LIKE-KIND EXCHANGES OF REAL ESTATE

(DEFERRED, REVERSE AND BUILD-TO-SUIT)

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NOTICE

This outline is not a substitute for legal, financial and/or tax counsel, and was not intended or written by the author to be used, and it may not be used by any taxpayer, for the purpose of avoiding tax and/or penalties that may be imposed by any governmental taxing authority or agency under the Internal Revenue Code of 1986, as amended.

DEFERRED LIKE-KIND EXCHANGES OF REAL ESTATE

EXCHANGES OF REAL PROPERTY:

This Outline provides a broad overview of the procedures for the "like-kind exchange" of real property, and discusses some of the tax and planning considerations for using Section 1031 of the Internal Revenue Code. This Outline should not be relied upon as a substitute for legal, financial and/or tax counsel.

IRC § 1031 provides as follows (underlines added):

> *"No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like-kind which is to be held either for productive use in a trade or business or for investment". IRC § 1031(a)(1).*

Based on the language of Section 1031, there are 4 essential elements to completing a valid like-kind exchange:

1. **Held For**: The "held for" requirement.
2. **Use**: Must be productive use . . . or for investment.
3. **Transfer**: An actual exchange/conveyance must occur.
4. **Like-Kind**: The exchanged properties must be like-kind.

Like-kind exchanges under Section 1031 are often referred to as "*tax-free exchanges*." This is a misleading description. Section 1031 provides an exception only from current recognition of realized gain. Recognition of the gain is deferred until the property acquired in the exchange is disposed of in a subsequent taxable transaction, or until another triggering event occurs. Thus, the gain is merely deferred, not tax-free.

Before offering advice to a client, always begin by answering two simple questions:

1. How much gain will the taxpayer recognize without completing a like-kind exchange of real estate?

2. Can the taxpayer utilize provisions of the tax Code other than Section 1031? (e.g., Section 1033, Section 121 (formerly Section 1034), gifts, charitable contributions, charitable remainder trusts, etc.)

Section 1031 applies to "**investment**" real estate only. Under certain circumstances, a taxpayer may convert a personal residence to investment real estate, then exchange. Typically, real property held by a "**dealer**" is <u>not</u> eligible for like-kind exchange treatment (i.e. a developer that is holding lots for sale to the public).

The taxpayer's basis in the "**Relinquished Property**" is carried over to the "**Replacement Property**". There is no recognition of gain (unless the taxpayer receives boot). For depreciation purposes, there will be no step-up in the basis of the Replacement Property (except to the extent that the purchase price of the Replacement Property exceeds the adjusted sales price of the Relinquished Property).

No gain or loss is recognized at the time of the exchange, except to the extent any "**boot**" is received by either party to the exchange. Boot is money or any property which is not like-kind property. If boot is received, gain is recognized to the extent of the boot received. The character of the gain is determined by the holding period of the exchanged property. (E.g., <u>**unfunded security deposits, prorated rental income, or the assumption of liabilities, may constitute boot**</u>.)

If the Relinquished Property is owned by an entity (e.g., corporation, partnership, or limited liability company) at the time of the exchange, other than a disregarded entity for tax purposes, then the entity (and not its shareholders, partners or members) must acquire the Replacement Property. If the entity undergoes a merger or other tax free reorganization during the exchange period, however, the successor entity may acquire Replacement Property because there is a carryover of Section 1031 attributes following a reorganization. Changes in the underlying ownership of the entity (i.e., transfer of stock, membership interests, etc.) during the exchange period should not affect the exchange because it remains a separate entity for tax purposes.

<u>EXCHANGE METHODS</u>:

1. Simultaneous Exchanges. (two-party and multi-party)

2. Deferred Exchanges. (requires a Qualified Intermediary or "QI")

3. Reverse Exchanges. (requires an Exchange Accommodation Titleholder or "EAT")

4. Build-To-Suit Exchanges. (a combination of a deferred exchange and a reverse exchange; requires an Exchange Accommodation Titleholder or "EAT")

DEFERRED EXCHANGE REQUIREMENTS:

The IRS Regulations to Section 1031 (adopted in 1991) specify the requirements necessary to accomplish a deferred like-kind exchange of real estate:

1. Must designate a Qualified Intermediary ("**QI**"). (Not necessary if the exchange is a simultaneous exchange of real estate.)

2. Written agreement must be entered into between the taxpayer and QI (the "**Exchange Agreement**").

3. There can be no actual or constructive receipt of sale proceeds. The taxpayer cannot have a right to receive, pledge, borrow, or obtain the benefits of the exchange proceeds, except in very limited situations.

4. Must be an exchange and transfer of qualified real property "held for productive use in a trade or business or for investment."

5. Fair market value (not equity) of qualified Replacement Property must equal or exceed the fair market value (not equity) of the Relinquished Property in order to avoid boot and recognition of gain.

6. Written assignment of real estate contracts to QI.

7. Written notice of real estate contract assignments.

8. 45 days to identify, in writing, a limited number (or amount) of Replacement Property (the "**identification period**").

9. 180 days to acquire the Replacement Property (or the date that the taxpayer's income tax return is due, including extensions, whichever is earlier) (the "**exchange period**"). This later rule most often affects end-of-year exchanges, i.e., when the closing occurs between October 18 and December 31, because there are less than 180 days before April 15, the filing deadline for most taxpayers (some taxpayers may have an earlier filing deadline). The tax filing deadline (and replacement period) can be extended to achieve the maximum 180 days, but the taxpayer must file for an extension. May also be extended by declaration of a Presidential disaster (e.g., Greensburg, Kansas tornado, hurricane Katrina, etc.).

10. Time-lines to identify and acquire the Replacement Property run concurrently, not consecutively. Clock begins to run when Relinquished Property is transferred.

11. The Closing Statement should identify (i.e., name) QI as a principal to the transaction (e.g., "Seller: Exchange Corporation as Qualified Intermediary on behalf of Mr. and Mrs. Taxpayer").

PAPER TRAIL FOR DEFERRED EXCHANGES:

Paper trail (typical written documentation necessary for a deferred exchange):

1. Exchange Agreement;
2. Real Estate Contract to sell Relinquished Property;
3. Assignment (of Relinquished Property);
4. Notice of Assignment (of Relinquished Property);
5. Deed to convey Relinquished Property;
6. HUD-1 Settlement Statement on sale of Relinquished Property;
7. IRS Form 1099 on sale of Relinquished Property;
8. Identification of Replacement Property;
9. Real Estate Contract to purchase Replacement Property;
10. Assignment (of Replacement Property);
11. Notice of Assignment (of Replacement Property);
12. Deed to receive Replacement Property;
13. HUD-1 Settlement Statement on purchase of Replacement Property;
14. IRS Form 1099 on purchase of Replacement Property; and
15. IRS Form 8824 (Like-Kind Exchanges) to report the exchange.

QUALIFIED INTERMEDIARY:

1. Cannot be the taxpayer or a "**disqualified person**" (i.e., the taxpayer's employee, attorney, accountant, investment banker, investment broker, real estate agent or real estate broker within the last 2-year period, but excludes routine financial, title insurance, escrow or trust services for the taxpayer by a financial institution, title insurance company or escrow company).

2. Local exchange companies.

3. National exchange companies.

4. Friends, acquaintances, etc.

5. Due diligence in selecting a QI:

   a) Is the QI bonded?

   b) Will the QI grant a security interest to taxpayer in the exchange proceeds, and what is the nature of the security interest (e.g., UCC, trust account, qualified escrow account, stand-by letter of credit, etc.)?

   c) Who will the QI use as the qualified escrow agent?

   d) Will the qualified escrow agent (or its parent company) give the taxpayer a personal guarantee?

   e) Will the QI take title to the property (e.g., construction, reverse exchange)?

   f) What fee will the QI charge?

   g) Will the QI prepare all of the necessary documents?

   h) Will the QI invest the exchange proceeds in a separate account, or comingle the funds?

   i) Will the QI invest the exchange proceeds in an interest-bearing account?

   j) Will taxpayer receive the interest earned on the exchange proceeds?

MECHANICS OF A DEFERRED EXCHANGE:

In a deferred exchange, the Relinquished Property is transferred to a buyer, but closing on the Replacement Property will not occur simultaneously. Maybe the taxpayer has yet to identify the Replacement Property. Maybe the Replacement Property has been identified, but closing on the Replacement Property cannot take place at the same time for some reason. Each deferred like-exchange of real property follows similar steps for the completion of the exchange, generally as follows:

Step 1. The Taxpayer enters into a real estate sales contract for the sale of the relinquished property.

Step 2. The Taxpayer enters into an Exchange Agreement with the Qualified Intermediary.

Step 3. The Taxpayer assigns the real estate sales contract for the relinquished property to the Qualified Intermediary.

Step 4. The net sale proceeds from the closing on the sale of the relinquished property are paid to the Qualified Intermediary at closing to be deposited and/or invested in a short-term account on behalf of the Taxpayer.

Step 5. The Taxpayer conveys title directly to the buyer of the relinquished property.

Step 6. The Taxpayer identifies the replacement property within 45 days from the transfer date of the relinquished property and notifies the Qualified Intermediary.

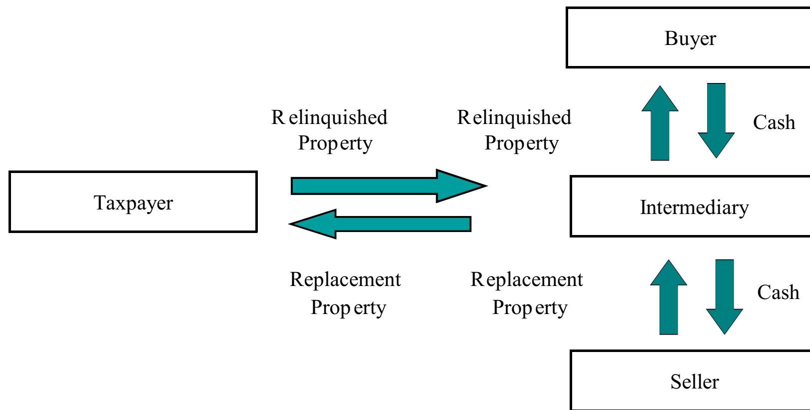
Step 7. The Taxpayer enters into a real estate purchase contract with the seller of the replacement property to acquire the replacement property.

Step 8. The Taxpayer assigns the real estate purchase contract for the replacement property to the Qualified Intermediary.

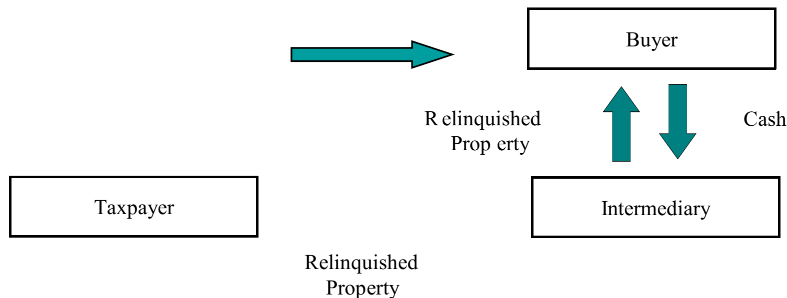
Step 9. The closing on the purchase of the replacement property must occur by the earlier of (i) 180 days following the transfer date of the relinquished property, or (ii) the due date of the Taxpayer's tax return for the year in which the transfer of the relinquished property occurred.

Step 10. The seller of the replacement property conveys the title directly to the Taxpayer.

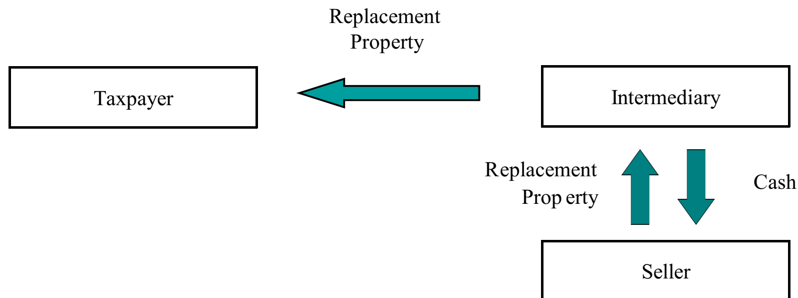
Step 11. The Qualified Intermediary transfers the proceeds of the relinquished property to the seller of the replacement property, and any remaining proceeds are transferred to the Taxpayer.



The first step of the exchange is for the taxpayer to convey the Relinquished Property to the QI, who then conveys the Relinquished Property to the buyer. In exchange, the buyer pays the sale proceeds to the QI. For purposes of this step of the exchange, the QI is treated as the seller, and should be identified as such on the HUD-1 settlement statement.



When the Relinquished Property transaction closes, two concurrent time periods are triggered. First is the 45-day identification period. Second is the 180-day exchange period (or the date that the taxpayer's income tax return is due, whichever is earlier). Within 45 days of the transfer of the Relinquished Property to the buyer, the taxpayer must identify, in writing, the Replacement Property. Within the exchange period, the QI acquires the Replacement Property using the proceeds from the first transaction. For purposes of this second step of the exchange, the QI is treated as the buyer, and should be identified as such on the HUD-1 settlement statement. The QI will then transfer the Replacement Property to the taxpayer.



The 1031 Regulations provide for "direct-deeding" of the Relinquished Property and the Replacement Property. In most deferred exchanges, there is no reason to deed either the Relinquished Property or the Replacement Property to the QI. Unusual circumstances, such as reverse-starker exchanges or the construction of Replacement Property, may necessitate deeding the Relinquished Property, the Replacement Property, or both to the QI.

WHAT CONSTITUTES "LIKE-KIND":

Non-recognition of gain or loss does **not** apply to any of the following.

1. Personal Property;

2. Intangible Property;

3. Real property held primarily for sale;

4. **Inventory** (e.g., developed lots or houses primarily held for sale);

5. **Personal residences**; or

6. **Property to be resold immediately after purchase** (e.g., fixer-upper).

Under the Tax Cuts and Jobs Act signed into law on December 22, 2017, exchanges of personal property and intangible property do not qualify under IRC § 1031 for like-kind exchange treatment for exchanges completed after Dec. 31, 2017. For example, assets that do not qualify for non-recognition of gain or loss as like-kind exchanges include machinery, equipment, farm machinery, vehicles, aircraft, railcars, boats, livestock, patents, franchise licenses, artwork, collectibles, and intangible business assets. Transition rules permit a personal property exchange to be completed in the year 2018 if either the (i) relinquished property was sold, or (ii) replacement property was acquired, by

the taxpayer before December 31, 2017. If the first step in either a forward deferred exchange or a reverse exchange occurred before Jan. 1, 2018, an exchange of certain personal property may qualify under IRC § 1031 for like-kind exchange treatment if all of the remaining requirements for an exchange are satisfied.

The category of real estate that can be exchanged under Section 1031 as like-kind is extremely broad. Whether property is "real" or "personal" is generally determined by state law, although exceptions do exist. For example, a lease of real property of 30 years or more is deemed real property for the purposes of Section 1031, regardless of state law. Also, IRS Chief Counsel is of the opinion that federal law, rather than state law, controls the final determination of whether exchanged properties are in fact like-kind under Section 1031, stating that while state law is relevant, all the facts and circumstances should be considered to determine whether properties are of the same nature and character and, therefore, of like kind (CCA 2012238027, TRC Sales: 30,108).

Differences in like-kind properties are characterized as relating to their grade or quality. Personal property is never considered like-kind to real property. As used in IRC § 1031(a), the phrase "like-kind real property" refers to the nature or character of the property and not to its grade or quality. The fact that real estate is improved or unimproved is immaterial, and relates only to the grade or quality of the property and not to its kind or class.

The taxpayer's purpose for holding the Relinquished Property and the Replacement Property is determined when the exchange takes place. Whether property is held for a proper purpose is a question of fact. The taxpayer has the burden of proof on this issue.

Examples of real property exchanges held to be like-kind are:

1. Improved real property for unimproved real property.

2. City real estate for a ranch or farm.

3. Commercial buildings for vacant lots.

4. A single property for multiple properties.

5. A tenancy-in-common interest for a fee interest.

6. An easement for a fee interest.

7. Perpetual water rights for a fee interest (where water rights are real property under state law).

8. Undivided fractional interest for an entire interest.

9. 30-year (or longer) leasehold, including renewal options, is considered to be like-kind to a fee interest.

10. Mineral rights may be considered to be real property under state law.

11. A scenic conservation easement for a fee interest in timberland, farm land or ranch land.

12. A remainder interest in one property for a life estate in another property (where the life tenant has a life expectancy of at least 30 years).

13. A perpetual agricultural conservation easement for a fee interest.

14. A condominium unit for a fee.

15. Outdoor advertising for other real property (where outdoor advertising qualifies for real property treatment under IRC 1033(g)(3)).

When structuring an exchange of farmland, the taxpayer may be entitled to treat unharvested crops as part of the exchange (rather than having the crops considered inventory and taxable as ordinary income). Unharvested crops must be considered real property for state law purposes to be like-kind to other real property. Trees and shrubs in a nursery may be considered unharvested crops and real property and, therefore, like-kind to other real property. IRC §1231(b) provides special rules for the determination of capital gains and losses from the sale or exchange of property used in a trade or business, and provides, in part, as follows:

> *"(4) UNHARVESTED CROP.- In the case of an unharvested crop on land used in the trade or business and held for more than 1 year, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as 'property used in the trade or business."*

<u>REPLACEMENT PROPERTY</u>:

Replacement Property must be of like-kind to the Relinquished Property, and must be located within the United States (IRC 1031(h)(1)). In a geographical sense, the term "United States" refers to the 50 states and the District of Columbia (IRC 7701). This means that real property located in the U.S. Virgin Islands, Guam and Puerto Rico is regarded as being located outside the United States for purposes of IRC Section 1031.

However, in the case of the Virgin Islands, the IRS ruled in PLR 9038030 that Virgin Islands property is not foreign property for this purpose. This was later reaffirmed and clarified in PLR 200040017, where the IRS, relying on IRC Section 932, explained that with respect to an individual who is a citizen or resident of the United States, the term "United States" shall be treated as including the Virgin Islands but only if the taxpayer received income (presumably gross income) from the Virgin Islands property during the year.

The 1031 Regulations restrict the number of replacement properties that a taxpayer may identify, as follows:

1. **Three Property Rule**: Up to 3 properties, without regard to valuation.

2. **200% Rule**: Unlimited number of properties, provided the aggregate fair market value does not exceed 200% of the value of the Relinquished Property.

3. **95% Rule**: Any number of Replacement Properties, provided the FMV of the properties actually received is at least 95% of the aggregate FMV of all the potential Replacement Properties identified.

Identification must be in writing, and should include the legal description, although an address or other general description may suffice. Property actually acquired by the taxpayer before the end of the identification period will be treated as identified. If all of the replacement property to be acquired is received by the taxpayer before the end of the identification period, then the exchange transaction is complete, and the taxpayer does not need to count such property actually acquired before end of 45 day period (in effect the taxpayer will have satisfied the 95% rule). If, however, a portion of the replacement property is acquired before the end of the identification period, and additional replacement property is to be acquired after the expiration of the identification period, then the taxpayer must still comply with the above-described limitations on the identification of replacement property (and the replacement property acquired before the expiration of the identification period must be counted towards the 3-property rule and the 200% rule).

What constitutes a "single" property? May contiguous lots or tracts of land be identified as a single Replacement Property? What if the lots or tracts of land are not contiguous? What if the taxpayer identifies multiple parcels of land as a single Replacement Property, but only acquires some, but not all of the parcels so identified?

The taxpayer may identify and construct improvements on land not owned by the taxpayer, then the improved property may be conveyed to the taxpayer within the exchange period as Replacement Property. Where improvements are to be constructed,

real property is properly identified if a legal description is provided for the underlying land and as much detail is provided regarding the construction of the improvement as is practical at the time the identification is made. Ideally, the taxpayer should attach or reference copies of building plans and specifications, if possible. For purposes of the 200 percent rule and the incidental property rule, the fair market value of Replacement Property that is to be constructed is its estimated fair market value as of the date it is expected to be received by the taxpayer.

Variations due to usual or typical production changes are not taken into account. However, if substantial changes are made in the property to be constructed, the property received will not be considered to be substantially the same property as identified. Construction of real property does not need to be complete to qualify as Replacement Property, however, the exchange value includes only the construction occurring prior to the receipt of the Replacement Property by the taxpayer. Any additional construction occurring after the property is conveyed to the taxpayer will not be treated as the receipt of like-kind property. Construction occurring after receipt by the taxpayer is considered the receipt of personal services. Construction materials and other fixtures which have not been installed before the end of the exchange period will not be deemed real property under local law, and their value will be treated as boot. Similarly, the labor involved in affixing these items after the taxpayer receives the real property will be considered taxable boot to the taxpayer.

Substantially the Same Property: When it comes to undivided fractional interests, or if improvements are to be constructed, the Replacement Property received before the end of the exchange period by the taxpayer must be **substantially the same** property as that identified by the taxpayer. This requirement is applied separately to each Replacement Property received by the taxpayer. The taxpayer should err on the side of caution, and describe any improvements to be made to the identified property to avoid having the IRS assert that the improvements alter the "nature and character of real property" and thus void the identification. Minor improvements such as the erection of a fence or a new roof should not change the nature or character of the Replacement Property. **The example in the Reg's says that acquisition of 75% of the identified property is the functional equivalent of acquiring the identified property**.

Revocation of Identification: An identification of Replacement Property may be revoked at any time before the end of the identification period. Such revocation must be made in a written document, signed by the taxpayer, and delivered, mailed, faxed or otherwise sent before the end of the identification period to the person to whom the identification of the Replacement Property was sent.

Section 1250 Recapture: If IRC1250 property is exchange under Section 1031, depreciation is only recaptured as ordinary income to the extent of the greater of (i) the

taxable boot recognized under Section 1031, or (ii) the excess of the amount of additional depreciation over the fair market value of the IRC 1250 property acquired in the exchange. Therefore, if no boot is received in the exchange and the value of the IRC 1250 property received in the exchange equals or exceeds the amount of the additional depreciation, then no depreciation will be recaptured in the exchange.

Tenancy-In-Common: Direct ownership as a tenant-in-common is permitted. In March 2002, the IRS issued Rev. Proc. 2002-22, which sets forth guidelines regarding the conditions under which the IRS will consider co-ownership arrangements.

COMBINED SALES:

Occasionally, the sale of real estate (especially improved, rural property) will constitute the combined sale of both personal residence and investment property. The taxpayer may choose to "bifurcate" (or divide) the sale of a personal residence on a large acreage into two separate transactions: (i) the sale of a personal residence and surrounding acreage, and (ii) an exchange of investment property.

For example, a house and 80 acres may be worth $700,000 total. The taxpayer may not want to buy a $400,000 replacement residence. Depending upon the reasonable value of the house and land, divide the sale into two separate transactions, for example: (i) house and 5 acres, worth $450,000; and (ii) like-kind exchange of 75 acres, worth $250,000.

INCIDENTAL PERSONAL PROPERTY:

Prior to the adoption of the Tax Cuts and Jobs Act signed into law on December 22, 2017, if personal property was "**incidental**" to a larger exchange of real property, it was not treated as a separate property for identification purposes, and did not need to be specifically identified. *Reg. 1.1031(k)-1(c)(5)(B).* Property was considered incidental to a larger item of property if (i) in standard commercial transactions, the property is typically transferred together with the larger item of property, and (ii) the aggregate fair market value of all the incidental property **does not exceed 15%** of the aggregate fair market value of the larger item of property. For example, furniture, appliances, laundry machines, and other miscellaneous items of personal property were not treated as separate property from the sale of an apartment building, nursing home, motel, etc., if the fair market value of personal property did not exceed 15% of the total sale price. Another common example was irrigation equipment sold in connection with the sale of farmland.

Under the Tax Cuts and Jobs Act signed into law on December 22, 2017, exchanges of personal property and intangible property do not qualify under IRC § 1031 for like-kind exchange treatment for exchanges completed after Dec. 31, 2017, including any such personal property that is associated with or incidental to real property. Instead, the entire

cost of any replacement tangible business use personal property assets (new or used) can now be written off in the year that such assets are placed in service by the taxpayer. Although gain on the sale of such assets can no longer be deferred under IRC § 1031, deduction of the entire cost of replacement property can be used to offset (in whole or in part) any gain or depreciation recapture that would otherwise be recognized in the same tax year. However, this deduction for the entire cost is temporary; and will be reduced to 80% for assets placed in service in 2023, 60% for 2024, 40% for 2025, and 20% for 2026.

MORTGAGED PROPERTY:

It is important to understand that the taxpayer is not exchanging the "equity" in property. It is the full fair market value of both the Replacement Property and the Relinquished Property that is of significance. If there is a mortgage on either the Relinquished Property, the Replacement Property, or both, and any of the properties will be transferred subject to the mortgage, or the mortgage will be assumed by the other party, then the net mortgage amount will be treated as boot to the party being relieved of some or all of his liability.

Thus, in a situation where there is a mortgage on one or both of the properties, the mortgages should either be (1) paid off, or (2) "equalized" with a replacement mortgage or cash (or a combination of a mortgage and cash) prior to closing to avoid receipt of boot (the receipt of boot triggers gain recognition). Publications and other literature, mostly from qualified intermediaries, often contain misleading references to the effect that the taxpayer must encumber the replacement property with debt which is equal or greater than the debt on the relinquished property. The complete statement is "*Mortgage boot received (meaning mortgage debt which is paid off when the relinquished property sells) must be replaced with mortgage boot given (meaning the taxpayer must put equal or greater debt on the replacement property), provided that cash boot paid may replace mortgage boot received (meaning the taxpayer can replace debt with cash)*." The IRS's concern is that a taxpayer not cash out in an exchange. If debt is paid off in connection with the sale of the relinquished property, the taxpayer will not have sufficient proceeds to acquire the replacement property. The taxpayer may remedy this deficit with replacement debt, or with cash, or with a combination of both.

VACATION HOMES:

Does Section 1031 apply to vacation homes? This question is often asked, and the issue is highly controversial. Vacation homes may qualify as investment property if personal use is minimal, or the home is also rented. A property is not "held for investment" within the meaning of Section 1031 if losses from a sale or exchange of the property cannot be deducted.

The taxpayer's purpose of holding the Relinquished Property and the Replacement Property is determined when the exchange takes place. The taxpayer has the burden of proof on this issue. Property will not be eligible for non-recognition treatment unless it is held by the taxpayer for either productive use in a trade or business or for investment. Unproductive real estate held by a non-dealer for future use or future appreciation is held for investment.

In 2007, the Tax Court ruled that the sale of a vacation home, and the purchase of another vacation home, did not qualify for like-kind exchange treatment under Section 1031, because the homes were not held for investment. *Moore*, TC Memo 2007-134. Taxpayer argued that the property was purchased with the expectation that the property value would increase, and could be sold at a profit, which was his investment motive. The Tax Court did not dispute the taxpayer's argument that he purchased the property with the expectation that its value would appreciate. However, it held that the taxpayer's primary use of the property was as a vacation home. At no time did the taxpayer try to rent the property to third parties or have the property available for sale, until the taxpayer was ready to purchase another vacation home. The mere hope or expectation of a gain cannot establish an investment intent, if the property is used as a residence.

On September 17, 2007, the Treasury Inspector General for Tax Administration issued a report critical of the lack of oversight and enforcement by the IRS on like-kind exchanges involving vacation homes. Exchanges involving vacation homes are likely to attract more scrutiny, and become a point of enforcement emphasis by the IRS.

Section 280A of the Internal Revenue Code provides that a taxpayer may not deduct losses with respect to a dwelling unit used as a residence by the taxpayer during the taxable year. Section 280A(d) provides that a taxpayer uses a dwelling unit as a residence if the taxpayer uses the unit for personal purposes for a number of days which exceeds the greater of 14 days, or 10% of the number of days during the year for which such dwelling unit is rented for fair market value (365 - 33 = 332 x 10% = 33 days maximum personal use per year). For these purposes, personal use includes the use of the property by persons related to the taxpayer, unless the related persons use the property as a principal residence and they are paying fair rental.

14 days min. 33 days max.
[--------------Personal Use--------------]

A taxpayer desiring to exchange an interest in a vacation home under Section 1031 should, at a minimum, not exceed the personal use limits of IRC § 280A(d) and should rent the property at fair rental at least during the year in which the exchange occurs and preferably for 12 months or longer. What little case law there is on this issue suggests

that the property should be actually rented (at fair market rental), and not just merely offered for rent.

A taxpayer who wants to defer the gain on a vacation home may consider converting the vacation home to the taxpayer's principal residence for sufficient periods to qualify the residence for the gain exclusion. IRC § 121 provides that a taxpayer, regardless of age, may exclude up to $250,000 ($500,000 for married persons filing jointly) of gain on the sale or exchange of a principal residence if, during the 5 year period ending on the date of sale or exchange, the property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more. (Note, 5-year holding period applies to a principal residence acquired in a 1031 exchange, as explained below.)

On March 10, 2008, the Internal Revenue Service released *Rev. Proc. 2008-16*, which sets forth the guidelines for completing a Section 1031 like-kind exchange on a vacation home. To avoid any challenge to your vacation home exchange, you have to meet certain requirements during the 24 month period preceding the sale of your vacation home, or the 24 months after the purchase of your vacation home, or both if they both are vacation home properties: (i) You must have rented the property, at a fair rental price, for at least 14 days during each 12-month block of the 24-month period, and (ii) you did not use the property personally for more than the greater of 14 days, or 10 percent of the days rented, during each 12-month block of the 24-month period. This revenue procedure is effective for taxable years beginning after December 31, 2006.

CONVERTING THE USE OF REPLACEMENT PROPERTY:

A taxpayer may have acquired property for the purpose of occupying the property as a principal residence. The use of such property may be converted and treated as investment property following the taxpayer's abandoning of the residential use purpose. A property previously occupied as a principal residence is converted to a qualifying use when the taxpayer abandons the personal use and thereafter holds it for rental income and appreciation in value.

The residence must be "held for investment or in a trade or business" to qualify under IRC § 1031. The residence may thus be exchanged after it has been rented for a sufficient period of time to establish abandonment of personal use and the holding for a qualified use. There is no bright line test for the length of time the residence must be rented out. The rental must be more than temporary.

Other factors to consider in determining whether the residence is a qualifying use property are the length of time the property was listed for rental even if not rented, the length of time used as a personal residence before rental, whether the taxpayer received

fair market rent, whether all personal use of the house was abandoned, the existence of offers to sell or rent, and the absence of a prearranged exchange.

If the taxpayer converts a highly appreciated residence to a rental, the taxpayer may want to refinance the residence to obtain funds to purchase a new residence. A taxpayer is not limited to a single Replacement Property if exchanging out a principal residence con verted to a rental property. This allows the taxpayer to diversify the taxpayer's real estate investments.

As of <u>October 22, 2004</u>, IRC § 121 which governs the exclusion of gain from the sale of a principal residence was revised to require a 5-year holding period following an exchange before you can sell a residence and exclude the gain under IRC § 121, by adding the following provision: "IRC § 121(d)(11) - If a taxpayer acquired property in an exchange to which section 1031 applied, subsection (a) shall not apply to the sale or exchange of such property if it occurs during the 5-year period beginning with the date of the acquisition of such property."

The IRS issued *Rev. Proc. 2005-14*, effective as of <u>January 27, 2005</u>. This Revenue Procedure provides guidance on the application of both IRC § 121 and IRC § 1031 to a single residential property. This Revenue Procedure applies to two different situations: (i) when part of a home has been used for business (i.e., a home office), or (ii) when the use of a home has been converted from a taxpayer's principal residence, to a rental property. The home sale exclusion in IRC § 121 enables a homeowner to exclude $250,000 of gain ($500,000 if married filing jointly), provided that the home was owned and used as a principal residence for two out of the last five years. If a home office is physically located in a part of the residence, the entire residence will qualify for the IRC § 121 exclusion. If the business portion is in a separate structure (e.g., in a second home or other building on the same lot), the IRC § 121 exclusion is not available for gain from the business portion unless it was also used for two of the previous five years as the principal residence. The IRC § 121 exclusion does not apply to gain attributable to the recapture of depreciation deductions taken after May 6, 1997 (effective date of IRC § 121 changes).

<u>RELATED PARTY RULES</u>:

IRS Revenue Ruling 2002-83, provides that a taxpayer who transfers Relinquished Property to a QI in exchange for Replacement Property formerly owned by a related party is **<u>not</u>** entitled to non-recognition treatment under Section 1031 (a), if, as part of the transaction, <u>the related party receives cash or other non-like-kind property for the Replacement Property</u>. Under these circumstances, the IRS position is that the exchange will not qualify under Section 1031(f)(4), even if the taxpayer holds the Replacement Property for more than two years. Essentially, the IRS has closed the door on related party exchanges on the <u>Replacement Property</u> side of the transaction.

The taxpayer can still convey Relinquished Property to a related party (provided the related party holds the Relinquished Property for at least two years), but the taxpayer cannot acquire Replacement Property from a related party, except under very limited circumstances. Some commentators have suggested that the IRS would impose the 2 year holding rule when the taxpayer sells Relinquished Property to a related party, and subsequently purchases Replacement Property from an unrelated party. In a private letter ruling (200709036), the IRS concluded that Section 1031(f) does not apply to such exchanges, and that the taxpayer may "sell" to a related party in a deferred exchange, and that the related party may re-sell the property without a holding period restriction.

The related party rules of Sections 1031(f) and (g) are intended to prevent taxpayers from using Section 1031 to effectively shift tax basis (i.e., basis shifting) between properties owned by related parties to avoid the recognition of gain on the sale of one of the properties. Even if the related party has a lower basis, the transaction may constitute basis shifting if the related party has a NOL (net operating loss) which may be used to offset some or all of the taxable gain.

Subsection 1031(f) denies non-recognition treatment to a taxpayer who exchanges property with a related person, if either the taxpayer or the related person disposes of the property that either one received in the exchange within two years of the date of the last transfer which was part of the exchange. Subsection 1031(f)(4) provides that non-recognition treatment does not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purpose of subsection (f). The purpose of Section 1031(f) is to prohibit basis shifting between related parties.

IRS Letter Ruling 200440002, released October 1, 2004, involved the acquisition of Replacement Property by a taxpayer from a related partnership. However, this transaction required that the related partnership proceed to complete its own Section 1031 exchange. The IRS discusses Subsection 1031(f) and IRS Revenue Ruling 2002-83 in this context, and concludes that both the taxpayer and the related partnership are eligible for nonrecognition treatment under Section 1031(a). Because there was no "cashing out" of either party's investment in real estate, there was no basis shifting and no intent to avoid federal income taxation and, therefore, Subsection 1031(f) and IRS Revenue Ruling 2002-83 do not apply. Similarly, if the amount of the capital gain to be deferred by a taxpayer is less than or equal to the seller's (related party) taxable gain from selling the replacement property to the taxpayer then, consistent with the above ruling, there is no basis shifting and no intent to avoid federal income taxation.

Subsection 1031(g) provides that the two-year holding period is suspended if either the taxpayer's or the related party's risk of loss with respect to its property is substantially diminished by:

1. the holding of a put;

2. the holding by another person of a right to acquire the property; or

3. a short sale or any other transaction.

A disposition within the two-year period will not cause an exchange to fail, where:

1. The transfer occurs after the earlier of the death of the taxpayer or the death of the related person; or

2. In a compulsory or involuntary conversion (within the meaning of Section 1033), if the exchange occurred before the threat or imminence of such conversion; or

3. It is established to the satisfaction of the Secretary (of the Treasury) that neither the exchange nor the disposition had as one of its principal purposes the avoidance of Federal income tax.

It is a common, but often mistaken, belief that a taxpayer may exchange into property owned by a related party (when transferring the Relinquished Property to an unrelated party), provided that the taxpayer merely holds the Replacement Property for two years. The IRS does not share this overly-simplistic belief. A taxpayer may still acquire Replacement Property from a related party if the taxpayer comes within one of the tax avoidance exceptions intended by Congress, as follows:

1. Transactions involving an exchange of undivided interests in different properties that result in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of such properties;

2. Dispositions of property in non-recognition transactions (e.g., gifts, charitable contributions, etc.); and

3. Transactions that do not involve the shifting of basis between properties.

The definition of a "*related person*" means any person bearing a relationship to the taxpayer described in IRC § 267(b) or § 707(b)(1), and include:

1. Members of a family (siblings whether whole or half blood, spouse, ancestors, and lineal descendants);

2. An individual and a corporation, where **more than 50 percent** in value of the outstanding stock is owned directly or indirectly by or for such individual (Note: The constructive ownership rules of IRC § 267(c) provide that an individual shall be considered as owning the stock owned, directly or indirectly, by or for his family);

3. Two corporations which are members of the same control group;

4. A grantor and a fiduciary of the same trust;

5. A fiduciary and a beneficiary of the same trust;

6. A fiduciary of a trust and the fiduciary or beneficiary of another trust where the same person is the grantor of both trusts;

7. A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is the grantor of the trust;

8. A person and an IRC § 501 organization (i.e., certain educational and charitable organizations exempt from tax), if the organization is controlled by that person or that person's family;

9. A corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of capital interest, or profits interest, in the partnership;

10. An S corporation and another S corporation, or a C corporation, if the same persons own more than 50 percent of the value of the outstanding stock of each corporation;

11. A partnership (or limited liability company) and a person owning, directly or indirectly, more than 50 percent of the capital interest, or profits interest, in such partnership (or limited liability company);

12. Two partnerships (or limited liability companies) in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests of each partnership (or llc); and

13. An executor of an estate and a beneficiary of such estate.

The definition of a "*related person*" does not include in-laws, nephews, nieces, aunts, uncles, friends, employees, domestic partners, entities in which the taxpayer or a related party own 50% or less of "profits and capital", or tenants in common.

A related party may lease land, for a term in excess of 30 years, to a contractor or EAT, who in turn may construct improvements on the leasehold, and then convey the lessee's interest in the ground lease and improvements to the taxpayer as Replacement Property. The taxpayer has not exchanged into improvements on land owned by a related party, because the improvements were constructed by an unrelated party. Although the ground lease may be from a related party lessor, the ground lease has no value if there is a fair market rental. Thus, the only value is in the improvements.

LIKE-KIND EXCHANGES BY PARTNERSHIPS:

The most frequently encountered problem in like-kind exchanges may involve the treatment of partnerships that own the Relinquished Property. It is a common occurrence for a partnership with multiple partners to sell property, and one or more of the partners want to complete a like-kind 1031 exchange, and one or more partners want to "cash out" in the transaction. There are 3 commonly used methods to cash out a partner from a partnership:

1. **Special Allocations**: Some partnerships use special allocations of the gain to the partner who wants to cash out. The problem with this approach is that it is not clear whether such special allocations have substantial economic effect. Although the net effect is no net tax liability, it is difficult to theoretically justify this special allocation under IRC Section 704(b). Most informed tax advisors would advise against this method.

2. **Drop and Swap**: In a classic "drop-and-swap" transaction, the partnership distributes the property to the partners, as tenants-in-common. Each partner receives a pro-rata undivided interest in the property immediately before the sale (this distribution to the members is the "drop"), followed by like-kind exchanges by the individual members (this is known as the "swap"). The partner who wants to cash out can receive cash at closing, recognize gain, and pay taxes. The partner(s) who want to complete a like-kind 1031 exchange go together to purchase Replacement Property, or complete separate individual exchanges. The most common problem with this method is that the partners may not satisfy the "held for" requirement when they receive their undivided interests immediately before the sale, by reason of the fact that they may have held the distributed real estate for a very short period of time. Accordingly, partners that engage in drop

and swap transactions are at risk that the IRS may deny like-kind exchange treatment.

The preferred method for a drop and swap, is to liquidate the partnership first, and then have the partners enter into the contract of sale preferrably several months later. The more time that passes between the events the better. Depending on the nature of the use of the property, the former partners (and now co-tenants) may want to enter into a tenancy-in-common (TIC) agreement to avoid having their ownership reclassified as a partnership for tax purposes.

When considering drop-and-swap transaction, always ask two questions: (1) Did the partnership already execute a contract for the sale of the property in the name of the partnership?, and (2) What is the nature of the property being sold, and is it the kind of property that would typically be owned in fractional interests as tenants-in-common? Like most herd mentality, everyone is doing it, even though it is subject to attack by the IRS, and most informed tax advisors would advise against this method.

The *ABA Joint Report on Section 1031 Open Issues Involving Partnerships* concludes that the pre-exchange distribution by, and post exchange contribution to, a partnership should not prevent the qualified use test (of which the "held for" test is a part) from being satisfied.

The IRS has apparently determined that while it does not agree with *Bolker* and *Magneson*, in a 1999 Field Service Advisory, IRS FSA 19995104 (IRS FSA Dec 24, 1999, corrected and re-released April 29, 2005) it states: "*Although we disagree with the conclusion that a taxpayer that receives property subject to a prearranged agreement to immediately transfer the property 'holds' the property for investment, we are no longer pursuing this position in litigation in view of the negative precedent*."

3. **Installment Note Method**: Although this may be the most complicated alternative, it is also the most effective method for a partner to cash out of the transaction. Upon closing of the Relinquished Property, the buyer conveys to the seller a combination of cash plus an installment note that can be distributed to the cash-out partners in liquidation of their interests. The note can be secured by a stand-by letter of credit. Distribute the note to the cash-out partners. The note typically provides for 98-99% of the payments thereon to be made within a very short period fo time after closing, with the remaining payments to be made after the beginning of the next tax year. The remaining partners purchase Replacement Property and complete a like-kind 1031 exchange. The down side to the remaining partners is that the value of the Replacement Property must equal or

exceed the total value of all of the Relinquished Property, not just the value of their pro-rata interests.

GRANTOR TRUSTS:

A taxpayer may desire to acquire the Replacement Property in a revocable living trust or "grantor" trust for estate planning reasons. Alternatively, a taxpayer who has held the Relinquished Property in a revocable living trust or grantor trust may desire to hold the Replacement Property outside the trust. Either of these changes in ownership will not disallow exchange treatment under Section 1031.

Revocable living trusts or other "grantor" trusts (under IRC §671-678) **are not considered separate entities for federal tax purposes (disregarded entity)**. Typically, the taxpayer's own tax identification number is used, and a separate tax return for the trust will not be filed. For purposes of Section 1031, the grantor, not the trust, is the taxpayer.

A taxpayer may transfer Relinquished Property to a grantor trust immediately prior to an exchange, or transfer Replacement Property to a grantor trust immediately after an exchange. The transfer of Replacement Property by a taxpayer, to a grantor trust, within two years of a related-party exchange is not a disposition under Section 1031(f), and should not trigger recognition of gain. A transfer by a grantor trust to a third party, or termination of grantor trust status, may result in a transfer to a new taxpayer triggering recognition of gain depending upon the specific circumstances. The taxpayer should not terminate grantor trust status immediately before, after or during an exchange.

DEATH OF TAXPAYER:

If the taxpayer dies during the exchange period, the taxpayer's estate or trustee may complete the exchange. The Replacement Property must be acquired by the taxpayer's estate or trustee, and not in the name of a surviving spouse or other beneficiary, in order to qualify. The deceased taxpayer's estate defers the tax, and also receives a stepped up basis in the Replacement Property under IRC 1014(a).

If the exchange is not completed with the acquisition of Replacement Property by the personal representative or testamentary trust of the taxpayer, the disposition of the Relinquished Property would be taxable to either the taxpayer on his/her final income tax return, or to the estate or testamentary trust as income with respect to a decedent. *IRC 691(4). Ltr. Rul. 9829025.*

SINGLE MEMBER LIMITED LIABILITY COMPANIES:

Many states, including Kansas, have laws that allow single member limited liability companies. The taxpayer can elect to have a single member limited liability company be taxed as either a sole proprietorship or a corporation for federal tax purposes. If the taxpayer elects taxation as a sole proprietorship, then the taxpayer may hold the Relinquished Property as an individual and the Replacement Property as a single member limited liability company in an exchange. **For federal income tax purposes, the single member limited liability company is a "disregarded entity."** This option might allow the taxpayer to take advantage of certain benefits, such as the liability protection of a limited liability company.

This option may also allows the taxpayer to satisfy the "single asset entity" requirements that many lenders impose on the Replacement Property. The IRS has approved the use of a single member limited liability company for the Replacement Property in an exchange.

OPTION AGREEMENTS:

It is possible to delay the acquisition of Replacement Property for an indefinite period of time, in order to qualify for Section 1031 treatment, by the use of option agreements. An option to purchase may even be combined with a lease agreement, so that the purchaser may take immediate possession of the Replacement Property, even though the transfer of fee title may be delayed for some period of time. If lease payments are applied to the purchase price, the arrangement may be deemed a transfer of beneficial ownership.

An option agreement may constitute a transfer of beneficial ownership if the non-refundable option payment or earnest money is so great that it is highly unlikely that the buyer will not exercise the option and close. The amount of the option payment must be reasonable. An option payment in excess of 20-25% of the total purchase price may be excessive and create a problem for the taxpayer.

Earnest money and option payments are considered mere deposits, and are not taxable until the transaction closes, because they cannot be characterized as income until the option is either exercised or expires. On the sale of Relinquished Property, such payments may be deposited with the QI before closing, and should qualify as part of the exchange proceeds.

INSTALLMENT SALES:

Assuming the other requirements of Section 453 are met, a taxpayer can claim the benefits of installment sale reporting under the installment sale rules. This allows a

taxpayer to defer reporting of gain to a later period even if the taxpayer elects not to complete the like-kind exchange transaction.

Installment sales and exchanges can be combined, with the down payment being used to complete an exchange and the balance receiving installment treatment. As a general matter, all of the taxpayer's basis in the Relinquished Property is associated with the Replacement Property, to the extent the value of the Replacement Property does not exceed the basis (the excess basis may be applied towards the installment note).

The party who holds an interest in real property for purposes of Section 1031 is determined by who has the economic bundle of rights, rather than by who holds bare legal title. For purposes of Section 1031, the rights created in property determine the character of the property owned. The issue turns on when the benefits and burdens of ownership of real property have shifted. The seller's interest in an installment real estate contract is similar to that of a creditor under a secured note, and the exchange of such an interest is excluded from non-recognition treatment, *IRC §1031(a)(2)(B).* A seller under an installment real estate contract retains legal title to the real property until the buyer completes payment and fully performs in accordance with the terms of the contract. However, the buyer is entitled to possession and beneficial ownership, subject to the buyer's performance of the remaining obligations under the contract.

The Regulations relating to installment sales and deferred exchanges treat a deferred exchange in which Replacement Property is not acquired as an installment sale with the exchange proceeds being taxed when received by the taxpayer. *Reg. 1.1031(k)-1(j)(2).*

DEALER STATUS:

Dealer status will disqualify a taxpayer from non-recognition of gain under Section 1031. The distinction between "dealer" property and property "held for productive use in trade or business or for investment" is one of fact and there are no safe harbor provisions. Factors to be considered in determining whether a taxpayer holds property primarily for sale to customers in the ordinary course of a trade or business include:

(a) The initial purpose for which the property was acquired;

(b) The purpose for which the property was subsequently held;

(c) The extent to which improvements, if any, were made to the property;

(d) The frequency, number and continuity of sales by the taxpayer;

(e) The extent and nature of the transactions involved;

(f) The ordinary business of the taxpayer;

(g) The extent of advertising, promotion or other efforts used in marketing the property for sale and soliciting buyers;

(h) The listing of the property with a broker; and

(i) The use the property at the time of sale.

Subdividing and selling activities may be taken into account or disregarded in determining whether property is stock in trade. A taxpayer who enters into a joint venture with a dealer may be considered a dealer. Property held for future appreciation is held for investment where held by one other than a dealer. A taxpayer who has held land for investment may change its plans and decide to subdivide the land and sell it in lots. These activities could cause the taxpayer to become a dealer with respect to the property with the result that all gain, even the gain built up in the property prior to conversion to dealer status, will be taxed as ordinary income and Section 1031 will not be available. A taxpayer may wish to exchange out of the property prior to the dealer activity and convey the property to a related party, such as a wholly owned corporation, who will perform the dealer activities. This allows the taxpayer to effect an exchange of the property and avoid ordinary income on the appreciation from the investment activities. The related party then recognizes the ordinary income from the dealer activities. Such an arrangement must not run afoul of the related party rules of IRC § 1031(f), and is subject to IRC § 1239 (b) which provides that a taxpayer selling depreciable property to a controlled entity will recognize ordinary income and not capital gain, and IRC § 707(b)(2) which provides that any gain on sale or exchange between a partnership and a related person will be ordinary income if the asset is not a capital asset under § 1221 in the hands of the transferee.

Therefore, if the Relinquished Property is depreciable and the exchange is not completed because, for example, the taxpayer cannot find suitable Replacement Property, the taxpayer will have ordinary income rather than capital gain even if the Relinquished Property was held by the taxpayer for investment. The taxpayer must also receive a fair market value for the property and not an inflated value designed to reduce the ordinary income to the related party from the subsequent dealer activities. The installment method of reporting gain is not available for the sale of depreciable property to a controlled entity under IRC § 453(g). Alternatively, the taxpayer may acquire Replacement Property from a related party, and each may then hold their respective properties for two years to satisfy the related party rules under IRC § 1031(f).

GROWTH FACTOR:

Subject to agreement with the QI, a taxpayer may direct the investment of exchange proceeds during a like-kind exchange, and receive interest or a "growth factor" during the replacement period, subject to the constructive receipt rules. The interest or growth factor received by the taxpayer in a deferred exchange is treated as interest income for federal income tax purposes, regardless of whether it is paid to the taxpayer in cash or property, including if it is applied to the purchase price of the Replacement Property or used to pay intermediary fees.

If the interest income is applied to the purchase price of the Replacement Property, it should be treated as cash boot paid by the taxpayer and should offset boot received in the form of non-exchange expenses paid at closing and will increase the basis of the Replacement Property. The IRS has issued proposed regulations dealing with transactions involving qualified escrow or trust accounts. *Prop. Reg 1.468B-6.* The proposed regulations do not require the QI to provide 1099's to every taxpayer that earns interest or a growth factor.

EARLY RELEASE OF EXCHANGE PROCEEDS:

The "(g)(6)" limitations under Section 1031 provided that the Exchange Agreement must limit the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period.

The Exchange Agreement may provide that if the taxpayer has not identified any Replacement Property before the end of the identification period, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property at any time after the end of the identification period.

The Exchange Agreement may provide that if the taxpayer has identified any Replacement Property, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property upon and after:

1. The receipt by the taxpayer of all of the Replacement Property to which the taxpayer is entitled under the Exchange Agreement; or

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

If a taxpayer has timely identified Replacement Property and the 45-day identification period has expired, the taxpayer may not receive the exchange funds, even if the taxpayer decides not to complete an exchange because the Replacement Property or properties identified have been sold, or taken off the market, or the terms of purchase do not meet the taxpayer's requirements, or for other reasons. The (g)(6) limitations preclude the taxpayer from receiving exchange proceeds until the expiration of the exchange period. In PLR 2000027028, the IRS concluded that the inability to negotiate a purchase agreement with the seller was not a material contingency beyond the taxpayer's control and the taxpayer had not received all the Replacement Property to which it was entitled under the Exchange Agreement.

Under general contract principals, the QI and the taxpayer should be able to amend the Exchange Agreement to provide for the early release of the exchange proceeds. However, the QI should not make this a general practice, because this could undermine the QI's credibility with the IRS. Also, it can be argued that the Exchange Agreement can be amended to provide that the taxpayer will not acquire any additional Replacement Property and, thus, has received all the Replacement Property to which it is entitled.

The issue of early release of exchange proceeds may arise before the expiration of the 45-day identification period. For example, there may be exchange proceeds remaining after a simultaneous exchange, or the taxpayer may identify and acquire a single Replacement Property prior to the 45th day, and have excess exchange proceeds remaining after the acquisition.

JUDICIAL LIMITATIONS ON EXCHANGES:

Certain judicial limitations pervade the body of tax law and, consequently, also apply to Section 1031. The limitations include the (i) substance-over-form doctrine, and (ii) and step transaction doctrine. In applying the substance-over-form doctrine, courts will judge the tax effects of a transaction based on its economic consequences rather than its form. In applying the step transaction doctrine, courts will integrate several steps and view the transaction as a whole to determine the tax consequences.

For example, a taxpayer may want to exchange into property which the taxpayer already owns. The taxpayer may try to accomplish this by conveying the Replacement Property to an unrelated person and then, in a prearranged transaction, acquire (or reacquire as the case may be) the Replacement Property in an exchange. The substance-over-form doctrine should prevent such a transaction from qualifying as an exchange.

PRORATIONS ON CLOSING STATEMENTS:

IRS Form 8824 provides that the taxpayer may deduct "exchange expenses." Typical transactional costs should be deductible if paid in connection with the exchange. Such costs might include commissions, finder's fees, title insurance premiums, title endorsements, survey fees, escrow fees, closing fees, legal fees, intermediary fees, transfer taxes and recording fees.

Other transactional items typically found on a closing statement may constitute non-exchange expenses, and do not reduce the amount realized or recognized and are not added to the basis of the Replacement Property. These non-exchange items might include mortgage interest, property taxes, pre-paid rents, security deposits, utility charges, association fees, and insurance premiums. Although these items may result in taxable boot, they may also be deductible for income tax purposes (e.g., interest, taxes or operating expenses). Non-exchange expenses debited to the taxpayer and paid with exchange equity will be taxable boot, but items credited to the taxpayer (e.g., prepaid taxes or dues) will be treated as cash paid by the taxpayer and may offset the taxable boot.

Security deposits and prepaid rent are treated as non-exchange items. If the buyer of the Relinquished Property receives a credit, and the taxpayer (seller) receives a corresponding debit for the security deposits and prepaid rent, the taxpayer has received taxable boot. If the taxpayer (seller) pays the buyer of the Relinquished Property a sum equal to the security deposits or prepaid rent, this payment does not cause taxable boot to the taxpayer. To avoid taxable boot, the taxpayer should transfer (i.e., fund) the security deposits and prepaid rent to the buyer at closing, rather than the buyer receiving a credit against the purchase price of the Relinquished Property.

Costs associated with a loan obtained by the taxpayer on the Replacement Property are most likely non-exchange expenses, and do not reduce the amount of realized or recognized gain. For example, loan fees, points, loan application fees, commitment fees, mortgage insurance, lender's title insurance, assumption fees, appraisal fees, and other costs related to the acquisition of a loan for the Replacement Property are probably non-exchange expenses.

STATE LAW ISSUES:

State Transfer Taxes: Many states impose a transfer tax or recording tax on the conveyance of real property interest. Some states even impose a real estate transfer tax on transfers of an interest in an entity that owns real estate (e.g., Maine). These states may or may not recognize a specific exemption for transfers to a QI or EAT. Before recording a deed to convey the Relinquished Property or Replacement Property to a QI or EAT, check to see if the local jurisdiction has a transfer tax, and what alternatives, if any,

there may be to avoid payment of the transfer tax. For example, the QEAA can state that the EAT is the taxpayer's agent for all purposes, except for federal income tax purposes, which may suffice to avoid state transfer taxes. See PLR 200148042. Another possible alternative is to "deliver" a deed to the EAT, but not "record" the deed, which may suffice in those states where the mere act of "delivery" constitutes a legal conveyance of real property. Finally, the use of single-member limited liability company (or other disregarded entity for federal income tax purposes) may be used in most states to avoid transfer taxes.

State Income Taxes: Until recently, most States that impose income taxes have mirrored the federal tax code in allowing the deferral of gain in a tax-deferred exchange under Section 1031. That is no longer the situation in a number of States. It used to be that you could sell Relinquished Property in just about any State with an individual income tax, and acquire Replacement Property in another State that had little or no individual income tax. Eventually, the out-of-State Replacement Property could be sold, the gain recognized, and the taxpayer would have effectively reduced or avoided the State income tax portion on the gain. A savings of 6% (or more) in State income taxes on a significant amount of taxable gain could save the taxpayer several thousands of dollars, making it worthwhile for the taxpayer to at least consider acquiring Replacement Property in a State with little or no individual income tax. States with no personal income tax include Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

Claw-Backs and Withholding Taxes: A growing number of States have enacted or are considering additional requirements, claw-backs, and/or special reporting rules where the Replacement Property is located in another State. These additional requirements typically apply when a taxpayer attempts to sell property and export the unrealized gain, at the State level (not the federal level), to another State under Section 1031, where that gain might be realized at a future date with little or no applicable State income tax. If the Relinquished Property is located in the same State, then this is not much of an issue. The problem arises, if at all, when the Relinquished Property is located in one State, and the taxpayer desires to acquire Replacement Property in yet another State. Some States have "claw-back" provisions (e.g., California, Massachusetts, Montana, Oregon, etc.), while others require withholding taxes on real estate transfers (e.g., California, New York, Maryland, Maine, Georgia, New Jersey, Hawaii, South Carolina, Rhode Island, Vermont, etc.).

Federal Conformity: Other States (e.g., Arkansas, Pennsylvania, etc.) do not follow federal nonrecognition of gain, and have not adopted Section 1031. The Pennsylvania Department of Revenue issued a legal letter ruling, No. PIT-05-009, dated June 13, 2005, to address the issue does Pennsylvania follow the Federal nonrecognition rules for like-kind exchanges pursuant to IRC 1031 or 1033? This letter ruling reached the conclusion that Pennsylvania does not follow the Federal nonrecognition rules for like-kind

exchanges pursuant to IRC 1031, and that the gain in this particular situation would be subject to Pennsylvania personal income tax.

Other Issues: Texas has a gross margin tax that applies to all typical real estate owning entities (corporations, partnerships, LLCs, joint ventures). Arizona has a transaction privilege tax. California has an LLC margin fee that applies to all state situs income. Non-community property states (all but California, Louisiana, Nevada, Washington, Idaho, Texas, New Mexico, Arizona, and Wisconsin) must have separate LLC's for husband and wife, or it will be deemed a tax partnership. Several states have mortgage registration taxes. Several states impose reals estate transfer tax on transfers of a controlling interest in an entity that owns real estate (e.g., Connecticut, Maine, New Hampshire, New York, Oregon, Pennsylvania, South Carolina, Washington, etc.).

Some helpful websites containing a variety of multi-State 1031 exchange information, along with multi-State transfer tax requirements are as follows:

- American Bar Association State Survey (Spring 2005):
  http://www.abanet.org/tax/groups/seb/results1031.pdf

- National Association of Realtors Summary of Realty Transfer Taxes by State:
  http://www.realtor.org

- State websites: Federation of Tax administrators:
  http://www.taxadmin.org/fta/link/default.html

QI Registration and Regulation: Another recent multi-State development is the concept of Qualified Intermediary (QI) registration. The State of Nevada, Department of Business and Industry Real Estate Division, is the first such State to enact legislation requiring the registration of QI's. See NRS 645.606 et. seq. The State of Nevada has adopted a requirement for annual registration (as opposed to licensing) of QI's. The registration process imposed on QI's by Nevada requires the completion of a registration form, payment of a registration fee, bonding, finger printing, and a requirement that all complaints will be handled through the Nevada court system.

TENANCY-IN-COMMON ("TIC's"):

When it comes to multiple ownership of real property, the distinction between owning the real property as tenants in common ("TIC"), versus an actual partnership, is of critical importance. Partnership interests belong to a category of property excluded from IRC §1031. TIC treatment is essential for multiple property owners to gain IRC §1031 eligibility.

In response to a large number of requests for rulings from taxpayers that specific TIC arrangements would not be treated as partnerships for tax purposes, the IRS issued Rev. Proc. 2000-46, which stated the intention of the IRS to issue public guidance concerning whether a TIC interest in real estate would be treated as giving rise to a separate business entity for federal income tax purposes. A couple of years later, the IRS issued Rev. Proc. 2002-22, to address the tax treatment of an investor in a TIC under like-kind exchange rules, and provided taxpayer guidance. Essentially the TIC industry was born, and has experienced substantial growth and increasing acceptance by real estate investors ever since.

TIC investments are a way of sharing ownership of property among two or more persons (not partners) in which each co-tenant owns an undivided fractional interest in the property with the other co-tenants owning interests of the same or of differing sizes. Each co-tenant will (i) share in the net income and changes in property values, (ii) receive a separate deed and title insurance for his or her interest in the property, and (iii) enjoy rights identical to those of a single owner. Ownership may be established through a will, deed, or other document of title.

A TIC can be brokered in two ways: (i) as a real estate offering, or (ii) as a securitized offering. If the TIC is a securitized offering, it is subject to federal and state securities regulations, including the requirement that the broker have the necessary securities license. Because a securitized TIC also involves the ownership of real property interests, its sale is also subject to state real estate license laws, which require a real estate license to engage in the promotion and sale of real estate. **May need both a security dealer license and a real estate license to sell a TIC and to receive a commission**.

Current rules regarding securitized offerings require that non-broker dealers, including real estate professionals, cannot be compensated for their participation in a sale of a security. The *National Association of Realtors* (NAR) has highlighted the conflict between state laws and securities regulations, and argued to the *Securities and Exchange Commission* (SEC) that it is in an investor's best interest to have the benefit of a real estate professional's advice regarding the real estate aspects of a securitized TIC.

Before requesting a Private Letter Ruling from the IRS, Rev. Proc. 2002-22 requires that the following conditions must be met:

1. *TIC Ownership*. Each co-owner must hold title, as a tenant-in-common, under local law.

2. *Maximum number of co-owners*. The maximum number of co-workers is capped at 35. A husband and wife are treated as a single person as are those who acquire interests by inheritance from a co-owner.

3. *No entities.* None of the co-owners may be able to be identified as entities, i.e.: the co-owners may not file partnership or corporate returns or conduct business under a common name. The Service will not issue a ruling if the co-owners previously held the property through a partnership or corporation immediately prior to formation of the co-ownership interests.

4. *Co-ownership agreement.* The co-owners can enter into a limited co-ownership agreement. The agreement can provide that a co-owner must first offer the co-ownership interest for sale to the other co-owners, sponsor or the lessee at fair market value before exercising any rights to partition. The co-owners may agree to be bound by a majority vote.

5. *Voting.* The co-owners must retain the right to approve hiring of a property manager, as well as sale, lease and financing decisions regarding the property. All of those issues must be by unanimous approval.

6. *Alienation restrictions*. Each co-owner must have the rights to transfer, partition and encumber the co-owner's undivided interest without the agreement or approval of any person. Lender restrictions that are consistent with customary lending practices are not prohibited.

7. *Sale of Property*. If the property is sold, any debt secured by the property must be paid and net proceeds distributed to co-owners.

8. *Revenue and expense allocation*. Co-owners must share in the revenue and costs of the property in proportion to their undivided interests. Other co-owners, the sponsor and the manager cannot advance funds to a co-owner to cover expenses associated with the co-ownership unless the advance is recourse to the co-owner and for a period not to exceed 31 days.

9. *Debt allocation*. Co-owners must share in any indebtedness in proportion to their undivided interests.

10. *Options.* A co-owner may issue an option to purchase the co-owner's interest provided the exercise price is at fair market value at the time the option is exercised. Co-owners cannot acquire a put option to the sponsor, lessee, another co-owner or the lender or any person related to the aforementioned.

11. *Co-owners' activities*. The co-owner's activities must be limited to those customarily performed in connection with the ownership of rental

property. If the sponsor or lessee is a co-owner for longer than six months, all of the activities of that party will be considered in determining whether the co-owners' activities are customarily undertaken by co-workers of real property and do not rise to the level of partnership activity.

12. *Leasing, management agents*. Management and brokerage agreements with a sponsor or co-owner cannot be longer than one year and cannot be entered into with a lessee. The co-owners must unanimously approve the agreement and compensation to the managers cannot depend on co-owner income or net profits and cannot exceed fair market value for the services provided. The co-owners must retain the right to approve any sale or lease of a portion or all of the property. The terms of leases must reflect fair market value. If a manager is employed to collect revenue, the manager must disburse to the co-owners their share of net revenues within three month of receipt of those revenues.

13. *Leases*. All leases must be bona fide leases for federal tax purposes. Rents must be at fair market rates and cannot be determined based on the income or profits derived by any person from the property.

14. *Unrelated lender*. The lender providing financing for the property or for any co-owner to acquire an undivided interest cannot be a related person to any co-owner, the sponsor, the manager or any lessee of the property.

15. *Sponsor fees*. The amount paid to the sponsor to acquire a co-ownership interest must reflect the fair market value of the interest and cannot depend on the income or profits derived by any party from the property.

REVERSE LIKE-KIND EXCHANGES OF REAL ESTATE

REVERSE EXCHANGES:

The IRS issued *Rev. Proc. 2000-37*, effective as of September 15, 2000. Prior to this time, taxpayers had been using a wide variety of parking transactions to facilitate reverse exchanges. Rev. Proc. 2000-37 provides a safe harbor that allows a taxpayer to utilize an ***Exchange Accommodation Titleholder*** ("**EAT**"), and treat the EAT as the owner of property for federal income tax purposes, thereby enabling the taxpayer to accomplish a reverse exchange. **The EAT holds title to property, while the QI holds exchange proceeds**.

Revenue Procedure is not law. It is not a statute nor is it a regulation. It is the IRS's position. It is no more binding in court than a brief filed by the IRS in any other case.

The IRS emphasized that no inference was intended in Rev. Proc. 2000-37 with respect to the transactions not covered by the safe harbor. Thus, the IRS specifically recognized that "parking" transactions could be accomplished outside of the safe harbor. If the safe-harbor requirements are not satisfied, the determination whether the taxpayer or the EAT is the owner of the property for federal income tax purposes, and the proper treatment of any transactions entered into by the parties, will be made without regard to the safe harbor. The IRS further indicated that no inference should be drawn with respect to parking transactions entered into prior to the Procedure's effective date.

"***Exchange First***" (park the Relinquished Property) occurs when the taxpayer acquires the Replacement Property first, and conveys the Relinquished Property to the EAT. Least common of the two possible arrangements.

"***Exchange Last***" (park the Replacement Property, most common) occurs when the EAT acquires the Replacement Property, and holds it until the taxpayer has sold the Relinquished Property, then conveys the Replacement Property to the taxpayer. This is the most common form of reverse exchange transactions. The EAT holds the Replacement Property from its purchase until the taxpayer sells the Relinquished Property. **For build-to-suit arrangements, Exchange Last is the only option**.

In both the Exchange First and Exchange Last structures there will typically be mechanisms such as a lease (or management agreement) transferring operating control of the parked property to the Taxpayer or an affiliate while the EAT holds legal title. State transfer taxes are a particular concern when structuring reverse exchanges, because of the multiple transfers caused by the parking arrangement (see State Law Issues, above).

THE QEAA:

A ***Qualified Exchange Accommodation Agreement*** ("**QEAA**") is the fundamental concept underpinning the safe harbor in Rev. Proc. 2000-37. The IRS will not challenge the qualification of property as either Replacement Property or Relinquished Property for purposes of Section 1031, or the treatment of the EAT as the beneficial owner of such property for federal income tax purposes, if the property is held in a QEAA. Typically, a QI holds money, whereas an EAT holds title to property.

Property is held in a QEAA if six requirements are satisfied:

1. **Qualified indicia of ownership**. "Qualified indicia of ownership" of the property must be held by an EAT who is not the taxpayer or a disqualified person at all times from the date of acquisition by the EAT until the property is transferred as described below. For purposes of this rule, qualified indicia of ownership includes:

- Legal title to the property. (As a practical matter, in most instances this requirement will be satisfied by having the EAT either directly, or through a single-member LLC, acquire legal title to the property.
- Other indicia of ownership of property that are treated as beneficial ownership of the property under applicable commercial law principles (e.g., a contract for deed).
- Interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (for example, a single-member LLC) and that holds either legal title to the property or other indicia of ownership.

2. **Intent**. At the time the qualified indicia of ownership of the property is transferred to the EAT, it is the taxpayer's bona fide intent that the property held by the EAT represents either Replacement Property or Relinquished Property in an exchange that is intended to qualify for non-recognition of gain (in whole or in part) under Section 1031.

3. **Qualified Agreement**. No later than **five "business" days after the transfer** of qualified indicia of ownership to the EAT, the taxpayer and the EAT enter into a written QEAA that provides that the EAT is holding the property for the benefit of the taxpayer in order to facilitate an exchange under Section 1031 and Rev. Proc. 2000-37. The QEAA also must state that the taxpayer and the EAT agree to report the acquisition, holding, and disposition of the property as provided in Rev. Proc. 2000-37. To satisfy this requirement, the QEAA must specify that the EAT will be treated as the beneficial owner of the property for all federal income tax purposes, and both parties must report the

federal income tax attributes of the property on their federal income tax returns in a manner consistent with the QEAA. The purpose of the 5-day grace period is to accommodate the situation where an exchange falls apart at closing, and you have to shift gears to a reverse exchange.

4. **Identification**. No later than 45 days after the transfer of qualified indicia of ownership of the Replacement Property to the EAT, the property to be relinquished must be identified in the manner set forth in Reg. 1.1031(k)-1(c) (which permits the taxpayer to identify alternative or multiple properties). Identification must be made in the manner provided in such Regulations, which presumably means that written notice must be given by the taxpayer to the EAT as to the identity of the Relinquished Property by no later than midnight on the 45th day after acquisition of the Replacement Property. Such notice must identify the Relinquished Property with sufficient particularity. Rev. Proc. 2000-37 adopts the same identification rules that apply in deferred exchanges, which require written identification be delivered to another party to the exchange and limit the number of alternative and multiple properties that can be identified.

5. **Sale**. No later than 180 days after the transfer of qualified indicia of ownership of the property to the EAT, either (i) the parked property is transferred (directly or through a QI) to the taxpayer as Replacement Property (*exchange-last transaction*), or (ii) the parked property is transferred to a person who is not the taxpayer or a disqualified person as Relinquished Property (*exchange-first transaction*). A safe harbor reverse exchange must be completed within 180 days after the parked property is first acquired by the EAT. The duration limit on safe harbor transactions reflects an apparent effort by the IRS to maintain the symmetry between a safe harbor parking transaction and a typical deferred exchange, which by statute must be completed within the lesser of 180 days and the due date of the taxpayer's return for the year in which the Relinquished Property is transferred.

6. **Time Period**. The combined time period that the Relinquished Property and the Replacement Property are held in a QEAA does not exceed 180 days. It may be possible to combine a reverse exchange with a regular deferred exchange, for a maximum exchange window of 360 days.

STEPS IN SUCCESSFUL REVERSE EXCHANGES:

Walking through the steps of a successful real estate parking transaction and tax deferred exchange illustrates the flexibility allowed taxpayers by Rev. Proc. 2000-37. A typical real estate parking transaction involving an income producing asset would be achieved as follows under the new reverse exchange rules:

Step No. 1 The taxpayer enters into a contract to acquire a potential Replacement Property and arranges acquisition financing, in the form of seller

financing, third party financing or the taxpayer advances the acquisition funds.

Step No. 2 The taxpayer enters into a written qualified exchange accommodation agreement ("QEAA") with an exchange accommodation titleholder ("EAT") before the EAT acquires any qualified indicia of ownership. The QEAA may permit the taxpayer or the taxpayer's designee to acquire the parked property for a fixed price at the end of the safe harbor parking period and the EAT and the taxpayer may agree to a transfer at the end of the safe harbor parking period to the taxpayer the entire ownership interest in any special purpose entity used by EAT to hold the parked property.

Step No. 3 The EAT acquires title to the Replacement Property, with financing arranged by the taxpayer and sometimes guaranteed by the taxpayer. A sophisticated EAT may use a single member, special purpose, single asset limited liability company to hold title to the parked property (a "Single Purpose Entity" or "SPE"). The use of an SPE is designed to minimize any exposure to EAT's other assets and protects the taxpayer's expectation that the parked property will not be commingled with other assets or liabilities of the EAT.

Step No. 4 Either in the QEAA or in a separate identification notice, the taxpayer identifies one or more relinquished properties to complete the exchange and delivers the identification notice to the EAT within 45 days after the EAT first acquires title to the parked property.

Step No. 5 The EAT may triple net lease the parked property to the taxpayer for a period that does not exceed the safe harbor parking period with lease rates set at a level intended to meet any debt service requirements and operating expense requirements borne directly by the EAT.

Step No. 6 While the parked property is held by the EAT, the taxpayer locates a buyer for the Relinquished Property and enters into a sale agreement.

Step No. 7 Taxpayer enters into an exchange agreement with a QI and assigns to the QI the taxpayer's right to dispose of the Relinquished Property to the buyer. Taxpayer also assigns to QI the right to acquire the parked property held by EAT under the QEAA.

Step No. 8 The QI causes the taxpayer to convey the Relinquished Property by "direct deed" to the buyer, who transfer the exchange proceeds to the QI. In turn, the QI uses the exchange proceeds to buy the parked property from the

EAT, who uses the same sales proceeds to satisfy any closing costs and any acquisition debt that is not intended to be assumed by the taxpayer upon completion of the exchange.

Step No. 9 Under the exchange agreement, the QI directs the conveyance of the parked property from the EAT to the taxpayer by "direct deeding" the parked property to complete the exchange.

PROS AND CONS OF EXCHANGE LAST vs. EXCHANGE FIRST:

Exchange Last (most common, park Replacement Property):

a. Where acquisition of a specific parked Replacement Property will not fully defer gain realized on disposition of the Relinquished Property, Section 1031(a)(3) periods will start later.

b. If the taxpayer is not certain about which of several Relinquished Properties will be utilized in the exchange, the decision can be made when a contract to sell one of them is made, rather than at the time the Replacement Property is acquired. [Note, however, that for transactions intended to qualify for the safe harbor under Rev. Proc. 2000-37, the taxpayer's flexibility will be limited by the 45-day identification requirement.]

c. For non-safe harbor transactions, there is less risk that the EAT will be disregarded and the taxpayer treated as having never transferred the parked property since the parked property will not have previously been owned or controlled by taxpayer.

d. Since the exchange takes place concurrently with the sale of the Relinquished Property, reconciliation of equity values can occur with knowledge of the market value of the Relinquished Property, rather than based on a value assumed at the time of the Replacement Property's purchase.

e. For build-to-suit arrangements, Exchange Last is the only option.

Exchange First (park Relinquished Property, decision often driven by lender):

a. When a lender providing outside purchase financing for acquisition of the Replacement Property requires the Taxpayer to secure the loan with a mortgage, exchange-first allows the taxpayer to execute a mortgage since the taxpayer is obtaining title to Replacement Property immediately.

b. If Replacement Property has particular management problems, immediate acquisition of title by the taxpayer may be necessary.

c. It may just be too late to change deeds already drawn and executed conveying title of Replacement Property to taxpayer.

d. For safe harbor QEAA transactions, there is no identification requirement in the exchange-first structure. The only time constraint is the 180-day period during which the EAT must dispose of the parked Relinquished Property to a third-party buyer.

FLEXIBLE ARRANGEMENTS:

The most important aspect of Rev. Proc. 2000-37 may be the flexibility that it gives to taxpayers and EATs in setting up the accommodation arrangement. An important aspect of the simplification created by Rev. Proc. 2000-37 is the express elimination of several requirements and uncertainties. Specifically, property will not fail to be treated as being held in a QEAA as a result of any one or more of the following legal or contractual arrangements, regardless of whether such arrangements contain terms that typically would result from arm's-length bargaining between unrelated parties with respect to such arrangements.

1. **Acting as QI**. An EAT may not be a disqualified person, but may serve as the QI in a simultaneous or deferred exchange of the property. This provision allows the numerous title companies and exchange accommodators that have been serving as QIs to provide one-stop shopping. The same person will serve as the EAT for the acquisition of the Replacement Property and the QI in the sale of the Relinquished Property.

2. **Financing**. The taxpayer or a disqualified person may loan or advance funds to the EAT or guarantee a loan or advance to the EAT. Rev. Proc. 2000-37 does not require that the loan bear interest, or that any charge be imposed for the loan guarantee. Assuming the EAT is not related to the taxpayer (which would not be permitted in any event under Rev. Proc. 2000-37), no interest would be required under the OID rules in Sections 1272 and 1273 on an interest-free loan, as long as the loan is for a period of less than one year. Because the maximum term of a QEAA is only 180 days, there should be no imputed-interest problem in an interest-free loan made by a taxpayer to an EAT.

3. **Loan guarantees**. The taxpayer or a disqualified person may guarantee some or all of the obligations of the EAT, including secured or unsecured debt incurred to acquire the property, or indemnify the EAT against costs and expenses. This addresses the practical problem that the EAT does not want to bear the risk of any environmental or

tort liability. The ownership of the property by the EAT is a mere fiction, which is confirmed by this type of indemnification.

4. **Leases**. The property is leased by the EAT to the taxpayer or a disqualified person. Rev. Proc. 2000-37 does not require that any rent (arm's length or otherwise) be charged with respect to such lease. Accordingly, it appears that the EAT may allow the taxpayer to use the property without charge. As a practical matter, however, the taxpayer will pay rent to the EAT equal to any debt service on the loan, if any, used by the EAT to acquire the property.

5. **Management**. The taxpayer or a disqualified person may manage the property, supervise improvement of the property, act as a contractor or otherwise provide services to the EAT with respect to the property. Even though the EAT owns the property, as a practical matter the taxpayer is responsible for everything, including improvements to the property. This is particularly important in situations involving build-to-suit arrangements, in which the EAT is holding title to the Replacement Property while the taxpayer erects improvements on the property.

6. **Puts and Calls**. The taxpayer and the EAT may enter into agreement and arrangement relating to the purchase or sale of the property, including puts an calls at fixed or formula prices, effective for a period not more than 185 days from the date the property is acquired by the EAT. This allows both the EAT and the taxpayer to assure themselves that, at the end of the QEAA, the property will be transferred by the EAT to the taxpayer Although Rev. Proc. 2000-37 specifically provides that puts and calls will not adversely affect a QEAA and also refers to "agreements or arrangements relating to the purchase or sale of the property," it does not refer to a binding contract of the EAT to sell the property to the taxpayer on a specific date. Because the EAT is merely serving as an accommodation title holder, there does not seem to be any reason why such a contract would violate the intent or purpose of Rev. Proc. 2000-37.

7. **Make whole**. In an exchange-first transaction, the EAT acquires the Relinquished Property from the taxpayer and (at least theoretically) is subject to risk from any changes in the value of the Relinquished Property. To avoid this result, the QEAA may allow the taxpayer and the EAT to enter into agreements or arrangements providing that any variation in the value of a Relinquished Property from the estimated value on the date of the EAT's receipt of the property be taken into account on the EAT's disposition of the Relinquished Property. This "make whole" provision can be accomplished through the taxpayer's advance of funds to, or receipts of funds from, the EAT.

8. **Other tax treatment**. Property will not fail to be treated as being held in a QEAA merely because the accounting, regulatory, or state, local, or foreign tax treatment of the arrangement between the taxpayer and the EAT is different from the

federal income tax treatment. Thus, although the EAT must be treated as the owner of the property for federal income tax purposes, the EAT does not have to be treated as the owner of the property for any other purposes.

This part of Rev. Proc. 2000-37 could have significant impact, particularly for accounting and state and local tax purposes. From an accounting perspective, the various permissible contractual arrangements with respect to the property usually will give the taxpayer (and not the EAT) the benefits and burdens of ownership of the property. Under generally accepted accounting principles, such property would have to be treated as an asset owned by the taxpayer. The taxpayer also could be the record owner of the property for purposes of the state and local property tax rolls, even though the taxpayer did not have legal title to the property.

This provision also could be important for transfer tax purposes. One of the significant practical problems in a reverse exchange is that transfer tax could be owned twice–once when the property is acquired by the EAT, and again when the property is acquired by the taxpayer. This problem would be avoided if the EAT were treated as the agent of the taxpayer for transfer tax purposes, in which event the acquisition of the property by the EAT would be treated as an acquisition of the Replacement Property by the taxpayer. As a result, no transfer tax would be due when the taxpayer acquires the Replacement Property from the EAT.

DISREGARDED CIRCUMSTANCES:

The latitude allowed to taxpayers by Rev. Proc. 2000-37 in structuring safe harbor reverse exchange transactions is underscored by listing some of the possible aspects of a reverse exchange ***not*** required by the new IRS ruling, including:

- The EAT is not required to have any equity investment in the parked property during the safe harbor parking period.

- The EAT can be indemnified by the taxpayer or disqualified person against costs and expenses associated with the parking transaction.

- The EAT is not required to guarantee any indebtedness incurred to acquire the parked property; and any taxpayer guarantee of the acquisition financing is permitted.

- The EAT is not required to control the management or operation of the parked property, which can effectively be delegated to the taxpayer under a management or lease agreement.

- The EAT is not required to control or supervise any construction of improvements on the parked property; the taxpayer may approve the construction contract and change orders.

- The EAT is not required to profit on the transfer of the parked property to the taxpayer; and the EAT is not required to bear any significant risk of loss for the parked property.

REMAINING PROBLEMS:

Several problems involving reverse exchanges remain to be solved, however.

1. **The 180-day limit**. The most obvious one concerns transactions in which the taxpayer is concerned that sale of the Relinquished Property, or construction of the Replacement Property, will take more than the 180 days permitted by Rev. Proc. 2000-37. In those situations, the taxpayer usually will need to avoid a QEAA because of the agency-like nature of the arrangement. Instead, the taxpayer will have to make certain that the EAT has some of the benefits and burdens of ownership for the Replacement Property. In that regard, the factors that are permitted in a QEAA provide a checklist of the arrangements to avoid (or enter into on an arm's-length basis) in a transaction that will not be subject to Rev. Proc 2000-37.

2. **Depreciation**. Another problem concerns depreciation on the property that is subject to the QEAA. Because the property must be treated for federal income tax purposes as owned by the EAT, it is clear that the taxpayer is not able to claim depreciation with respect to the property. Nevertheless, it also appears that the EAT cannot claim depreciation with respect to the property, either. Section 167 limits depreciation to property held for investment or used in a trade or business, but an EAT acquires a property with the intent to sell it to the taxpayer. Furthermore, in most situations an EAT will not even have an economic interest in the property, so it would be difficult for the EAT to claim that it suffers the economic loss that depreciation is supposed to reflect. Thus, it is questionable whether the EAT could ever claim depreciation on the property it holds subject to QEAA.

There are several aspects to the loss of depreciation on the property. First, from an economic perspective, the taxpayer will have lost the time-value benefit of depreciation during the period that the property is held in the QEAA. Although the taxpayer eventually will obtain that benefit, it is effectively postponed until the end of the recovery period for the property (i.e., the depreciation that should have been taken by the taxpayer when the EAT acquires the property is claimed, instead, at the end of the property's useful life). For commercial realty, the effect is to postpone depreciation for 39 years–a substantial loss.

Second, if the EAT needs third-party financing to acquire the property, care must be taken to avoid adverse income tax consequences to the EAT as a result of amortization of principal. In a typical debt-financial exchange-last transaction, the EAT will acquire the property using a bank loan, and the EAT will then rent the property to the taxpayer; the rent will be set at the level needed to pay debt service on the loan. The EAT will have to treat the rent as income, and the EAT can deduct interest (but not principal) payments on the loan. But because the EAT will not be entitled to claim depreciation with respect to the property, the EAT would have "phantom" income to the extent of any principal paid while the property is held by the EAT.

Any level-amortization debt will cause this problem. The problem is best avoided by arranging with the lender that principal payments on the loan will not be made until the seventh month (i.e., after the 180-day period). Alternatively, the taxpayer could "gross up" the rent payments to compensate the EAT for the additional tax liability, but this is an expensive solution to a problem that can be resolved by having the loan structured properly in the first place.

3. **Identity of the EAT**. Another problem that must be considered when a taxpayer enters into a QEAA involves who will serve as the EAT. There are at least two important aspects to this question from the taxpayer's perspective.

First, if the EAT files for bankruptcy or insolvency while holding the "taxpayer's" property, the taxpayer could suffer a significant economic loss. To minimize this risk, taxpayers should insist that the EAT be a creditworthy entity, such as a trust company or an established exchange accommodator. Furthermore, the EAT should hold property through a single-member limited liability company (LLC) formed for that purpose. Although use of an asset-holding LLC will not eliminate any bankruptcy risk to the taxpayer, it may reduce the potential adverse impact. The theory is that the interests in an asset-holding LLC will be the asset held by the bankrupt person, rather than a direct ownership of the asset. Although there is no assurance that this will protect puts and calls written by the LLC, this should give the taxpayer a good argument if the EAT goes bankrupt.

Second, the taxpayer needs to make certain that the identity of the EAT will not change through acquisition or otherwise. Although it is possible that an EAT could *merge* with a different entity without adverse tax consequences to the taxpayer, nothing in Rev. Proc. 2000-37 permits an EAT to *assign* title to another person. Thus, a taxpayer should enter into an agreement with the EAT that prohibits any assignment but permits the EAT to engage in merger transactions (so that any transfers are by operation of law rather than by assignment). Furthermore, the EAT is required to continuously hold the property that is subject to the QEAA. Therefore, the QEAA itself should contain an anti-assignment

provision, and the taxpayer should be comfortable that the chosen EAT will respect this provision.

4. **State and local taxes**. The most significant issues involving EATs will likely arise in the context of state and local taxes. As noted previously, taxpayers will want to argue that the EAT is merely its agent for such purposes, so that the EAT can be disregarded for transfer tax purposes. It is not clear whether the taxpayer will be required to pay transfer tax when the taxpayer acquires the property from the EAT. Furthermore, if the property involved is personal property, care will have to be taken to prevent local governments from charging sales and use tax on the transfers (in a exchange-last transaction, particularly the transfer from the EAT to the taxpayer). Here, the use of an LLC may help, as the LLC may merge with the taxpayer's entity to avoid a "transfer."

5. **Arm's-length arrangements**. As discussed previously, Rev. Proc. 2000-37 does not require that the EAT charge any rent to the taxpayer for the use of the property, and the taxpayer is not required to charge any interest to the EAT with respect to a loan made to the EAT. Nevertheless, because state law often will provide protection in landlord-tenant and lender-borrower situations, it usually will be advisable for the parties to enter into all of the documents that would be found in a normal, arm's-length arrangement, although the consideration that will be paid would be nominal. For example, if a taxpayer loans money to the EAT to permit the EAT to acquire the property, the taxpayer should attempt to encumber the property with a mortgage (senior lenders permitting). Likewise, it can be anticipated that EATs will want to have the right to put the property to productive use if the taxpayer fails to honor its obligation to indemnify the EAT.

UNANSWERED QUESTIONS:

Although the new guidelines clearly address most of the common tax questions faced in routine reverse exchanges, many questions remain unanswered, including:

- What is the result if the parked property is condemned or destroyed during the 180-day parking period? Is the taxpayer or only the EAT entitled to any benefits of Code §1033 for purposes of reinvesting the condemnation award or insurance proceeds?
- If an accommodation titleholder fails to satisfy the standards for an EAT established by the safe harbor, can the taxpayer nonetheless claim successfully that the acquisition of the Replacement Property by the EAT and the disposition of the Relinquished Property qualify as a pure exchange?
- Will safe harbor status be lost if the EAT resigns or is fired by the taxpayer?

- Can the taxpayer's rights under the QEAA be assigned to another related or unrelated taxpayer?

- Will the IRS entertain private letter rulings for non-safe harbor parking transactions, e.g., where the parking period exceeds one year because substantial improvements are being constructed on the parked property that cannot be completed within 180 days?

- When taxpayers structure parking exchanges outside the safe harbor, what elements of the transaction are most likely to lead the IRS to conclude that the accommodation titleholder is actually the taxpayer's agent?

- To what extent will the IRS seek to recharacterize dealings between the taxpayer and the accommodation titleholder within a "safe harbor" transaction? For example, if the taxpayer advances loans to the accommodation titleholder at less than commercial market rates (after taking into consideration the risk of the loan), will the IRS seek to input additional interest income and expense? As a further example, will the IRS seek to challenge lease rental rates when the parked property is eased by the accommodation title holder to the taxpayer at a rate that only reimburses the accommodation titleholder for its out of pocket expenses?

- Since the qualified exchange accommodation agreement must clearly indicate that the accommodation title holder is holding the parked property within the purposes of transferring it to the taxpayer, under what circumstances would the accommodation titleholder not be viewed as a "dealer" with respect to the property?

- Rev. Proc. 2000-37 states that the duration of the "parking period" is limited to 180 days. Is the 180 day period affected in any way by the earlier due date of either the taxpayer's or the accommodation titleholder's tax return for the year in which the parked property is acquired?

- A qualified exchange accommodation agreement must be entered into with five (5) business days after the accommodation titleholder acquires qualified indicia of ownership of the parked property. What is the meaning of "business days"?

- In the deferred exchange area, taxpayers are permitted to revoke identification notices within the first 45 days after the transfer of the Relinquished Property. Can a taxpayer revoke the identification of a Relinquished Property that must be made within 45 days after the accommodation titleholder acquires the parked property?

- In a deferred exchange, a taxpayer can identify any number of replacement properties, so long as their aggregate fair market value does not exceed 200 percent of the aggregate fair market value of all of the relinquished properties as of the date the relinquished properties were transferred. Rev. Proc. 2000-37 §4.02(4) incorporates these identification rules into the safe harbor for parking transactions. How does the 200% rule operate? Is the value of the relinquished properties measured at the time the Replacement Property is acquired?

Rev. Proc. 2000-37 is not a panacea. Many reverse exchanges, particularly build-to-suit arrangements, will not fall within the scope of the Procedure because 180 days is not sufficient time to construct the improvements that the taxpayer desires to acquire. In addition, there are important collateral tax consequences, such as the loss of depreciation, that the taxpayer will have to consider. From an economic perspective, there will be numerous situations in which the taxpayer is unable to obtain financing to acquire the Replacement Property before the taxpayer can sell Relinquished Property, which would make a reverse exchange economically impossible. On the other hand, Rev. Proc. 2000-37 will create tax certainty for those taxpayers who are able to qualify. Before this pronouncement, the treatment of reverse exchanges was unclear; now, taxpayers know that a reverse exchange can be engineered in appropriate circumstances. There is every reason to believe that, by providing certainty where uncertainty reigned before, Rev. Proc. 2000-37 is an important development that will be used by many taxpayers.

BUILD-TO-SUIT LIKE-KIND EXCHANGES OF REAL ESTATE

GENERAL CONCEPTS:

The transfer of the taxpayer's Relinquished Property in exchange for real estate with improvements constructed according to the taxpayer's specifications may qualify for non-recognition under Section 1031. The Regulations permit the identification of Replacement Property not in existence or which is being produced at the time it is identified. Real property, where the improvements are to be constructed, is identified in accordance with the Regulations if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practical at the time the identification is made. Preferably, the taxpayer's written identification of Replacement Property will describe the building plans and specifications.

The party constructing the improvements must not act as the taxpayer's agent. The improvements must be constructed before the taxpayer acquires the Replacement Property. The party making the improvements may acquire the land and complete the improvements solely for the purpose of making the exchange.

If new construction or improvements are to be considered Replacement Property for the purposes of IRC §1031, then the work must be completed before the taxpayer's acquisition of the Replacement Property. The taxpayer cannot pre-pay for construction services to be completed after the exchange. Improvements done after the taxpayer has acquired the property do not qualify as Replacement Property. *Bloomington Coca Cola Bottling Co. v. Commissioner,* 189 F.2d 14 (7th Cir 1951). The deferred exchange Regulations provide that "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." Regulations §1.1031(k)-1(e). **By themselves, materials and labor are merely personal property, not real property**.

During the period of construction, the Replacement Property will typically be owned by the Contractor, QI or EAT. The Exchange Agreement will need to provide for the Replacement Property to be constructed, and the QI or EAT will be responsible for all construction draw payments. Construction of the improvements must be completed, and the property must be transferred to the taxpayer, before the expiration of the 180-day period for acquisition of Replacement Property.

In determining whether the Replacement Property received by the taxpayer is substantially the same property as identified, where the identified Replacement Property is property to be produced, variations due to usual or typical production changes are not

taken into account. However, if substantial changes are made in the property to be produced, the Replacement Property received will not be considered to be substantially the same property as identified. No examples are given in the Regulations to help in a determination of what changes are substantial and which are variations due to usual or typical production changes.

CONSTRUCTION BY QI OR EAT:

If Relinquished Property can be sold first and if sufficient improvements to be Replacement Property can be completed within the 180-day exchange period, then the construction is typically done by either a QI or an EAT. Note, however, that the QI or EAT must (i) acquire a fee or fee-equivalent interest in the Replacement Property, (ii) pay for the construction of the improvements during the 180-day period, and (iii) transfer the Replacement Property, as improved, to the taxpayer before the end of the exchange period to complete the exchange.

Rev. Proc. 2000-37 Permits a QI to act as an EAT and provides that services as an EAT will not be taken into account in determining whether the QI is a disqualified person. In most instances, both the typical QI entity and the taxpayer will want to separate the QI and the EAT functions in a safe harbor reverse exchange so that the EAT can be established as a "bankruptcy remote" special purpose entity (a/k/a "**SPE**").

The deferred exchange Regulations provide specific identification requirements for property to-be-constructed during the deferred exchange period. Regulations §1.1031(k)-1(e)(2). Under Regulation §1.1031(k)-1(e)(3), a taxpayer may acquire partially completed replacement real property to-be-constructed if the property received constitutes real property under local law.

REVERSE EXCHANGE STRUCTURES:

In many situations, a taxpayer will need to acquire a Replacement Property and commence construction of improvements prior to the disposition of the Relinquished Property. If these tasks can be completed (and the Relinquished Property can be sold within 180 days), the taxpayer may engage a QI or an EAT to effect a safe harbor parking exchange. However, the time frames involved in obtaining permits, financing and construction contracts (let alone the time for the actual construction), often will acquire in excess of 180 days.

The validity of build-to-suit exchanges outside of the QI or QEAA safe harbors depends on whether the party owning the land and constructing the improvements is the taxpayer's agent.

CONSTRUCTION ON LAND OWNED BY TAXPAYER:

If the improvements are constructed on land the taxpayer owns, the transaction will not qualify under Section 1031. Improvements to the taxpayer's own real estate are not like-kind to an interest in real estate. Instead, the transaction will be described as the purchase of personal property and services, rather than an exchange of real property, and is not of the same nature or charter as a building. In effect, there is no "transfer" of an interest in real property (i.e., no deed or conveyance of qualified Replacement Property) if the improvements are constructed on real estate already owned by the taxpayer.

The taxpayer may own raw land upon which the taxpayer wishes to construct improvements. However, the taxpayer cannot construct the improvements on a property that the taxpayer already owns, because it is not like-kind under IRC §1031(a). A possible solution to this problem, but not without risk, is for the taxpayer to convey the land to the taxpayer's contractor, QI or EAT (or to another independent, unrelated third party) under the terms of an agreement whereby the taxpayer will purchase the land back with the improvements completed as the taxpayer's Replacement Property. This transaction is subject to attack by the IRS as a step transaction. The conveyance may also trigger recognition of gain on the sale of the unimproved land to the contractor, QI or EAT (or independent third party), depending upon the valuation that is placed on that property in the conveyance. As a further precaution, the taxpayer should include only the increase in value due to the construction of improvements when calculating the value of the Replacement Property to be acquired, and not include the value of the raw land that was initially owned and conveyed to the QI or EAT.

A preferable alternative for constructing improvements on land already owned by the taxpayer, but not without some risk as well, is for the taxpayer to deed the land to the EAT, require the EAT to construct the improvements, and then have the EAT create a 30-year leasehold estate between the EAT, as landlord, and the taxpayer, as tenant. The 30-year (or more) leasehold estate with the taxpayer constitutes an entirely new estate in the property, and satisfies the Replacement Property requirements. Although the term of the lease must be at least 30 years, the lease may contain early termination or buyout provisions.

In response to this Replacement Property leaseback arrangement, the IRS issued Rev. Proc. 2004-51, effective as of July 20, 2004. Essentially, Rev. Proc. 2004-51 provides that Rev. Proc. 2000-37 does not apply if the taxpayer owns the property intended to qualify as Replacement Property within 180 days before initiating a qualified exchange accommodation arrangement (QEAA). In other words, a taxpayer is directly prohibited from using Rev. Proc. 2000-37 to engage in an exchange transaction where the taxpayer purports to lease or transfer property to

an EAT, and then reacquire the property as Replacement Property (note: a leasehold estate is deemed to be part of the taxpayer's existing property).

An important distinction must be made concerning construction of improvements on land owned by the taxpayer, versus land owned by an affiliate of the taxpayer. In Letter Ruling 200251008, the taxpayer was able to use Rev. Proc. 2000-37 to construct improvements on land owned by an affiliate. This presents a planning opportunity for taxpayers who have at least 180 days before initiating a QEAA. All unimproved real property that a taxpayer may want to improve should be acquired or held by the taxpayer in separate legal entities (that are not disregarded), each of which are related to and controlled by the taxpayer.

RELATED PARTY AS CONTRACTOR:

IRC §1031(f) appears to preclude a related party from acquiring the land and constructing the improvements for the taxpayer. See PLR 9748006 (Taxpayer's acquisition of Replacement Property from his mother violates §1031(f)). A related party to the taxpayer may act as a construction contractor, however, and may enter into a construction contract with the QI or EAT, provided that the related party construction contractor does not take title to the real estate. A related party may apparently receive construction draws from the exchange proceeds without constituting constructive receipt by the taxpayer. PLR 9413006. A more prudent approach would be to disburse draws directly to suppliers and subcontractors, to help avoid any argument that the taxpayer received actual or constructive receipt of the exchange proceeds resulting in taxable boot.

IRS Revenue Ruling 2002-83, provides that a taxpayer who transfer Relinquished Property to a QI in exchange for Replacement Property formerly owned by a related party is not entitled to non-recognition treatment under Section 1031 (a), if, as part of the transaction, the related party receives cash or other non-like-kind property for the Replacement Property. Essentially, the IRS has taken the position that related party exchanges on the Replacement Property side of the transaction will be denied like-exchange treatment. The taxpayer can still convey Relinquished Property to a related party, but the taxpayer cannot acquire Replacement Property from a related party.

DEFERRED GAIN ON SALE OF REAL ESTATE
COMPARISON OF TAX CODE
Sections 1031, 1033 and 121

Requirements	**§1031**	**§1033**	**§121 (Replaced §1034)**
Use of Property	Investment	Investment or Primary Residence	Primary Residence (include in-home business)
Replacement Property Value	Equal or Greater	Equal or Greater	N/A
Replacement Property Debt	Meet or Exceed Former Debt	No Requirement to Match Debt	N/A
Replacement Property Cash	Meet or Exceed Cash from Sale of Relinquished Property	No Requirements to Invest Certain Amount of Cash	N/A
Time to Complete	45 days to I.D., and 180 days to Close (or tax return filing date)	3 years After Close of First Tax Year Realized	N/A
Holding Period Before Next Sale or Exchange	No Specific Time; Intent Controls	No Specific Time	2 Years out of last 5 years occupied as principal residence*
Qualified Intermediary or EAT Required	Yes	No	N/A
Recognition of Gain Deferred	Yes	Yes	N/A
Exclusion of Qualified Gain ($250,000, or $500,000 if married)	No	No	Yes (every 2 years)*

***As of October 22, 2004, IRC § 121 which governs the exclusion of gain from the sale of a principal residence was revised to require a 5-year holding period following an exchange before you can sell a residence and exclude the gain under IRC § 121. The IRS issued *Rev. Proc. 2005-14*, effective as of January 27, 2005. This Revenue Procedure provides guidance on the application of both IRC § 121 and IRC § 1031 to a single residential property**.

Internal Revenue Code §1031
Exchange of Real Property Held for Productive Use or Investment

(a) **Nonrecognition of gain or loss from exchanges solely in kind**.

(1) **In general**.
No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment.

(2) **Exception for real property held for sale**.
This subsection shall not apply to any exchange of real property held primarily for sale.

(3) **Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property**.
For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if -

a) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

b) such property is received after the earlier of–

(i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or
(ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

(b) **Gain from exchanges not solely in kind**.

If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) **Loss from exchanges not solely in kind**.

If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(d) **Basis**.

If property was acquired on an exchange described in this section, section 1035(a), section 1036(a), or section 1037(a), then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by this section, section 1035(a), section 1036(a), or section 1037(a), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. For purposes of this section, section 1035(a), and section 1036(a), where as part of the consideration to the taxpayer another party to the exchange assumed (as determined under section 357(d)) a liability of the taxpayer, such assumption shall be considered as money received by the taxpayer on the exchange.

(e) **Application to certain partnerships**.

For purposes of this section, an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.

(f) **Special rules for exchanges between related persons**.

(1) **In general**.
If--

(A) a taxpayer exchanges property with a related person,

(B) there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange of such property (determined without regard to this subsection), and

(C) before the date 2 years after the date of the last transfer which was part of such exchange--

(i) the related person disposes of such property, or

(ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer,

there shall be no nonrecognition of gain or loss under this section to the taxpayer with respect to such exchange; except that any gain or loss recognized by the taxpayer by reason of this subsection shall be taken into account as of the date on which the disposition referred to in subparagraph (C) occurs.

(2) **Certain dispositions not taken into account**.
For purposes of paragraph (1)(C), there shall not be taken into account any disposition--

(A) after the earlier of the death of the taxpayer or the death of the related person,

(B) in a compulsory or involuntary conversion (within the meaning of section 1033) if the exchange occurred before the threat or imminence of such conversion, or

(C) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.

(3) **Related person**.
For purposes of this subsection, the term "related person" means any person bearing a relationship to the taxpayer described in section 267(b) or 707(b)(1).

(4) **Treatment of certain transactions**.
This section shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection.

(g) **Special rule where substantial diminution of risk**.

(1) **In general**.

If paragraph (2) applies to any property for any period, the running of the period set forth in subsection (f)(1)(C) with respect to such property shall be suspended during such period.

(2) **Property to which subsection applies**.
This paragraph shall apply to any property for any period during which the holder's risk of loss with respect to the property is substantially diminished by--

(A) the holding of a put with respect to such property,

(B) the holding by another person of a right to acquire such property, or

(C) a short sale or any other transaction.

(h) **Special rules for foreign real property**.

Real property located in the United States and real property located outside the United States are not property of a like kind.

(i) **Repealed**.

REVERSE EXCHANGE PROCEDURE

Revenue Procedure. 2000-37; 2000-40 IRB 1 (September 15, 2000)

Part III
Administrative, Procedural, and Miscellaneous

26 CFR 1.1031(a)-1: Property held for productive use in trade or business or for investment; 1.1031(k)-1: Treatment of deferred exchanges.

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor under which the Internal Revenue Service will not challenge (a) the qualification of property as either "Replacement Property" or "Relinquished Property" (as defined in section 1.1031(k)-1(a) of the Income Tax Regulations) for purposes of section 1031 of the Internal Revenue Code and the regulations thereunder or (b) the treatment of the "exchange accommodation titleholder" as the beneficial owner of such property for federal income tax purposes, if the property is held in a "qualified exchange accommodation arrangement" (QEAA), as defined in section 4.02 of this revenue procedure.

SECTION 2. BACKGROUND

2.01 Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.

2.02 Section 1031(a)(3) provides that property received by the taxpayer is not treated as like-kind property if it: (a) is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the Relinquished Property; or (b) is received after the earlier of the date that is 180 days after the date on which the taxpayer transfers the Relinquished Property, or the due date (determined with regard to extension) for the transferor's federal income tax return for the year in which the transfer of the Relinquished Property occurs.

2.03 Determining the owner of property for federal income tax purposes requires an analysis of all of the facts and circumstances. As a general rule, the party that bears the economic burdens and benefits of ownership will be considered the owner of property for federal income tax purposes. See Rev. Rul. 82-144, 1982-2 C.B. 34.

2.04 On April 25, 1991, the Treasury Department and the Service promulgated final regulations under section 1.1031(k)-1 providing rules for deferred like-kind exchanges under section 1031(a)(3). The preamble to the final regulations states that the deferred exchange rules under section 1031(a)(3) do not apply to reverse-Starker exchanges (i.e., exchanges where the Replacement Property is acquired before the Relinquished Property is transferred) and consequently that the final regulations do not apply to such exchanges. T.D. 8346, 1991-1 C.B. 150, 151; see Starker v. United States, 602 F.2d 1341 (9th Cir. 1979). However, the preamble indicates that Treasury and the Service will continue to study the applicability of the general rule of section 1031(a)(1) to these transactions. T.D. 8346, 1991-1 C.B. 150,151.

2.05 Since the promulgation of the final regulations under section 1.1031(k)-1, taxpayers have engaged in a wide variety of transactions, including so-called "parking" transactions, to facilitate reverse like-kind exchanges. Parking transactions typically are designed to "park" the desired Replacement Property with an accommodation party until such time as the taxpayer arranges for the transfer of the Relinquished Property to the

ultimate transferee in a simultaneous or deferred exchange. Once such a transfer is arranged, the taxpayer transfers the Relinquished Property to the accommodation party in exchange for the Replacement Property, and the accommodation party then transfers the Relinquished Property to the ultimate transferee. In other situations, an accommodation party may acquire the desired Replacement Property on behalf of the taxpayer and immediately exchange such property with the taxpayer for the Relinquished Property, thereafter holding the Relinquished Property until the taxpayer arranges for a transfer of such property to the ultimate transferee. In the parking arrangements, taxpayers attempt to arrange the transaction so that the accommodation party has enough of the benefits and burdens relating to the property so that the accommodation party will be treated as the owner for federal income tax purposes.

2.06 Treasury and the Service have determined that it is in the best interest of sound tax administration to provide taxpayers with a workable means of qualifying their transactions under section 1031 in situations where the taxpayer has a genuine intent to accomplish a like-kind exchange at the time that it arranges for the acquisition of the Replacement Property and actually accomplishes the exchange within a short time thereafter. Accordingly, this revenue procedure provides a safe harbor that allows a taxpayer to treat the accommodation party as the owner of the property for federal income tax purposes, thereby enabling the taxpayer to accomplish a qualifying like-kind exchange.

SECTION 3. SCOPE

3.01 **Exclusivity**. This revenue procedure provides a safe harbor for the qualification under section 1031 of certain arrangements between taxpayers and exchange accommodation titleholders and provides for the treatment of the exchange accommodation titleholder as the beneficial owner of the property for federal income tax purposes. These provisions apply only in the limited context described in this revenue procedure. The principles set forth in this revenue procedure have no application to any federal income tax determinations other than determinations that involve arrangements qualifying for the safe harbor.

3.02 **No Inference**. No inference is intended with respect to the federal income tax treatment of arrangements similar to those described in this revenue procedure that were entered into prior to the effective date of this revenue procedure. Further, the Service recognizes that "parking" transactions can be accomplished outside of the safe harbor provided in this revenue procedure. Accordingly, no inference is intended with respect to the federal income tax treatment of "parking" transactions that do no satisfy the terms of the safe harbor provided in this revenue procedure, whether entered into prior to or after the effective date of this revenue procedure.

3.03 **Other Issues**. Services for the taxpayer in connection with a person's role as the exchange accommodation titleholder in a QEAA shall not be taken into account in determining whether that person or a related person is a disqualified person (as defined in section 1.1031 (k)-1(k)). Even though property will not fail to be treated as being held in a QEAA as a result of one or more arrangements described in section 4.03 of this revenue procedure, the Service still may recast an amount paid pursuant to such an arrangement as a fee paid to the exchange accommodation titleholder for acting as an exchange accommodation titleholder to the extent necessary to reflect the true economic substance of the arrangement. Other federal income tax issues implicated, but not addressed, in this revenue procedure include the treatment, for federal income tax purposes, of payments described in section 4.03(7) and whether an exchange accommodation titleholder may be precluded from claiming depreciation deductions (e.g., as a dealer) with respect to the Relinquished Property or the Replacement Property.

3.04 **Effect of Noncompliance**. If the requirements of this revenue procedure are not satisfied (for example, the property subject to a QEAA is not transferred within the time period provided), then this revenue procedure does not apply. Accordingly, the determination of whether the taxpayer or the exchange accommodation titleholder is the owner of the property for federal income tax purposes, and the proper treatment of any transactions entered into by or between the parties, will be made without regard to the provisions of this revenue procedure.

SECTION 4. QUALIFIED EXCHANGE ACCOMMODATION ARRANGEMENTS

4.01 **Generally**. The Service will not challenge the qualification of property as either "Replacement Property" or "Relinquished Property" (as defined in section 1.1031(k)-1(a)) for purposes of section 1031 and the regulations thereunder, or the treatment of the exchange accommodation titleholder as the beneficial owner of such property for federal income tax purposes, if the property is held in a QUALIFIED EXCHANGE ACCOMMODATION AGREEMENT

4.02 **Qualified Exchange Accommodation Arrangements**. For purposes of this revenue procedure, property is held in a QEAA if all of the following requirements are met:

(1) Qualified indicia of ownership of the property is held by a person (the "exchange accommodation titleholder") who is not the taxpayer or a disqualified person and either such person is subject to federal income tax or, if such person is treated as a partnership or S corporation for federal income tax purposes, more than 90 percent of its interests or stock are owned by partners or shareholders who are subject to federal income tax. Such qualified indicia of ownership must be held by the exchange accommodation titleholder at all times from the date of acquisition by the exchange accommodation titleholder until the property is transferred as described in section 4.02(5) of this revenue procedure. For this purpose, "qualified indicia of ownership" means legal title to the property, other indicia of ownership of the property that are treated as beneficial ownership of the property under applicable principles of commercial law (e.g., a contract for deed), or interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (e.g., a single member limited liability company) and that holds either legal title to the property or such other indicia of ownership;

(2) At the time the qualified indicia of ownership of the property is transferred to the exchange accommodation titleholder, it is the taxpayer's bona fide intent that the property held by the exchange accommodation titleholder represent either Replacement Property or Relinquished Property in an exchange that is intended to qualify for nonrecognition of gain (in whole or in part) or loss under section 1031;

(3) No later than five business days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, the taxpayer and the exchange accommodation titleholder enter into a written agreement (the "qualified exchange accommodation agreement") that provides that the exchange accommodation titleholder is holding the property for the benefit of the taxpayer in order to facilitate an exchange under section 1031 and this revenue procedure and that the taxpayer and the exchange accommodation titleholder agree to report the acquisition, holding, and disposition of the property as provided in this revenue procedure. The agreement must specify that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with this agreement;

(4) No later than 45 days after the transfer of qualified indicia of ownership of the Replacement Property to the exchange accommodation titleholder, the Relinquished Property is property identified. Identification must be made in a manner consistent with the principles described in section 1.1031(k)-1(c). For purposes of this section, the taxpayer may properly identify alternative and multiple properties, as described in section 1.1031(k)-1(c)(4);

(5) No later than 180 days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, (a) the property is transferred (either directly or indirectly through a qualified intermediary (as defined in section 1.1031(k)-1(g)(4))) to the taxpayer as Replacement

Property; or (b) the property is transferred to a person who is not the taxpayer or a disqualified person as Relinquished Property; and

(6) The combined time period that the Relinquished Property and the Replacement Property are held in a QEAA does not exceed 180 days.

4.03 **Permissible Agreements**. Property will not fail to be treated as being held in a QEAA as a result of any one or more of the following legal or contractual arrangements, regardless of whether such arrangements contain terms that typically would result from arm's length bargaining between unrelated parties with respect to such arrangements:

(1) An exchange accommodation titleholder that satisfies the requirements of the qualified intermediary safe harbor set forth in section 1.1031(k)-1(g)(4) may enter into an exchange agreement with the taxpayer to serve as the qualified intermediary in a simultaneous or deferred exchange of the property under section 1031;

(2) The taxpayer or a disqualified person guarantees some or all of the obligations of the exchange accommodation titleholder, including secured or unsecured debt incurred to acquire the property, or indemnifies the exchange accommodation titleholder against costs and expenses;

(3) The taxpayer or a disqualified person loans or advances funds to the exchange accommodation titleholder or guarantees a loan or advance to the exchange accommodation titleholder;

(4) The property is leased by the exchange accommodation titleholder to the taxpayer or a disqualified person;

(5) The taxpayer or a disqualified person manages the property, supervises improvement of the property, acts as a contractor, or otherwise provides services to the exchange accommodation titleholder with respect to the property;

(6) The taxpayer and the exchange accommodation titleholder enter into agreements or arrangements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, effective for a period not in excess of 185 days from the date the property is acquired by the exchange accommodation titleholder; and

(7) The taxpayer and the exchange accommodation titleholder enter into agreements or arrangements providing that any variation in the value of a Relinquished Property from the estimated value on the date of the exchange accommodation titleholder's receipt of the property be taken into account upon the exchange accommodation titleholder's disposition of the Relinquished Property through the taxpayer's advance of funds to, or receipt of funds from, the exchange accommodation titleholder.

4.04 **Permissible Treatment**. Property will not fail to be treated as being held in a QEAA merely because the accounting, regulatory, or state, local, or foreign tax treatment of the arrangement between the taxpayer and the exchange accommodation titleholder is different from the treatment required by section 4.02(3) of this revenue procedure.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for QEAAs entered into with respect to an exchange accommodation titleholder that acquires indicia of ownership of property on or after September 15, 2000.

CLASSIFICATION OF TRANSACTIONAL ITEMS

Item	Exchange Expense	Non-exchange Expense	Other/Non LKE Property
Appraisal costs incurred for Lender		x (Loan Cost)	
Attorney's Fee	x		
City/County tax/Stamp	x		
Closing Fee	x		
Commissions	x		
Delivery Charges	x		
Demand Fee	x		
Disclosure Fee	x		
Discount Points		x (Loan Cost)	
Document Prep Fees	x		
Environmental Reports	x		
Exchange Fees	x		
Federal Express	x		
Fix-up Expenses	x		
Flood Insurance		x (Loan Cost)	
Forwarding Fees	x		
Hazard Insurance		x	
Home Warranty/Ins	x		
Homeowners and Condo Assn. Dues		x	
Homeowners and Condo Assn. Transfer charges	x		

Item	Exchange Expense	Non-exchange Expense	Other/Non LKE Property
Impound Balances			x (Cash)
Interest earned by taxpayer			x (Taxable income)
Interest expense		x (Deduction)	
Intermediary fees	x		
Loan fees paid by Buyer for Buyer		x (Deduction)	
Loan fees paid by Seller for Buyer	x		
Loan fees		x (Loan Cost)	
Messenger fees	x		
Notary fees	x		
Origination fees		x (Loan Cost)	
Other loan costs		x (Loan Cost)	
Other personal property			x (Taxable boot)
Pest inspection fee	x		
Phase I Environmental	x		
Processing fees	x		
Processing fees - loans		x (Loan Cost)	
Property taxes		x (Loan Cost or taxable)	
QI fees	x		
Reconveyance fee	x		
Recording fees	x		
Rental income			x (Taxable income)
Repairs - not fix-up/selling costs		x (Deduction)	
Repairs - strictly selling expenses	x		

Item	**Exchange Expense**	**Non-exchange Expense**	**Other/Non LKE Property**
Sales commission	x		
Security deposits		x (Taxable boot)	
Seller carryback note			x
Settlement or closing fees	x		
State tax stamps	x		
Survey	x		
Tax service		x (Loan Cost)	
Termite report	x		
Title insurance	x		
Transfer taxes	x		
Warehouse fee		x (Loan Cost)	
Wire transfer fees	x		