable overall by the related parties and would therefore not be attractive to the related parties in most cases. *See* Tax Free Exchanges Under 1031, *supra* note 25, at §2:47.

[42] Code Sec. 1031(f)(4); *see also* FSA 199931002 (Apr. 12, 1999) as well as Tax Free Exchanges Under 1031, *supra* note 25, at §2:48.

[43] In Rev. Rul. 84-121, 1984-2 CB 168, a taxpayer acquired property for purposes of exchanging such property (upon exercise of an option) for other property. The IRS ruled that the relinquished property had not been held for investment.

[44] Reg. §1.1031(k)-1(e)(2).

[45] Under Reg. §1.1031(k)-1(g)(4)(i), "the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer."

[46] Reg. §1.1031(k)-1(e)(3)(iii).

[47] Reg. §1.1031(k)-1(e)(4) states as follows: "The transfer of relinquished property is not within the provisions of section 1031(a) if the relinquished property is transferred in exchange for services (including production services). Thus, any additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of a like-kind."

[48] Rev. Proc. 2000-37, IRB 2000-40, 308.

[49] A Form 8824 must be attached to the taxpayer's income tax return for the year in which the conveyance of relinquished property occurs.

[50] "Single-member" LLCs ("nullities" or "disregarded entities" for income tax purposes) are often established by the titleholder for purposes of acquiring the replacement property. Once the relinquished property has been conveyed, the titleholder simply assigns to the taxpayer its membership interest in the LLC. This not only avoids the duplication of deed recordation expense which would otherwise have occurred had the titleholder taken title, but it also keeps the titleholder out of the chain of title and thereby protects the titleholder from any environmental or other liabilities which may otherwise result from ownership in its name.

[51] Code Sec. 6110(k)(3) provides that "a written determination may not be used or cited as precedent."

[52] For a much more detailed discussion of tax deferred exchanges, *see* Tax Free Exchanges Under 1031, *supra* note 25.