DELAYED TAX DEFERRED EXCHANGES UNDER SECTION 1031

By

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GENERAL STATUTORY REQUIREMENTS

1. Both the property surrendered and the property received in an exchange must be held either for productive use in a trade or business, or for investment.
2. The property surrendered and the property received in an exchange must be of "like-kind."
3. The exchange must be a reciprocal transfer of properties as distinguished from a sale and re-purchase.

1. Business/Investment

Section 1031 does not define either the term "productive use in a trade or business," or "for investment." The regulations provide that otherwise unproductive property held by a non-"dealer" for future trade or business use or for future appreciation constitutes property held for investment. (Reg 1.1031-1(b).) The relevant qualified use is the use of each property in the taxpayer's hands. The use of either property in the hands of the other party to the exchange is irrelevant.

Prt Let Rul 8429039 has enunciated a safe harbor stating that two years of business use is sufficient to meet this test.

Post-Exchange Partnership Contribution

Magneson v. Commissioner, 753 F2d 1490

Taxpayer exchanged a fee simple interest for an undivided 10 percent interest in like-kind property which he then contributed under IRC Section 721 to a partnership in exchange for a general partner interest. Despite the fact that the contribution to the partnership was part of a pre-arranged plan, the court found that the interest of a general partner was sufficient to satisfy the holding for investment requirements.

Pre-Exchange Corporate Distribution

Bolker v. Commissioner, 760 F2d 1039

Taxpayer received property under an IRC Section 333 liquidation (eliminated by TRA '86) and exchanged it for other like-kind property. The court found that this also was sufficient to meet the holding requirement.

The law is not yet settled concerning the circumstances under which the transfer of replacement property soon after, or the transfer of the

primary property soon before, an exchange will disqualify the exchange from non-recognition treatment under Section 1031. Magneson and Bolker both involved the Tax Court and the Ninth Circuit. The views of other courts have not yet been expressed. Note that both Magneson and Bolker involve exchanges prior to enactment of Section (A)(2)(D) by TRA '84.

Possible Solutions Regarding Partnership Dissolutions

Frequently, partners desire to separate, each partner desiring to exchange his pro rata interest in the partnership's property for separate new properties to be owned individually by each partner. The partnership might exchange the primary property for replacement properties and then distribute the new properties to the partners. Alternatively, the partnership might distribute tenancy in common interests in the primary property to the partners. The partners would then exchange these tenancy in common interests for various new properties owned by the partners separately. A tenancy in common interest is like-kind and may be exchanged for a fee interest provided the tenancy in common is not treated as a partnership for tax purposes. Rev Rul 73-476. A tenancy in common, however, may constitute a partnership, regardless of intent, if the tenants actively carry on a trade or business, Reg §1.761-1.

2. Like-Kind

General Rule

All property classified as realty under state law is "like-kind".

Refers to the nature or character of property, not to its grade or quality. The fact that the real estate is improved or unimproved is immaterial. The non-recognition rules of Section 1031 concern the dichotomy between realty and personalty rather than real estate which has dissimilar locations, characteristics or profit-producing uses. Reg §1.1031(a)-1(b), (c).

Improved real estate may be exchanged for unimproved real estate, and city real estate may be exchanged for rural real estate. Domestic real estate may be exchanged for real estate in a foreign country (Rev Rul 68-363). Mineral and non-mineral real property interests are like-kind to each other provided the mineral interests are considered real property under applicable state law. A leasehold interest of at least 30-year duration including optional renewal periods is like-kind to be a fee. Reg §1.1031(a)-1(b), (c).

Excluded Property

Section 1031(a)(2) denies non-recognition treatment to the transfer, or receipt of the following categories of property:

- Stock in trade or other property held primarily for sale
- Stocks, Bonds, or Notes
- Other securities or evidences of indebtedness or interest
- Interests in a Partnership
- Certificates of Trust or Beneficial Interest
- Choses in action

3. <u>Property for Property</u>

The essence of an exchange is a reciprocal transfer of property as distinguished from a sale and reinvestment.

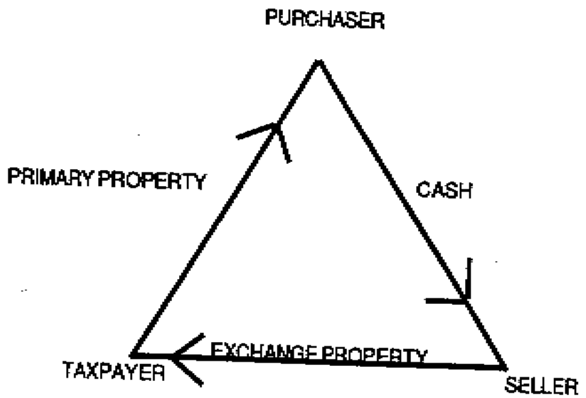
The Service took the position that the reciprocal transfer of property must be simultaneous. Under this view, a transfer of like-kind property in the future would not constitute an exchange. In Starker v. U.S. the Ninth Circuit rejected this position. The Tax Reform Act of 1984 attempted to provide more certainty in the area of delayed exchanges, but, as discussed later, this is not always the case.

The Service will likely use the step transaction doctrine in arguments to disallow treatment under Section 1031.

All the legs of the exchange must constitute an integrated, mutually dependent transaction.

The Tax Court will look to interdependence, intent, timing, and commitment of the parties to the exchange.

THREE CORNER EXCHANGE



The taxpayer must never have the right to receive the cash proceeds of sale of the primary property. The person from whom property is received need not be the same person to whom the primary property was transferred. Rev Rul 57-244; Haden v. Commissioner, 165 F2d 588 (5th Cir 1948).

Case Law Development

(A) Mercantile Trust Company of Baltimore v. Commissioner, Board of Tax Appeals, 1935

Mercantile involved a property owner-exchanger, a buyer of the exchanger's property, and a seller of like-kind replacement property. Interestingly, it also involved a title company that acted as a fourth party

facilitator in the transaction. Because of the tax consequences, Mercantile did not want to sell its property. Instead, they transferred it to the title company which in turn transferred it to the buyer. The title company took the buyer's money and used it to buy the replacement property and having bought it transferred it to Mercantile. All of the legs of this transaction were carried out pursuant to appropriate contracts entered into between the respective parties of each leg. Faced with this unique transaction, the Board of Tax Appeals rejected the Service's argument that the transaction did not give rise to a valid tax deferred exchange because the title company acted as the agent of the buyer and held that the purported exchange did in fact meet the requirements of §112, the precursor of §1031. The court's reasoning was that even if the title company was the agent of the buyer, it would not have mattered because it still would have resulted in an integrated transaction in which the taxpayer received, and was entitled only to receive, like-kind replacement property and not the buyer's purchase price. The only way the Service could have won its argument, said the court, would have been to show that the title company acted as Mercantile's agent in the transaction. If this were the case, there would have been two separate and unrelated transactions: 1) a sale of property by Mercantile to the buyer; and 2) a purchase by Mercantile of the replacement property, and this would not have qualified as a Tax Deferred Exchange. The key then is that all of the legs must constitute an integrated mutually dependent transaction. It is as simple as that and there hasn't been any significant change in the test enunciated in Mercantile in the entire 53 years following that decision.

(B) In Coupe v. Commissioner, 52 TC 394 (1960), acquiesced in 1970-2 Cum Bull XIX, a taxpayer agreed to sell his farm to a buyer for a "set" price. After consulting an attorney, Coupe realized an exchange was possible which would defer taxation. The agreement was amended so that the buyer would purchase suitable farm property for Coupe with the purchase money and exchange that farm property for Coupe's. The resulting transaction had the buyer depositing cash in an escrow payable to the titleholders of Coupe's farm to the buyer for cash and paid off the sellers of the farm which Coupe now owned. Despite amending the contract, the court held in this transaction that Coupe did not sell his lands to the buyer but exchanged them for like-kind property in accordance with Code §1031(a).

(C) In Alderson v. Commissioner, 317 F2d 790 (9th Cir 1963), revg 38 TC 214 (1962), the taxpayers agreed to sell land with the buyer immediately depositing earnest money of approximately ten percent with an escrowee. Subsequently, taxpayers located like-kind property which they desired to obtain in an exchange, rather than selling their land, paying tax and buying the new parcel. Therefore, the escrow agreement was amended providing that in lieu of the original cash deal, the buyer would acquire the land Alderson desired, and would exchange that property for Alderson's. Having done so with the money he otherwise would have used to pay Alderson, the exchange was effected. The court held that the transaction that finally occurred was an exchange and not a sale and purchase.

(D) In Rogers v. Commissioner, 44 TC 126 (1965) 377 F2d 534 (9th Cir 1967) taxpayers entered into an option agreement to sell property. Prior to the exercise of the option, the taxpayer entered into negotiations for the acquisition of similar property from a third party and the transfer to him of the property subject to the option. Taxpayer then deposited in escrow a deed with instructions that it be released to the third party when title to his property was vested in them. The third party"s deposits were made, but prior to that time the optionee had exercised his right to buy and had deposited money with the escrow agent. The court held that no exchange took place, but rather that taxpayers had sold their land to the optionee pursuant to the terms of the option. There could be no exchange here, the court said, because the petitioners received only cash, not property.

(E) Similarly, in Carlton v. United States, 385 F2d 238 (5th Cir 1967), the taxpayer failed to pay attention to details and ruined the exchange. Here, the taxpayer agreed to sell or exchange ranch land to a developer. Taxpayer elected the exchange, found the land he desired, and made the deposit on the parcel personally. He then notified the developer that he would require him to purchase the land and exchange it for his ranch, and the actual agreements of sale were executed by the developer. However, when it came time to close, rather than duplicate title transfer costs, the transaction was structured so that the land which the developer was buying to exchange was conveyed directly to the taxpayer and not to the developer and then to taxpayer. The taxpayer had received cash and the assignment of developer's right to buy that land in exchange for his ranch property. Consequently, the court found that since the developer had never acquired legal title to the property, it could not have exchanged it for taxpayer's ranch land. Therefore, the court found a taxable sale rather than a tax-free exchange.

This problem could have been avoided by the use of Rev Rul 57-244, cited above, so Carlton would have received a deed to land (rather than cash and an assignment) in exchange for a deed to his land.

Despite the holding in Carlton, in Pvt Ltr Rul 8008113, the Service ruled that a three-party exchange constituted a valid like-kind exchange notwithstanding the fact that the property exchanged was deeded directly to the first party by the third rather than to the second party for transfer to the first party. However, in a case where taxpayer's sales proceeds were placed in an escrow and then transferred to another escrow through which he acquired similar real estate, like-kind treatment was denied. Despite the simultaneous closing and the fact that the taxpayer received no cash, the court found that neither transfer could be considered part of an integrated transaction. Allen v. Commissioner, 43 TCM 620 (1982).

(F) A recent multi-party transaction case which should be reviewed for its facts is Biggs v. Commissioner, 632 F2d (1171) (5th Cir 1980), affg 69 TC 905 (1978), where a four-party exchange was sanctioned despite deficiencies in the contracts and the fact that the party to whom the

taxpayer's property was conveyed did not obtain an ownership interest in the exchange property prior to its conveyance.

(G) A significant case was decided by the Tax Court in 1983 in Garcia v. Commissioner, 80 TC 491 (1983), acq 1984-2 Cum Bull I. The Tax Court greatly emphasized the taxpayer's intent in deciding the tax consequences of a complex transaction. The court stated that contractual interdependence of escrow transfers is not a technical requirement for a finding that a multi-party exchange qualified for tax-free treatment. The Garcia standard requires that the taxpayer desired to effect a tax-free exchange, that his actions comported with that desire, and that no cash proceeds from the sale of the original property were received by the taxpayer, either actually or constructively.

(H) In a series of cases decided from 1975 through 1979, and generally referred to as the Starker cases, the 9th Circuit sanctioned the concept of nonsimultaneous exchanges. In Starker v. U.S., 1975-1 USTC, 9443 (D Ore, 1975), taxpayers agreed to exchange timberland with two corporations and the corporations, in turn, agreed to transfer similar properties to taxpayers in the future as those properties were found and proved acceptable to taxpayers. The taxpayers had to agree before each conveyance, however, on the value of the parcel conveyed in exchange. If the agreed value of the property received was not equal within five years to what was conveyed, buyers would have the right, but not the duty, to pay the balance to the Starkers in cash. In addition, the value of what the Starkers conveyed would be increased by six percent per annum to reflect the value of the growing timber. Despite the fact that the Starkers chose eight parcels, all of which were not owned by the corporations at that time, the transaction was held to be a Code §1031 exchange.

(I) Another member of the Starker family had a similar transaction tried in the same court at a slighter later date. In Starker II, 602 F2d 1341 (9th Cir 1979), the same judge held that an exchange of real estate for a promise is not a like-kind exchange and the taxpayer's gain or loss was to be recognized. The court held that the fair market value of the promise was equal to the fair market value of the land conveyed. In a major development regarding this issue, Starker II, was reversed by the Ninth Circuit Court of Appeals. The court directed itself in this case to the question of whether §1031 required a simultaneity of transfers for a qualifying exchange. Its decision was that the contract right to receive additional property in the future, though personal property in nature, should not be treated any differently from the ownership rights themselves. Thus, the promise to deliver like-kind property in the future was held to be qualifying property in a like-kind exchange.

(J) The nonsimultaneity of transfer issue was also addressed in Rutherford v. Commissioner, 37 TCM 1851-77 (1978), wherein the court stated that the fact that property constituting one side of an exchange was not in existence at the time of transfer did not preclude the applicability of §1031(a).

(K) On March 16, 1987, the Tax Court upheld the Service's disallowance of taxpayer's purported tax-deferred exchange in Garbis S.

Bezdjian v. Commissioner, TCM 1987-140, but supported its decision with an opinion filled with incorrect statements of multi-party exchange law. At the outset of its opinion holding in favor of the Service, the Tax Court stated the well-established rule that a sale of property followed by a separate and unrelated purchase of property is not an exchange pursuant to §1031. On the other hand, said the court, if the taxpayer's transfer and receipt of property were interdependent parts of an overall plan the result of which was an exchange of like-kind properties, §1031 applies. The court stated later in its opinion that the transfers involved in the case would not meet the exchange requirement of §1031 "even if the transfers were integrated, interdependent and aimed at a particular result." These two statements are simply irreconcilable under any circumstances and cast serious doubt on the quality of the court's scholarship in the case, although not on the decision itself.

In Nixon v. Commissioner, TCM 1987-318, taxpayers negotiated with a state conservation commission to sell 309 acres for $339,000 which was paid in the form of a check which taxpayers then deposited into a food freezer for safekeeping. The taxpayers later endorsed the check to a third party in exchange for 109 acres and cash of $218,900, which taxpayers deposited into their bank account. In denying §1031, nonrecognition treatment, the court stressed that the taxpayers had unfettered and unrestricted control over the original check and that a cash sale and reinvestment took place. Note: Putting the cash on ice will not avoid constructive receipt.

1984 Tax Reform Act

Sanctions delay between the disposition of taxpayer's primary property and acquisition of replacement property.

Imposes Strict Time Limits

1. 45-day Identification Period IRC §1031(a)(3)(A).

A limited number of properties must be designated as the property to be received in the exchange within 45 days from the date taxpayer surrenders control of the primary property.

The requirement in §1031(a)(3)(A) that the exchange property be identified within 45 days after the date on which taxpayer transfers the property relinquished in the exchange is an arbitrary cut-off date which presumably must be strictly complied with. The Conference Report states that "the designation requirement may be met by designating the property to be received in the contract between the parties." Multiple designations are permitted only if stated as alternatives "determined by contingencies beyond the control of both parties."

2. 180-day Completion Period IRC §1031(a)(3)(B).

Replacement property must actually be received within 180 days of the date taxpayer surrenders control of the primary property or the date (including extension) his tax return is due for the year in which the primary property was surrendered, whichever comes first. Thus, for exchanges beginning on or after October 17 (assuming a calendar basis), the

taxpayer filing date of the income tax return due April 15 of the following year will have to be extended in order to avoid shortening the 180-day period allowed for completing the exchange.

Cash and Liabilities as Boot

General Rule: Even or up in equity and even or up in value results in a fully tax deferred exchange.

If an exchange would be within the provisions of §1031(a) but for the fact that the property received consists of qualifying property and other property or money, the gain, if any, to the recipient is recognized to the extent of the sum of money and the fair market value of "other property" received. This "money or other property" is commonly called "boot" and includes liabilities assumed or attaching to property received in an exchange. "Other property" is either property specifically excluded (stock in trade, notes, choses in action, partnership interests, etc.) or property which is not of like-kind with property surrendered in the exchange.

Consideration given in the form of cash or other property is netted against consideration received in the form of an assumption of a liability or a transfer of property subject to a liability. Consideration received in the form of cash or other property is not, however, netted against consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability.

Boot: Netting Rules

1. Cash paid on the acquisition of replacement property offsets cash received on the disposition of primary property.
2. Cash paid on the acquisition of replacement property offsets debt relief on the disposition of primary property.
3. Debt assumed on the acquisition of replacement property offsets debt relief on the disposition of primary property.
4. Debt assumed on the acquisition of replacement property will not offset cash received on the disposition of primary property.

Cash Boot

PRIMARY PROPERTY	
Market value	$60,000
Adjusted Cost Basis	30,000
EXCHANGE PROPERTY	
Market value	50,000
Cash	10,000

Taxpayer has realized gain of $30,000 on the dispositon of primary property but is required to recognize gain of only $10,000, cash received in the exchange.

Liabilities as Boot

PRIMARY PROPERTY

Market value	$90,000
Debt	30,000
Equity	60,000
Adjusted Cost Basis	40,000

EXCHANGE PROPERTY

Market value	66,000
Debt	6,000
Equity	60,000

Taxpayer has realized gain of $50,000 on the disposition of primary property but is required to recognize gain of only $24,000 net debt relief.

Basis

The basis of property received in an exchange is equal to the adjusted basis of property surrendered plus the net increase or minus the net decrease in debt, minus the net cash received or plus the net cash paid, plus the amount of gain recognized in the exchange. This is known as "substitute basis."

Basis Computation

PRIMARY PROPERTY

Market value	$75,000
Adjusted Cost Basis	50,000

EXCHANGE PROPERTY

Market value		175,000
Less: Cost Basis	50,000	
Cash Paid	100,000	150,000
Gain Realized		25,000
Gain Recognized		-0-
Basis of Primary Property		50,000
Plus: Cash Paid		100,000
Plus: Gain Recognized		-0-
Substitute Basis		150,000

Basis Computation with Mortgages

PRIMARY PROPERTY

Market value	$500,000
Debt	200,000
Adjusted Cost Basis	100,000

EXCHANGE PROPERTY

Market value	500,000
Debt	300,000
Gain Recognized (cash received)	100,000

Substitute Basis Computation

Adjusted Cost Basis of Primary Property	100,000
Plus: Net Increase in Debt	100,000
Less: Net Cash Received	(100,000)
Plus: Gain Recognized	100,000
Substitute Basis in Exchange Property	200,000

Basis Computation with Mortgages

PRIMARY PROPERTY

Market value	500,000
Debt	250,000
Adjusted Cost Basis	100,000

EXCHANGE PROPERTY

Market value	500,000
Debt	200,000
Gain Recognized	-0-

Substitute Basis Computation

Adjusted Cost Basis of Primary Property	100,000
Less: Net Decrease in Debt	(50,000)
Plus: Net Cash Paid	50,000
Plus: Gain Recognized	-0-
Substitute Basis in Exchange Property	100,000

Investment Income and Constructive Receipt

IRC Regulations Section 1.451-2

Funds must be subject to "substantial restrictions" and not "within taxpayer's immediate control and dispostion."

Revenue Ruling 79-91

A "real and definite restriction must be placed on the seller," or a "specific economic benefit" conferred upon the purchaser.

Economic Benefit Test

Reed 723 F2d 138 (1983)

1. The arrangement is part of a bona fide arm's length agreement between the purchaser and the exchanger calling for deferred payment;

2. The exchanger receives no present beneficial interest or investment income from the purchase funds; and,

3. The intermediary is not acting under the exclusive authority of the taxpayer.

The Service's position will be that if the exchange account is not subject to these requirements, the taxpayer will be in constructive receipt of the purchase funds.

Constructive Receipt and Agency Issues

In planning a delayed exchange, the principal non-tax goal is to ensure the taxpayer is adequately secured between the time he surrenders the original property and the time he receives the exchange property. The principal tax goal is to ensure that the taxpayer does not receive cash or its equivalent in the interim.

Since agency is a contractual relationship in which one party agrees to have another act on his behalf, in our opinion, the least desirable alternative is that the purchaser's obligation be secured by cash in an escrow account. This would suggest that the purchaser was merely acting as the exchanger's agent and that the exchanger effectively received the cash proceeds of the sale. If the cash is retained in escrow at the exchanger's direction constructive receipt almost certainly has occurred. What the courts have long acknowledged is that in all exchanges where the intended purchaser had a right to purchase the property, the central issue is whether the taxpayer did in fact exchange his property in an integrated exchange or whether the taxpayer sold the property to a purchaser and then in a separate, independent transaction purchased like-kind property from a third party seller who was not involved in the original transaction. If the facts establish the existence of an integrated transaction, the tax deferred exchange will be upheld by the court. If there is no integration, however, there is no tax deferred exchange regardless of whether the taxpayer did in fact trade his property for other like-kind property. All that is required to establish the existence of an integrated transaction is proof that there was never a moment from the time the taxpayer entered into the contract conveying his property to the purchaser, until the time that he received like-kind property in exchange, when he had the unrestricted use of or right to acquire the use of the consideration paid for the acquisition of his property.

Chicago Title and Trust Company has prepared suggested language for a trust in satisfying the requirements of §1031(a)(3). The Trust Agreement provides that net proceeds of the closing escrow shall be

deposited by purchaser with the trustee representing the portion of the deferred purchase price payable to the exchanger from the transfer of his property. Then on behalf of the purchaser, the trustee invests the purchaser's funds which constitute the trust estate. If the purchaser and exchanger identify one or more properties by written notice to the trustee within 45 days from the date of the original transfer, the trustee will use its best efforts to purchase and convey to the exchanger each property so identified within 180 days from the date of the original transfer. The exchanger agrees to deliver to the trustee any additional funds required to complete the purchase of each exchange property.

It is our belief and interpretation of the constructive receipt doctrine that interest on purchaser's funds deposited into the trust should inure to the benefit of the purchaser. To compensate the exchanger for lost interest income, the exchanger and purchaser could agree in the real estate contract to pay interest to the exchanger to the extent of income earned on purchaser's deposit in the trust. Alternatively, the parties could estimate the net benefit to purchaser of income earned on the purchaser's deposit and increase the purchase price by that amount.

"Lost Interest" Income Alternatives

1. The taxpayer and the purchaser of the primary property could estimate the net benefit to the purchaser of income earned on purchaser's deposit and increases in the purchase price by that amount. Note: This may subject the exchange to risk of disallowance under §1031.

EXAMPLE

Sale price	100,000
Mortgage payoff	30,000
Seller's charges	10,000
Net proceeds	60,000
Interest rate	7%
Days to close	120/360
Investment income	1400
Exchange fee	(300)
Net income to purchaser	1100
Purchaser's average tax rate	(30%)
Net benefit to purchaser	770
Adjusted sale price	100,770

2. The taxpayer and purchaser could agree in the real estate contract to make a deferred payment to the taxpayer in a fixed amount to be limited by actual investment income earned on purchaser's deposit to the exchange account. Note: This will subject the exchanger to additional risk of disallowance under §1031.

EXAMPLE

"The Purchaser hereunder agrees to pay to the Exchanger in consideration of Exchanger's transfer of the subject premises an amount equal to 8 percent per annum on Purchaser's Funds as described in the Exchange Trust Agreement, provided however, said amount shall not exceed and shall be limited to the amount of interest earned on the investment of said funds by trustee. Any payment made under this provision shall be accumulated and added to corpus of said trust."

Other Alternatives

3. Use investment income to induce the purchaser to cooperate in the exchange.

4. Use investment income to compensate exchange trustee.

"Reverse" Starker Exchanges

Lee v. Commissioner, Tax Court Memo 1986-294

Taxpayer acquired property in Hawaii, giving cash and a note to the seller. Later, taxpayer sold property in California and directed that the sales proceeds be transferred to the note holder in Hawaii. Taxpayers purported §1031 exchange was disallowed.

The concern of the court was over lack of interdependence between taxpayer's acquisition of replacement property and later disposition of primary property, not that it would have amounted to new precedent.

Alternatives to Reverse Starker

1. Purchase an option on the replacement property, transfer the option to the purchaser of primary property and have him exercise option when taxpayer is ready to close on primary property. Then structure a simultaneous exchange.

2. Find an extremely trustworthy intermediary to purchase the targeted replacement property and hold it pending the disposition of taxpayer's primary property. Then structure a simultaneous exchange.

The taxable event in this fact situation both arises and is completed when taxpayer relinquishes control of his property.

Stretching the 180 Day Rule

1. IRC Regulation Section 1.1031(a)–1(c)(2) allows the exchange of a fee for a leasehold of 30 years or more.

2. In Starker v. Commissioner, 602 F2d 1341 (1979), a fee interest exchanged for an equitable interest in Articles of Agreement received favorable treatment.

3. Delivery of a deed presently transferring replacement property subject to a defeasance clause should constitute a present transfer subject to a condition subsequent.

Miscellaneous Considerations

Holding Period

The general rule is that with a tax-free exchange of property, the holding period of the new asset has tacked to it the holding period of the old asset. Code §1223(1). Thus, if a capital asset held for five months is exchanged for another capital asset in a Code §1031 transaction, the asset acquired starts off with five months towards the long-term capital gain holding period requirement if it is reinstated.

Depreciable Real Property—Depreciation Recapture

Where depreciable real property is sold or exchanged by its owner at a gain, there may be ordinary income recognized. Pursuant to Code §1250, that amount depends on the holding period, type of real property and whether accelerated depreciation has been used. However, certain limitations regarding Code §1031 transactions are contained in Code §1250(d)(4)(A). Ordinarily, if no gain is recognized under Code §1031, then no depreciation recapture (ordinary income) will be recognized. However, gain will be recognized if the §1250 gain which, but for §1031, would have been recognized exceeds the fair market value of §1250 property acquired in the transaction. Code §1250(d)(4)(A) and §1250(d)(4)(C). Thus, no Code §1250 gain will be recognized if the fair market value of §1250 property acquired in the exchange is equal to, or greater than, the §1250 gain.

If gain is recognized under Code §1031, then §1250(d)(4)(A) and §1250(d)(4)(C) require that §1250 gain be computed as the greater of the boot received or the excess of §1250 gain over the fair market value of §1250 property acquired.

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