

**ADVANCED ISSUES UNDER CODE SECTION 1031**

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SECTIONS OF REAL PROPERTY, PROBATE AND TRUST AND TAXATION  
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## I. REVERSE EXCHANGES

### A. History

1. The preamble to the deferred exchange Regulations
  - (a) characterized such an exchange as one in which the taxpayer acquired the replacement property before selling the relinquished property;
  - (b) indicated that the Regulations did not apply to reverse exchanges and that the Service would continue to study the applicability of the Regulations to reverse exchanges.
2. The Internal Revenue Service has long recognized that taxpayers were carrying out so-called “reverse” exchanges since issuance of the deferred exchange Regulations in 1991
3. Between 1991 and 2000 there were no PLR’s, Revenue Rulings, cases nor TAM’s disallowing reverse exchanges and it appeared that the Service did not intend to challenge them
4. In September, 2000, the Service announced Rev. Proc. 2000-37 providing a safe harbor for reverse exchanges

### B. Requirements of Revenue Procedure 2000-37

1. Theory of the Rev. Proc.
  - (a) If the Service had challenged the typical reverse exchange parking arrangement, it would likely have been on the theory that the accommodator held the replacement property as the taxpayer’s agent and that there was no exchange because the taxpayer constructively owned the replacement property, and could not acquire it from himself in an exchange
  - (b) The original Rev. Proc. addresses this as the issue in reverse exchanges by providing that so long as the safe harbor is followed, the Service will not challenge the qualification of property as either replacement property or relinquished property, nor treat the accommodator as the agent of the taxpayer
  - (c) The Rev. Proc. has just been revised in Rev. Proc. 2004-51 to modify this language but it still makes clear that if held in a qualified exchange accommodation arrangement the qualified exchange accommodation titleholder will be treated as the beneficial owner

2. Qualified Exchange Accommodation Arrangement

- (a) The Rev. Proc. confirms that the parking arrangements typically used to structure reverse exchanges will work and in fact such a structure is required to meet the rules of the safe harbor
- (b) The taxpayer must enter into a “qualified exchange accommodation arrangement” with an accommodator called a “qualified exchange accommodation titleholder (a “QEAT”) pursuant to which it holds the relinquished or replacement property
  - (1) The QEAT must have “qualified indicia of ownership” of the property.
  - (2) An exchange accommodation titleholder may not be the taxpayer or a disqualified person within the meaning of the deferred exchange Regulations:
    - (i) someone who was the agent of the exchanging party during the 2-year period prior to the transfer of the relinquished properties such as employees, attorneys, accountants, investment bankers or brokers, real estate agents or brokers, or a “related party” within the meaning of Sections 267 (b) or 707 (b) of the Code, substituting 10% for 50%), and
    - (ii) must be someone subject to Federal income tax.

3. Qualified Indicia of Ownership

- (a) “Qualified indicia of ownership” means legal title to the property and other indicia of ownership treated as beneficial ownership under commercial law
- (b) The party which bears the economic burdens and benefits of ownership will be considered the owner of the property for Federal income tax purposes and to have “qualified indicia of ownership
- (c) The QEAT must pay the expenses of ownership of the property and be entitled to any income earned from it during the period of ownership, and such income and expenses must be treated for tax purposes as the accommodator’s

4. Intent to exchange

- (a) During the period of ownership by the exchange accommodation titleholder it must be the *bona fide* intent of the taxpayer to qualify the transaction as a Section 1031 exchange

- (b) Within five business days after acquisition of either the replacement property or the relinquished property by the accommodator, it must enter into a written agreement with the taxpayer providing that
  - (i) the accommodator holds the property for the benefit of the taxpayer in order to facilitate an exchange under Section 1031;
  - (ii) they agree to report the acquisition, holding, and disposition of the property as provided in the Rev. Proc.;
  - (iii) the exchange accommodation titleholder will be treated as the beneficial owner of the property for all Federal income tax purposes; and
  - (iv) both parties must report the Federal income tax attributes of ownership of the property on their tax returns consistently with this requirement.

5. Time limits

- (a) Prior to the Rev. Proc. taxpayers often had open reverse exchanges for long periods of time
- (b) The Rev. Proc. imposes time limits for completion of the exchange:
  - (1) The taxpayer must identify the relinquished property to be exchanged for the replacement property within 45 days of transfer of the replacement property to the accommodator
  - (2) The 3 property/200%/95% rules of Reg. Sec. 1.1031(k)-1(c)(4) apply to designation
  - (3) No later than 180 days after transfer of either property to the exchange accommodation title holder, the exchange must be completed by transfer of the replacement property to the taxpayer or the relinquished property to an unrelated buyer
  - (4) Soon after the Rev. Proc. the Service announced that the 180-day time limit is unlikely to change. James Sowell, associate tax legislative counsel told a session of the ABA Section of Taxation on October 13, 2000 that it expected a lot of comments to the 180-day time limit, but nevertheless issued the Rev. Proc. because officials were “quite confident” that the 180-day limit was what they preferred.

He indicated that the safe harbor “target audience” was the smaller, less sophisticated owner, and that the 180-day limit was sufficient for them

- (5) The 180-day time limit makes reverse build-to-suit and multi-property relinquished property exchanges much more difficult to structure

6. Other Permissible Terms of a QEAA

- (a) The same accommodator entity can serve as both the exchange accommodation titleholder and the qualified intermediary in the forward exchange
- (b) The taxpayer may guaranty debt incurred by the accommodator to acquire the replacement property and “indemnify” the accommodator against the costs of ownership
- (c) The taxpayer may loan the funds necessary to acquire the replacement property to the accommodator
- (d) The property can be leased to the taxpayer or a disqualified person. Could the taxpayer build on or improve the property pursuant to such a lease while the QEAT holds legal indicia or ownership?
- (e) The taxpayer or a disqualified person can manage the property, supervise its renovation or improvement or provide any services to the accommodator in connection with the property
- (f) Open issues
  - (1) Must the promissory note evidencing the loan from the taxpayer to the accommodator for purchase of the replacement property bear interest under Code Section 7872?
    - (i) Code Sec. 483 which provides for allocation to unstated interest, provides that the section applies to payments on account of the sale or exchange of property which constitutes part of the purchase price which are due more than six months after the date of the sale or exchange and under which the payments are due more than a year after the sale or exchange.
    - (ii) Since notes in reverse exchanges are due in 180 days, it appears that such notes need not bear interest under this Code section.

- (2) What about payment of interest on the debt incurred to buy the replacement property which is certainly a “property related expense” under the Rev. Proc.?
  - (i) The taxpayer could be the borrower and the QEAT would give a third-party mortgage or deed of trust (non-recourse) to secure the debt.
  - (ii) This structure was approved in PLR 200251008 (discussed below)
- (3) The Rev. Proc. permits the taxpayer to “indemnify” the QEAT for property related expenses and QEAT’s typically require that
- (4) The accommodator must recognize rental income, and can deduct property expenses. What if excess income is earned while the accommodator holds title? The taxpayer will want the excess funds to be paid to him upon completion of the exchange, but how is that income to be characterized?
  - (i) Since the taxpayer was not the owner for tax purposes of the property, neither the income nor the offsetting deductions can be passed through to the taxpayer and the Rev. Proc. requires that in order to treat the accommodator as the owner of the property for tax purposes that it must be entitled to retain any profits earned from ownership
  - (ii) Presumably accommodators will want to retain sufficient rental income to pay tax on the income from the property
  - (iii) The Rev. Proc does not address these allocation issues. Since the accommodator must treat itself as the owner for tax purposes of the replacement property, a conservative structure of the reverse exchange might provide the following:
    - 1) Income is first used to pay property expenses;
    - 2) The QEAT retains sufficient funds from excess income to pay any tax liability on net operating income;

- 3) Excess net operating income is next used to offset fees charged to the taxpayer by the accommodator for handling the exchange;
- 4) Remaining net income is used to pay off the note to the exchanging party at closing; and
- 5) If proceeds of sale of relinquished property plus remaining net operating income exceeds the note balance, it is paid to the taxpayer as interest on the promissory note

C. Post Revenue Procedure Rulings

1. Technical Advice Memorandum 200039005

(a) On September 29, 2000, two weeks after issuing the reverse exchange Rev. Proc., the Service issued a TAM which disallowed a reverse exchange

(b) Facts: This taxpayer had intended to enter into a deferred exchange, but at closing the sale of the relinquished property fell through. The seller of the replacement property demanded that the taxpayer complete the closing of that purchase, so the taxpayer borrowed the funds necessary to purchase the replacement property, and paid the purchase price directly to the seller, but had the seller convey the property to the accommodator. The taxpayer apparently did not enter into an exchange agreement of any kind with the accommodator. At a later date the taxpayer sold the relinquished property, entered into an exchange agreement, exchanged the relinquished property for the replacement property, and reported the transaction as a Section 1031 exchange

(c) Held:

(1) The transaction was a reverse exchange and as noted in the preamble to the deferred exchange Regulations the Regulations and the safe harbors therein do not apply to reverse exchanges

(2) The qualified intermediary safe harbor of the deferred exchange Regulations was not available to the taxpayer because he did not enter into an exchange agreement with the accommodator, a requirement for the accommodator to be a qualified intermediary

(3) Since the accommodator did not qualify as an intermediary under the deferred exchange Regulations, it was deemed to

hold the replacement property as the taxpayer's agent, and because the taxpayer failed to enter into an exchange agreement it followed that the disposition of the relinquished property and acquisition of the replacement property were treated as separate and not an integrated exchange transaction

- (d) This ruling reinforces the theory of the reverse exchange Rev. Proc., the deferred exchange Regulations, and the post-Starker cases with a giant exclamation point!
  - (1) The taxpayer paid for the replacement property directly but directed that it be deeded to the accommodator.
  - (2) The accommodator could not be treated as the owner of the property for tax purposes because it had not paid for the property.
  - (3) Accommodator held as agent or nominee for the taxpayer.
  - (4) The taxpayer failed to enter into an exchange agreement it could not qualify under the deferred exchange Regulations, and had it concluded the transaction after the issuance of the Rev. Proc. he would not have met its requirements for the safe harbor.

2. DeCleene v Comm'r

- (a) In November of 2000, the Service for the first time disallowed a reverse exchange
- (b) Facts:
  - (1) Taxpayer owned property used in his trade or business.
  - (2) Located replacement property and acquired it directly with loan proceeds
  - (3) After acquiring the replacement property, an interested buyer made an offer to buy the existing property and taxpayer's accountant suggested a 1031 exchange structured by having the taxpayer quitclaim the new property to the buyer who constructed a building on the new property, then exchanged it with the taxpayer for the existing business property. The buyer paid for the property with a nonrecourse note due in a single payment, and paid the construction costs with a nonrecourse loan from the exchanging party's bank.

(4) Held:

- (i) The exchange was not subject to the reverse exchange revenue procedure because it occurred prior to its issuance
  - (ii) The buyer did not have an economic interest in the to-be replacement property and the parties treated the ownership by the buyer of the replacement property as having no economic significance because of the nonrecourse debt and the fact that the buyer had no liability even for property taxes.
  - (iii) Because the taxpayer made no effort to structure the parking arrangement as a reverse exchange with the economic burdens and benefits of ownership in the replacement property vested in the buyer/accommodator, the transaction was disallowed.
- (c) The court was clearly applying the principles of the reverse exchange Revenue Procedure, even though it held that the Revenue Procedure did not apply to the transaction, by requiring that the taxpayer respect the parking arrangement as one in which the intermediary bore the benefits and burdens of ownership of the property.
- (d) The failure of this taxpayer to make any attempt to document the transaction as a reverse exchange is consistent with the most basic principle of exchange common law: the taxpayer must demonstrate intent to exchange by documenting the interdependency of the sale of the relinquished property and the purchase of the replacement property. This taxpayer failed in every way to document the transaction as an exchange.

3. Private Letter Ruling 200251008

- (a) Taxpayer arranged a reverse build to suit exchange as follows:
- (1) Taxpayer agreed to sell relinquished property
  - (2) The replacement property was a leasehold leased by a corporation and subleased to an LLC which were both related to taxpayer
  - (3) Improvements were to be built on the leasehold replacement property by a single member LLC of which

QEAT was the member (“Titleholder”) after conveyance of the leasehold to Titleholder

- (4) The replacement property would be transferred to Taxpayer by transfer of the membership interest in Titleholder
- (5) The reverse build to suit exchange was structured to comply with all requirements of Rev. Proc. 2000-37

(b) Held:

- (1) Because Titleholder is a disregarded entity QEAT will be deemed to enter into any contract Titleholder enters into and to perform any activity Titleholder performs.
- (2) The transfer of all the interest in Titleholder to taxpayer will be treated as a transfer of the assets of Titleholder.
- (3) The leasehold interest owned by QEAT is sufficient to meet the qualified indicia of ownership interest (the leasehold was more than 30 years and was thus like kind with the fee simple relinquished property)
- (4) Because Titleholder is disregarded
  - (i) Ownership of the replacement property by titleholder is treated as ownership by QEAT
  - (ii) Acquisition of Titleholder by taxpayer is treated as acquisition of its assets by Taxpayer

D. Revenue Procedure 2004-51 Amending Revenue Procedure 2000-37

1. Modification of Section 1 (Purpose)

- (a) Current provision: *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.*

- (b) Revised provision: *This revenue procedure provides a safe harbor under which the Internal Revenue Service will treat an exchange accommodation titleholder as the beneficial owner of 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.*
- (c) Reason for change:
  - (1) Deleted the provision that Service will not “challenge” the qualification of the properties which precluded taxpayers from having to establish that the QEAT bore the burdens of ownership. Taxpayers interpreted this to mean that they could transfer replacement property to a QEAT and receive back the same property as replacement property thus shifting basis between two properties
  - (2) Confirms that an exchange of property for improvements constructed on land or improvements constructed on land owned by the same taxpayer does not meet the requirements of §1031

2. Modifications of Section 4 (Qualified Exchange Accommodation Arrangements)

- (a) Current provision (Section .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 QEAA.*
- (b) Revised provision: *In general. The Service will treat an exchange accommodation titleholder as the beneficial owner of property for federal income tax purposes if the property is held in a QEAA. Property held in a QEAA may, therefor, qualify as either “replacement property” or “relinquished property” (as defined in §1.1031(k)-1(a)) in a tax-deferred like-kind exchange if the exchange otherwise meets the requirements for deferral of gain or loss under § 1031 and the regulations thereunder.*
- (c) Added new section 4.05: Limitation. *This revenue procedure does not apply to replacement property held in a QEAA if the property owned by the taxpayer within the 180-day period ending on the date of transfer Review of qualified indicia of ownership of the property to an exchange accommodation titleholder.*

3. Read together the modifications are apparently intended to limit the ability of taxpayers to transfer relinquished property to a QEAT and then reacquire the property following disposition of other relinquished property and thus shift the basis of the relinquished property to another property recently held by the taxpayer

## II. BUILD TO SUIT EXCHANGES

### A. Improvements as Replacement Property

1. An exchange of property for improvements constructed on land or improvements constructed on land owned by the same taxpayer does not meet the requirements of §1031. Rev. Proc. 2004-51
  - (a) Improvements alone are not like kind with real estate even though improved real estate qualifies
  - (b) Improvements constructed after acquisition would be deemed post-closing construction which is not like-kind under Reg. §1.1031(k)-1(e)(3)(iii)
  - (c) Exchange funds cannot be released for payment of construction costs because the improvements are not like kind property
2. Exchanging party can arrange with seller to construct improvements according to his specs, and even control the process, then acquire the property “turn key” for price of land plus improvements in a “build-to-suit” exchange. PLR 91-49018 and PLR 94-13006

### B. Seller Accommodated Build To Suit Exchange

1. Seller agrees to build improvements to exchanging party’s specifications
2. Funds for construction can be borrowed directly by seller of build-to-suit property secured by property, but often seller does not want that level of involvement
  - (a) Seller could also borrow against replacement property but he would want the loan to be non-recourse as to him.
  - (b) Seller might have the lender loan directly to the exchanging party, and give a non-recourse mortgage of the replacement property
3. Exchanging party can borrow against other property (one possibility is the relinquished property), then loan to the seller/builder secured by a note and mortgage or deed of trust on the build-to-suit replacement property

4. Seller and buyer enter into an agreement covering the terms of the loan and construction project and providing that when building is done, seller will convey it to buyer for a price equal to the price of the land plus the actual hard and soft costs of construction
5. While building is being constructed, buyer/exchanging party sells relinquished property or properties, and funds are deposited in an exchange account but the exchange funds cannot be used to pay construction costs because the exchanging party is not entitled to have the benefit of the funds
6. Upon completion, replacement property is acquired for the cash in exchange accounts plus additional funds necessary to pay the purchase price.
7. Most difficult problem in these transactions for the exchanging party is borrowing sufficient funds to do the construction because exchange account funds resulting from sale of the relinquished property cannot be used,
  - (a) If the exchanging party borrows against the relinquished property, the loan balance will be paid down at sale of each relinquished property so that equity in relinquished property has been used to pay for construction
  - (b) Exchange funds cannot even be pledged to secure a loan to fund construction because the Regs. provide that the exchanging party is to have no right to “pledge, borrow or otherwise obtain the benefits of the funds”

C. Exchange Accommodator Build to Suit Exchange

1. Reverse exchange which must comply with Rev. Proc. 2000-37 including completion of the exchange within 180 days of parking the replacement property
2. Receipt of replacement property to be produced
  - (a) Identification
    - (1) identified replacement property received must be substantially the same as identified property to be produced
    - (2) 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

- (3) but variations due to usual or typical production changes are not taken into account.
  - (4) 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
  - (5) if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time the identification is made the property will be treated as having been identified
- (b) Receipt
- (1) if the identified replacement property is not completed before closing, the property received will be considered to be substantially the same property as identified only if the property received constitutes real property under local law
  - (2) if multiple properties are being relinquished undivided interests can be acquired equal to exchange value as improvements are completed within 180-day exchange periods

### **III. RELATED PARTY EXCHANGES**

#### **A. The Code**

##### **1. Section 1031(f)(1)**

- (a) if a taxpayer acquires replacement property from a related person or sells relinquished property to a related person; and
- (b) before 2 years after the date of the last transaction in the exchange, the related person disposes of the relinquished property or the taxpayer disposes of the replacement property, the exchange is disallowed
- (c) Related person means a person defined bearing a relationship defined in §267 (b) or §707(b)(1)
- (d) Legislative history of this section indicates that the Service was concerned about “basis shifting” in adopting this provision

- (1) Taxpayer owns Blackacre with FMV of \$1,000,000 and basis of \$100,000 and his father owns Whiteacre with FMV of \$1,000,000 and a basis of \$900,000
- (2) If Taxpayer wants to sell Blackacre and first trades for Whiteacre with father, and father sells then sells Blackacre, father will have a \$900,000 basis in Blackacre and will recognize only \$100,000 of gain
- (3) By requiring father to hold Blackacre for at least 2 years the transactions become “old and cold”

2. Section 1031(f)(4)

- (a) §1031 does not apply to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of §1031(f)
- (b) Example of a transaction violating Section 1031(f)(4) in the legislative history
  - (1) Taxpayer wants to exchange and acquire replacement property from a related party
  - (2) Taxpayer has his buyer buy the replacement property from the related party then trade it for the relinquished property with the taxpayer
  - (3) taxpayer would not acquire any property from a related party and the related party would not trade with or sell to the taxpayer so the related party rules would not apply
- (c) This transaction is clearly structured to avoid §1031(f)(4) and would cause the exchange to be disallowed

3. Operation of Sections 1031(f)(1) and (4)

- (a) A taxpayer who sells relinquished property to a third party and buys replacement property from a related party has exactly the same result as a taxpayer which has the related party sell to the buyer and who then trades with the buyer
  - (1) Unrelated third party gets taxpayers property
  - (2) Related party gets buyers money
  - (3) Taxpayer gets related party’s property

- (b) Difference is only in the route to the result
  - (1) §1031(f)(1) means that if you deal directly with a related party, and either related party gets property in the exchange, the party who gets the property in the exchange is subject to the two-year rule
  - (2) §1031(f)(4) means if taxpayer does not deal directly with a related party but either party gets property in the exchange that you have structured to avoid §1031(f)(1) and the exchange is disallowed because acquisition was indirect

B. The Negative Rulings

1. TAM 9748006, TAM 200126007 and PLR 2002-83 all involved purchase of replacement property by taxpayer
  - (a) No taxpayer disposed of replacement property within 2 years
  - (b) All taxpayers properly structured the exchange and used a qualified intermediary
  - (c) Rights under replacement property contract were assigned to the exchange accommodator and replacement properties were directly deeded to the exchanging party in order to qualify the intermediary
  - (d) All exchanges were disallowed on the theory that use of the accommodator was a violation of 1031(f)(4) because the replacement property was first “transferred” to a party other than the taxpayer
  - (e) PLR 200251008 which allowed a reverse build to suit exchange had identical facts (a qualified intermediary was used both to facilitate the build to suit exchange and to transfer the replacement property in the forward exchange) but the transaction was approved
2. Effect of the Rulings
  - (a) The essence of the rulings must have been to treat the transaction as if the taxpayer had first traded with the related party and the related party had then sold the relinquished property thus violating the 2-year rule
  - (b) Service hinted at this in the first TAM because it noted that the taxpayer ended up with the related party’s property and the related party ended up with the cash in the exchange

- (c) The rulings (and those who agree with them) say that because the taxpayer got the result that would have occurred if the fact pattern of the legislative history had been followed (conveyance of replacement property first to an unrelated third party followed by a trade with the taxpayer) that you should recharacterize the transactions as if that had in fact occurred

3. Are the Rulings Correct?

- (a) A transaction in which exchanging party deals directly with related party cannot by definition violate 1031(f)(4) and exchanging party or related party are subject to 1031(f)(1)
- (b) Transactions with qualified intermediaries do not “cleanse” the transaction with a related party and therefore do not taint the transaction as an attempt to structure around 1031(f)(1)
  - (1) “Transfer” to QI is procedural not substantive
  - (2) Required to qualify the intermediary
  - (3) The QI is not the agent of EP
  - (4) Purpose of “acquisition” is to transfer the right to the funds only
    - (i) Transfer of relinquished property contract rights transfers right to receive payment only
    - (ii) Transfer of replacement property contract rights transfers right to buy the property using the funds
  - (5) Transfer is not literal in a real estate sense
- (c) The Service was apparently applying the step transaction doctrine by viewing the results of the transaction and disregarding the clear view of the Tax Court that the form of an exchange transaction is as important as the substance and that the form will not be disregarded nor the step transaction doctrine applied

*The exchange requirement poses an analytical problem because it runs headlong into the familiar tax law maxim that the substance of a transaction controls over form. In a sense, the substance of a transaction in which the taxpayer sells property and immediately reinvests the proceeds in like-kind property is not much different from the substance of a transaction in which two parcels are exchanged without cash. Yet, if the exchange requirement is to have any significance at all, the perhaps formalistic difference*

*between the two types of transactions must, at least on an occasion, engender different results. Bell Lines v. U.S., 73-2 USTC 9524 , 480 F2d 710, 711 (4th Cir. 1973)*

- (d) The Tax Court and other Federal Courts refuse to apply the step transaction doctrine in exchanges where the taxpayer has
    - (1) Observed the integrated transaction rule by entering into an exchange agreement, and
    - (2) Observed the no control of funds rule
  - (e) Effect is to collapse the transactions as if a different series of transactions occurred
  - (f) Writes 1031(f)(1) out of the Code
    - (1) No taxpayer which uses an accommodator can qualify a related party exchange
    - (2) A taxpayer who holds replacement property for 2 years loses
4. Private Letter Ruling 200251008 permitting a reverse build to suit exchange in which a related party conveyed a leasehold interest to the QEAT approved the exchange but made no mention of the use of an accommodator and in fact noted that it was a “related party” exchange

#### **IV. TENANT IN COMMON INTERESTS**

##### **A. The History**

1. The difficulty of finding suitable replacement property within the limited 45-day identification period has spawned companies that acquire large parcels of land and commercial properties and then sell small tenant in common interests to taxpayers as replacement properties in exchanges.
2. This practice came to the attention of the Service and because so many taxpayers were seeking private letter rulings as to whether such interests would qualify as replacement property or constituted partnership interests, and the Service first announced that it would not issue any rulings while it studied the matter. Rev. Proc. 2000-46
3. The Service subsequently announced Rev. Proc. 2002-22 specifying the conditions under which it will consider a request for a ruling that an undivided fractional interest in real property (other than a mineral property as defined in Code Sec. 614 ) is not an interest in a business entity within

the meaning of §301.7701-2(a) of the Procedure and Administration Regulations

B. Revenue Procedure 2002-22

1. Describes when the Service will give a letter ruling on acquisition of a tenant in common interest.
2. Includes a lengthy, detailed analysis of the factors which would lead to the conclusion that a tenant in common interest is in fact a partnership interest and not an interest in real estate and specifies the conditions under which the Service will consider a ruling request that an undivided fractional interest in real property is not an interest in a business entity, within the meaning of Reg. §301.7701-2(a)
3. Describes the regulations which define whether an organization is an entity separate from its owners for federal tax purposes
  - (a) the determination is not based upon whether it is an entity under state law;
  - (b) determined by whether the participants carry on a trade, business, financial operation or venture and divide the profits from their joint activities.
4. Co-ownership of property that is maintained, kept in repair and rented or leased does not *per se* constitute a separate entity for federal tax purposes.
5. A business entity for tax purposes contrasted with a tenancy in common. Tenancy in common is characterized by
  - (a) each participant owning individually a physically undivided part of the entire parcel of property;
  - (b) being entitled to share with the other owners in possession of the property; and
  - (c) having the right to a proportionate share of rents or profits from the property, to transfer the interest and to demand a partition of the property.

C. Information to be Submitted.

1. The name, taxpayer identification number, and percentage fractional interest in property of each co-owner;

2. The name, taxpayer identification number, ownership of, and any relationship among, all persons involved in the acquisition, sale, lease and other use of property, including the sponsor, lessee, manager and lender;
3. A full description of the property;
4. A representation that each of the co-owners holds title to the property (including each of multiple parcels of property treated as a single property under this revenue procedure) as a tenant in common under local law;
5. All promotional documents relating to the sale of fractional interests in the property;
6. All lending agreements relating to the property;
7. All agreements among the co-owners relating to the property;
8. Any lease agreement relating to the property;
9. Any purchase and sale agreement relating to the property;
10. Any property management or brokerage agreement relating to the property; and
11. Any other agreement relating to the property, including agreements relating to any debt secured by the property (such as guarantees or indemnity agreements) and any call and put options relating to the property.

D. Conditions for Rulings

1. Tenancy in Common Ownership. Each of the co-owners must hold title to the property (either directly or through a disregarded entity) as a tenant in common under local law
2. Number of Co-Owners. The number of co-owners must be limited to no more than 35 persons.
3. No Treatment of Co-Ownership as an Entity. The co-ownership cannot
  - (a) file a partnership or corporate tax return,
  - (b) conduct business under a common name,
  - (c) execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity.

The Service generally will not issue a ruling under this revenue procedure if the co-owners held interests in the property through a partnership or corporation immediately prior to the formation of the co-ownership.

4. Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that may
  - (a) run with the land
  - (b) providing for such things as offering the co-ownership interest for sale to the other co-owners, the sponsor or the lessee at fair market value before exercising any right to partition, or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the property.
5. Voting. The co-owners must retain the right to approve
  - (a) the hiring of any manager,
  - (b) the sale or other disposition of the property,
  - (c) any leases of a portion or all of the property,
  - (d) the creation or modification of a blanket lien,
  - (e) the sale, lease or re-lease of a portion or all of the property,
  - (f) negotiation or renegotiation of indebtedness secured by a blanket lien,
  - (g) the negotiation of any management contract must be by unanimous approval of the co-owners.
6. Restrictions on Alienation. Each co-owner must have the rights to
  - (a) transfer, partition, and encumber his or her undivided interest in the property without the agreement or approval of any person,
  - (b) restrictions on the right to transfer, partition, or encumber interests in the property imposed by a lender, rights of first refusal, and an obligation of co-owners to first offer it to other co-owners before seeking partition are not prohibited.
7. Sharing Proceeds and Liabilities upon Sale of Property. If the property is sold, debt secured by a blanket lien must be paid and the remaining sales proceeds distributed to the co-owners.

8. Proportionate Sharing of Profits and Losses. Each co-owner must share in
  - (a) all revenues generated by the property and all costs associated with the property in proportion to the co-owner's undivided interest in the property;
  - (b) advances to a co-owner to meet expenses associated with the property must be with recourse with repayment required in not less than 31 days.
9. Proportionate Sharing of Debt. The co-owners must be liable for indebtedness secured by a blanket lien in proportion to their undivided interests.
10. Options.
  - (a) An option to purchase a co-owner's undivided interest must be at fair market value at the time the option is exercised.
  - (b) A co-owner may not acquire an option to sell the co-owner's undivided interest to the sponsor, the lessee, another co-owner or the lender, or any person related to the sponsor, the lessee, another co-owner or the lender.
11. No Business Activities. The co-owners' activities with respect to the property must be limited to maintenance and repair of rental real property (customary activities).
12. Management and Brokerage Agreements. The co-owners may and the manager must
  - (a) enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee.
  - (b) authorize the manager a common bank account for the collection and deposit of rents and to pay property expenses, obtain and modify insurance, negotiate leases or indebtedness, subject to approval of the co-owners.
  - (c) disburse shares of net revenues within 3 months from the date of receipt of the revenues.
  - (d) fees paid to the manager must not depend in whole or in part on the income or profits derived from the property and may not exceed the fair market value of the manager's services.

13. Leasing Agreements.
  - (a) All leasing arrangements must be bona fide leases for federal tax purposes at fair market value.
  - (b) The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales).
14. Loan Agreements. The lender holding a blanket lien may not be a related person to any co-owner, the sponsor, the manager or any lessee of the property.
15. Payments to Sponsor. The payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must be at fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the property.

E. Revenue Procedure 2004-86

1. Taxpayer exchanged real property for an interest in a Delaware statutory trust
2. A Delaware statutory trust is an unincorporated association recognized as an entity separate from its owners under Delaware law
3. The Delaware statutory trust described in the ruling is deemed an investment trust, under § 301.7701-4(c), that will be classified as a trust for federal tax purposes
4. A taxpayer may exchange real property for an interest in the Delaware statutory trust described in the ruling without recognition of gain or loss under §1031, if the other requirements of §1031 are satisfied.

**V. DEFERRED EXCHANGE SAFE HARBOR SECURITY ARRANGEMENTS**

A. Exchange Funds. The Internal Revenue Code and the regulations do not regulate how the "exchange funds" held by a qualified intermediary in a deferred exchange are invested pending the acquisition of a replacement property. The Regulations do establish "safe harbors" for certain security arrangements. These safe harbors create a mechanism for protecting the exchange funds until they are needed for the acquisition of the replacement property.

B. Safe Harbors. The Regulations provide that certain tax principles, such as agency and constructive receipt, essentially will be disregarded if one of the safe harbors is used. The two most important broad categories of four safe harbors are:

1. A security to guarantee arrangement: a taxpayer may insist that the obligation of the transferee to transfer the replacement property may be secured by guaranteed by one or more of the following:
  - (a) a mortgage, deed of trust, or security interest in property (other than cash or a cash equivalent);
  - (b) a standby letter of credit which satisfies all of the requirements for a standby letter of credit delivered under the installment sale rules;
  - (c) a guarantee of a third party.
2. A qualified escrow or qualified trust arrangement: the escrow holder and the trustee cannot be disqualified persons and the escrow agreement and the trust agreement must expressly limit the taxpayer's right to receive, pledge, borrow or otherwise obtain the benefits of the exchange funds.

## **VI. DISREGARDED ENTITIES**

A. Advantages. Disregarded entities are advantageous in the context of a tax deferred exchanges. Because a single owner limited liability company is disregarded for federal income tax purposes, if title to replacement property in a tax-deferred exchange is taken by a single owner limited liability company owned by the exchange taxpayer, the taxpayer will be treated as completing the Section 1031 exchange. PLR 985001.

B. Parking Transactions. In the context of a safe harbor parking transaction, a QEAT can acquire the required qualified indicia of ownership by owning the sole membership interest in a single owner limited liability company.

C. Lender Requirements. Lenders often insist that title to replacement property be held by a special purpose entity in order to protect the security interest of the lender. Problems arise when the lender insists on the formation of a limited liability company to own the replacement property in circumstances where the relinquished property was owned by co-tenants or by a husband and wife.

D. DST's. Rev. Rul. 2004-86, involving the "disregarded status" of a Delaware statutory trust treated as a "disregarded" grantor trust, sanctions the use of a different form of "disregarded entity" in certain limited circumstances.

## **VII. PARTNERSHIP ISSUES**

Tax deferred exchanges involving partnerships and partners create unique tax issues, many of which were addressed by the American Bar Association -Tax Section in a request for guidance in February, 2001. A copy of the ABA-Tax Section Report is attached to this outline as Appendix A.

## **VIII. UNRESOLVED ISSUES**

Guidance is still lacking for many issues commonly encountered in tax deferred exchanges. Almost ten years ago, the American Bar Association-Tax Section requested guidance from the Internal Revenue Service on the open issues addressed in the report attached to this outline as Appendix B.

APPENDIX A

JOINT REPORT ON IRC SECTION 1031  
OPEN ISSUES INVOLVING PARTNERSHIPS

Release Date: FEBRUARY 21, 2001

February 21, 2001

The Honorable Charles O. Rossotti  
Commissioner  
Internal Revenue  
Room 3000  
1111 Constitution Avenue, NW  
Washington, DC 20224

Re: **Joint Report on [IRC Section 1031](#)** Open Issues Involving  
Partnerships

Dear Commissioner Rossotti:

[1] I am enclosing comments on the above noted [Section 1031](#) as prepared by members of the Committees on Sales, Exchanges and Basis; Partnerships; and Real Estate. Principal responsibility was exercised by Mary Foster, Bellevue, WA; Ronold Platner, Snell & Wilmer LLP, Phoenix, AZ; John Schmalz, PricewaterhouseCoopers, Washington, DC. Substantive contributions were made by Adam Handler, PricewaterhouseCoopers, Los Angeles, CA; Louis S. Weller, Deloitte & Touche LLP, San Francisco, CA.

[2] These comments represent the individual views of those members who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

William J. Wilkins  
Vice Chair, Communications  
American Bar Association  
Washington, D.C.

Enclosure:

cc: The Honorable Stuart L. Brown, Chief Counsel, Internal Revenue  
Service

Jonathan Talisman, Acting Assistant Secretary, Tax Policy,  
Department of Treasury

\* \* \* \* \*

**JOINT REPORT ON [IRC SECTION 1031](#) OPEN ISSUES  
INVOLVING PARTNERSHIPS**

[3] The following report represents the individual views of the members of the Section of Taxation who prepared them and does not represent the position of the American Bar Association or the Section of Taxation.

[4] The comments in this Joint Report ("Report") were prepared by individual members of the following three Tax Section Committees: Sales, Exchanges and Basis; Partnerships; and Real Estate. Principal responsibility was exercised by Mary Foster, Ron Platner, and John Schmalz, and the report reflects their personal views. Substantive contributions were made by Adam Handler and Lou Weller. The Report was reviewed by Howard Levine of the Section's Committee on Government Submissions and by Stanley Blend, Council Director for the Committee on Sales, Exchanges and Basis.

[5] Although members of the Section of Taxation who participated in preparing the Report have clients who would be affected by the federal tax principles addressed by the Report or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of the Report.

Contact Person:

Ronold Platner  
(602) 382-6256  
[rplatner@wlaw.com](mailto:rplatner@wlaw.com)

Date: February 8, 2001

\* \* \* \* \*

**JOINT REPORT ON [IRC SECTION 1031](#) OPEN ISSUES  
INVOLVING PARTNERSHIPS**

INTRODUCTION

[6] The purpose of this Report is to propose answers to a number of open questions that arise in the context of partnership [Section 1031](#) /1/ exchanges. The issues discussed in this Report represent questions that arise in everyday practice and have not been resolved by published guidance.

[7] Many like kind exchanges are undertaken regularly by taxpayers of relatively modest means. Many of these exchanges are frequently consummated by partners with property distributed to them by partnerships in anticipation of an exchange. The goal of this Report is to encourage the Internal Revenue Service to issue guidance that addresses areas of concern to taxpayers attempting to understand and apply [Section 1031](#) in a partnership context.

[8] It is common for taxpayers holding property through a partnership (including limited liability companies treated as partnerships for income tax purposes) to attempt: (i) to dissolve and liquidate the partnership in order to permit each partner to separately sell or consummate a subsequent [Section 1031](#) exchange, (ii) to distribute undivided interests in

the relinquished property to some partners to allow partner-specific 1031 exchanges, or (iii) to use special allocations at the partnership level to reflect the scope of participation by specific partners in partnership level exchanges.

[9] Clarification is needed of the legal standards to be applied when: (i) a relinquished property was formerly held by a partnership and distributed to one or more partners in anticipation of an exchange, (ii) a relinquished property is held by a partnership and only some of the partners desire to participate (indirectly) in the exchange, and (iii) a replacement property received in an exchange is transferred to a partnership. In our experience, each of these transactions are common and existing guidelines do not lead to clear conclusions. Further, published guidance also does not address how [Section 752\(b\)](#) and [Section 465](#) should be applied in the context of exchanges.

[10] The liquidation of an entire partnership and the distribution of co-tenancy interests in a prospective relinquished property can be successfully accomplished for income tax purposes, but for commercial reasons such transactions are often complicated and represent an unduly expensive route for preparing for a [Section 1031](#) exchange. For example, a closely held partnership holding encumbered and improved real estate must typically obtain lender consent before liquidating and distributing co-tenancy interests to its former partners. Property management issues involving tenants of the prospective relinquished property and vendors of various services to the property often complicate resulting co-tenancy arrangements.

[11] Tax characterization issues also complicate the day-to-day operations of a co-tenancy arrangement because of the uncertainty about the scope of a valid protective [Section 761](#) election out of Subchapter K.

[12] Such complications often compel taxpayers to seek other means of accomplishing the same end result: a [Section 1031](#) exchange.

[13] Many of the legal issues confronting taxpayers would become irrelevant or far less important if the "qualified use" /2/ standard for [Section 1031](#) exchanges was clarified to make clear that: (i) qualified use by a distributing partnership or a contributing partner can be attributed to the distributee partner or recipient partnership where the new owner's basis is determined by reference to the old owner's basis and (ii) by recognizing that partnership level exchanges with boot can be combined with valid [Section 704\(b\)](#) allocations to effectively retire or partially liquidate the interest of a partner with boot proceeds.

[14] This report is presented in a question and answer format to identify the commonly encountered issues in applying [Section 1031](#) in the partnership context. The answers represent the recommended clarification to address these partnership [Section 1031](#) open issues.

#### DISCUSSION OF PARTNERSHIP [SECTION 1031](#) OPEN ISSUES: QUESTIONS AND ANSWERS

Q-1 Can like-kind property satisfy the "qualified use" requirement, under the following circumstances:

a. If the relinquished property is distributed to one or more partners by a partnership in anticipation of the distributee's transfer of the property in an exchange?

b. If like-kind replacement property received by a partnership

in an exchange is distributed to one or more partners by the partnership immediately following the exchange?

c. If like-kind property is contributed to a partnership in anticipation of the partnership's transfer of the property in an exchange?

d. If like-kind property is contributed to a partnership following its receipt by the contributing partner as replacement property in an exchange?

A-1 Yes, in all cases, if the person or entity who owns the relinquished or replacement property immediately before the exchange does not intend to liquidate the investment or to convert the relinquished property or replacement property to a personal purpose, the taxpayer engaging in the exchange has satisfied the qualified use requirement. Transferring either replacement property or prospective relinquished property to a partner who does not sell the property or convert it to a personal use should not bar the satisfaction of the qualified use standard by distributor/partnership or the distributee/partner. Similarly, if a partner contributes prospective relinquished property or replacement property to a partnership in a transfer governed by [Section 721](#), the receiving partnership or the contributing partner should be viewed as satisfying the qualified use standard.

[15] The IRS has been unwilling to attribute an entity's qualified use to the taxpayer before or after a tax free transfer to or from the entity. For example, in [Rev. Rul. 75-292](#), the IRS found that the taxpayer had not held the replacement property for qualified use when, immediately after the exchange, the taxpayer contributed the replacement property to his wholly-owned corporation. In [Rev. Rul. 77-337](#), the IRS found that a taxpayer had not held the relinquished property for a qualified use when the taxpayer received the relinquished property as a liquidating distribution from his wholly-owned corporation and then immediately exchanged the relinquished property for a replacement property.

[16] Similarly, in [Rev. Rul. 84-121, 1984-2 C.B. 168](#), the IRS ruled that property acquired by a taxpayer for purposes of acquiring another property upon exercise of an option could not be transferred to the owner of the optimal property in a [Section 1031](#) exchange because the taxpayer had not held the relinquished property for a qualified use.

[17] The IRS has cited some of these rulings in a partnership context in [TAM 9645005](#), in ruling that a partner who received a distribution of partnership property immediately prior to a sale under [Section 1033\(g\)](#) had not held the property for a qualified use. ([Section 1033\(g\)](#) has a qualified use requirement similar to [Section 1031\(a\)\(1\)](#)).

[18] However, it is not necessary to "attribute" a predecessor owner's purpose in holding a property to a subsequent holder of the same property in order to satisfy the qualified use requirement. In *Bolker v. Commissioner*, 181 TC 782 (1983), aff'd [760 F.2d 1039 \(CA9 1985\)](#), the taxpayer entered into an exchange agreement the same day he received the relinquished property in a liquidating distribution from his wholly-owned corporation in a tax free liquidation governed by former [Section 333](#). The exchange closed three months later. The Court held that if a taxpayer does not intend to liquidate the relinquished property or use it for personal pursuits, then the taxpayer satisfies the qualified use requirement. Thus, the most appropriate interpretation of the qualified use requirement is an interpretation that facilitates like kind exchanges that do not represent an effort to "cash in" the taxpayer's investment.

[19] In [Maloney v. Commissioner, 93 TC 89 \(1989\)](#), /3/ a corporation exchanged real property and, at the time of the exchange, intended to liquidate and distribute the replacement property to its shareholders. One month following the exchange, the corporation did liquidate (tax free under former [Section 333](#)), distributing the replacement property to the shareholders. The Court found that the exchange satisfied the qualified use requirement because there was continuity of investment even though there was a change in the form of ownership. The taxpayers had not "cashed in" their investment and continued to have an economic interest in the same investment. The Court concluded that a [Section 1031](#) exchange may be preceded or followed by a tax free transfer under [Section 721](#).

[20] The IRS did not appeal or issue a nonacquiescence with respect to the Maloney case, which may suggest that the IRS may not be prepared to litigate this issue, notwithstanding the earlier holdings in [Rev. Rul. 75-292](#), [Rev. Rul. 77-337](#), and [Rev. Rul. 84-121](#).

[21] In [Magneson v. Commissioner, 753 F.2d 1490 \(9th Cir. 1985\)](#) aff'd [81 TC 767 \(1983\)](#), the taxpayer exchanged a fee interest in real property for an undivided interest in another property in a [Section 1031](#) exchange. Immediately thereafter, the taxpayer contributed the replacement property to a partnership in a transaction governed by [Section 721](#). The contribution of the replacement property to the partnership was treated as a continuation of the taxpayer's investment in another form and not a liquidation of the taxpayer's investment, and the [Section 1031](#) exchange was respected by the courts.

[22] There is no compelling policy reason why [Section 1031](#) should be administered in a manner that imports a vague or indefinite temporal holding period requirement into [Section 1031\(a\)\(1\)](#). The statute does not literally impose a durational requirement.

[23] The ABSENCE of taxpayer intent to liquidate an investment in the subject property or convert the subject property to a personal use should be recognized as the appropriate standard for satisfying the "qualified use" test of [Section 1031](#). Such a standard is most consistent with the judicial precedents. /4/

Q-2 Can a [Section 1031](#) deferred exchange be completed if the partnership that transferred the relinquished property is terminated under [Section 708\(b\)\(1\)\(B\)](#) because of the sale or exchange of 50% or more of the capital or profits interest in the partnership?

A-2 Yes, the new partnership that arises out of the [Section 708\(b\)\(1\)\(B\)](#) termination can acquire the replacement property to complete the [Section 1031](#) exchange.

[24] Under [Treas. Reg. section 1.708-1\(b\)\(1\)\(iv\)](#), upon the termination of a partnership, the terminating partnership contributes all of its assets to a new partnership in exchange for an interest in the new partnership and, immediately thereafter, the terminated partnership distributes the interests in the new partnership to the purchasing partner and to the remaining partners in the terminated partnership in proportion to their respective interests in the terminated partnership.

[25] Under [Sections 704\(b\)](#), 704(c) and 737, the effects of a [Section 708\(b\)\(1\)\(B\)](#) termination are disregarded. The capital accounts of the partners in the terminated partnership are carried over to the new partnership. [Treas. Reg. section 1.704-1\(b\)\(2\)\(iv\)\(1\)](#). See also [Treas. Reg. section 1.704-3\(a\)\(3\)\(i\)](#), section 1.737-2(a). The holding period and the character of the terminated partnership's assets in the hands of the new partnership are determined under the general rules for contributions of property to a partnership. [Treas. Reg. section 1.708-1\(b\)\(1\)\(iv\)](#).

[26] The overall effect of [Treas. Reg. section 1.708-1\(b\)\(l\)\(iv\)](#) and the related changes made under other regulations has been to minimize or eliminate any artificial adverse effect of a partnership termination caused by [Section 708\(b\)\(1\)\(B\)](#). There is no policy reason why a like-kind exchange, which "straddles" a [Section 708\(b\)\(1\)\(B\)](#) termination, should fail to be governed by [Section 1031](#) because a "new" partnership completes the exchange. The new partnership should be viewed as a continuation of the old partnership for purposes of [Section 1031](#).

[27] The principles of this treatment can be illustrated by the following example:

EXAMPLE NO 2(a)

[28] ABCD, a limited liability company ("ABCD") owns Whiteacre, which has an adjusted basis of \$ 100,000 and a fair market value of \$ 400,000. ABCD is treated as a partnership for income tax purposes.

[29] A has a 40% interest in the capital, profits and losses of ABCD. Each of B, C and D have a 20% interest in the capital, profits and losses of ABCD. ABCD begins a deferred exchange and transfer Whiteacre to a qualified intermediary under an exchange agreement. Thereafter, A and B sell their interests in ABCD to X for \$ 240,000 before ABCD acquires Blackacre as a replacement property. A and B collectively own a 60% interest in the profits and capital of ABCD. Consequently, the purchase by X of the 60% interest causes the ABCD partnership to terminate under [Section 708\(b\)\(1\)\(B\)](#). Nevertheless, for purposes of [Section 1031](#), the new partnership of XCD is viewed as a continuation of ABCD. The result in this illustration would not change if, alternatively, X acquired the 60% interest in ABCD immediately before the transfer of Whiteacre or immediately after the acquisition of Blackacre. /5/ /6/

Q-3 In connection with a [Section 1031](#) exchange can a partnership make special allocations of the "boot" gain recognized pursuant to [Section 1031\(b\)](#) exchange, including historical pre-contribution gain governed by [Section 704\(c\)](#)?

PART ONE -- [SECTION 704\(b\)](#) ISSUE

A-3 We believe that gain recognized by a partnership in a partially tax deferred exchange governed by [Section 1031\(b\)](#) may be specially allocated to one or more partners under [Section 704\(b\)](#), if such recognized gain is appropriately reflected in the partners' respective capital accounts and such allocation has substantial economic effect.

[30] The most appropriate application of [Section 704\(b\)](#) is illustrated in the following examples, which illustrate circumstances where a [Section 704\(b\)](#) allocation should be recognized. However, not all attempted allocations of "boot" gain should be recognized, as noted in the last example in this portion of the Report.

EXAMPLE NO. 3(a)

[31] ABC limited liability company ("LLC") was formed in 199X by individuals A, B and C, each of whom contributed \$ 100,000 in cash in exchange for a one-third interest in the profits, losses and capital of LLC. ABC is treated as a partnership.

[32] The operating agreement for LLC provides that allocations of income, gain, loss and deduction are reflected in the member's respective capital accounts, and liquidating distributions, including in complete retirement or redemption of a member's interest would

be made in accordance with the member's capital account balances.

[33] LLC purchased Whiteacre, a rental office building, for \$ 300,000 in cash.

[34] In 200X, the adjusted basis of Whiteacre has been reduced to \$ 200,000 through straight line depreciation deductions and the fair market value of Whiteacre had increased to \$ 600,000. At that time, A agrees with B and C that A's one-third interest in LLC should be fully retired and liquidated for the amount of \$ 200,000, representing one-third of the fair market value of the assets of LLC.

[35] LLC enters into a contract to exchange Whiteacre for Blackacre, which has a fair market value of \$ 400,000, plus \$ 200,000 in cash. Immediately before the exchange, the capital account of each of A, B and C is \$ 66,667. The LLC has no other significant assets and no liabilities at that time.

[36] Immediately prior to the closing of the exchange, A, B and C agree to modify their operating agreement for LLC such that \$ 133,333 of the "boot" gain recognized in the exchange for Blackacre and \$ 200,000 in cash is specially allocated to A, thereby increasing her capital account to \$ 200,000. (In the [Section 1031\(b\)](#) exchange, LLC will realize \$ 400,000 of gain, of which \$ 200,000 will be recognized.) The remaining \$ 66,667 of "boot" gain is allocated equally to B and C. A also agrees to accept a cash distribution of \$ 200,000 from LLC in complete retirement of A's interest in the LLC. B and C agree to continue the LLC indefinitely as equal members, and B and C intend that the LLC will hold Blackacre for productive use in LLC's trade or business.

[37] The disproportionate allocation of \$ 133,333 of gain to A and \$ 66,667 to B and C should be recognized as a valid [Section 704\(b\)](#) allocation because the allocation has substantial economic effect and is consistent with the respective partner interests of A, B and C under two alternative tax analyses.

#### (i) VALUE EQUALS BASIS ANALYSIS

[38] The economic effect of the disproportionate allocation of boot gain to A is substantial because the second to the last sentence in [Treas. Reg. section 1.704-1\(b\)\(2\)\(iii\)\(c\)](#) (i.e., the so-called "value-equals-basis rule") provides that "for purposes of section 1.704-1(b)(2)(iii), the adjusted basis of partnership property . . . will be presumed to be the fair market value of such property, and adjustments to the adjusted basis of such property will be presumed to be matched by corresponding changes in such property's fair market value. Thus, there can not be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by gain or loss from the disposition of property." Accordingly, because at the time of the special gain allocation, it is assumed that the fair market value and adjusted basis of Blackacre are \$ 200,000 and neither the IRS nor ABC could presume the existence of \$ 200,000 of gain inherent in Blackacre to "charge back" to B and C. Thus, B and C are deemed to bear the burden of the disproportionate gain allocation to A in the form of a relatively smaller increase in the capital account balances of B and C. Objective facts indicating that Blackacre actually retained its fair market of \$ 400,000 are, therefore, ignored under the value-equals-basis analysis.

#### (ii) ALTERNATIVE ECONOMIC ANALYSIS

[39] Alternatively, the special allocations to A, B and C have "substantial economic effect," within the meaning of [Treas. Reg. section 1.704-1\(b\)\(2\)\(1\)](#), because the allocations will be reflected in the capital accounts of A, B and C, and A's adjusted capital account balance of \$

200,000 will determine the liquidating distributions made to A. [Treas. Reg. section 1.704-\(B\)\(2\)\(ii\)\(b\)\(2\)](#).

[40] The economic effect of the allocation made to A is "SUBSTANTIAL" because, as an objective economic matter, A will not participate in the future economic profits or losses attributable to Blackacre after his interest in LLC is retired.

[41] Under [Treas. Reg. section 1.704-1\(b\)\(2\)\(iii\)\(a\)](#), the economic effect of an allocation is "substantial" if there is a "reasonable possibility" that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. There is more than a "reasonable possibility" that the special allocation to A will affect the dollar amount received by A because B and C, as the remaining partners, will incur all of the economic risk and potential profit associated with Blackacre, the replacement property.

[42] [Treas. Reg. section 1.704-1\(b\)\(2\)\(iii\)\(b\)](#) and (c) describe two types of special allocations that are not recognized as "substantial." The first type is referred to as a "shifting tax consequence" allocation. (For example, allocating all taxable interest income to one partner and all tax-exempt interest income to another partner in the same dollar amount.) Such allocations fail because they result in net increases and decreases in capital accounts that do not differ substantially from the net increase and decrease that would occur in the absence of the special allocation. See [Treas. Reg. section 1.704-1\(b\)\(5\)](#) example (6), (7)(ii), (iii) and (10)(ii).

[43] The second type of "insubstantial allocation" is the so-called "transitory allocation," where the original allocation will be largely offset by one or more offsetting allocations. (For example, an allocation of tax loss in one year to a partner combined with a promise that an offsetting allocation of taxable income will be made in the following year.) The allocation of gain to A attributable to \$ 133,333 of the cash boot is neither a prohibited "transitory allocation" NOR a "shifting tax consequence" allocation.

[44] Finally, [Treas. Reg. section 1.704-1\(b\)\(2\)\(iii\)](#) establishes a "catchall" prohibition against any allocation if ". . . at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequence of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocations were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequence of no partner will, in present value terms, be substantially DIMINISHED compared to such consequences if the allocation were not contained in the partnership agreement." Example (5) and Example (9) of [Treas. Reg. section 1.704-1\(b\)\(5\)](#) illustrate the application of the "catchall" prohibition. Neither of these examples suggest that a special allocation of gain to a retiring partner should be barred by the "catchall" prohibition.

[45] The application of this "catchall" prohibition is unclear in the context of a retiring partner; however, a pragmatic approach would not apply the prohibition in this instance, where there is a strong likelihood that the after-tax economic consequences to A, as a former partner of LLC, will be substantially diminished by the special allocation to A because A will no longer participate in the partnership's future gains or losses attributable to its replacement property investment in Blackacre. Permitting a special allocation of gain in this situation also will simplify the application of [Section 704\(b\)](#) in the context of the retirement of a partner who does not wish to participate in a partnership's continuing investment in a Partnership's [Section 1031](#) replacement property. Thus, under the alternative analysis, the special allocation to A also should be recognized.

EXAMPLE NO. 3(b)

[46] Assume the same facts in example 3(a), but assume that ABC amended its operating agreement before the exchange in order to allocate all of the \$ 200,000 "boot" gain to A, increasing her capital account to \$ 266,667. However, upon liquidation and retirement of A's interest, she receives only \$ 200,000 in cash. The purported special allocation of the entire \$ 200,000 of boot gain to A would not be recognized, and only \$ 133,333 of such disproportionate allocation to A would be recognized, which would increase her capital account balance to \$ 200,000.

PART TWO -- [SECTION 704\(c\)](#) ISSUE

[47] If property contributed to a partnership has a basis to the contributing partner (a "[Section 704\(c\)](#) Partner") that is more or less than its fair market value, the property has a built in gain or loss and such property is referred to as "[Section 704\(c\)](#) property." [Treas. Reg. section 1.704-3\(a\)\(3\)](#). /7/

[48] A partnership that disposes of property with a built in gain or loss is required to allocate any remaining built in gain or loss to the 704(c) Partner in order to prevent the shifting of tax consequences among partners with respect to such built in gain or loss. [Section 704\(c\)\(1\)\(A\)](#).

[49] [Treas. Reg. section 1.704-3](#) permits the adoption of various methods to allocate for built in gain or loss, including the traditional method and so-called curative methods.

[50] If a partnership disposes of [Section 704\(c\)](#) property in a [Section 1031](#) nonrecognition transaction in which no gain or loss is recognized, [Treas. Reg. section 1.704-3\(a\)\(8\)](#) requires that the replacement property be treated as [Section 704\(c\)](#) property. If gain or loss is recognized in such an exchange, [Treas. Reg. section 1.704-3\(a\)\(8\)](#) states that "appropriate adjustments" are required. The regulations do not state how such appropriate adjustments should be determined.

[51] The appropriate adjustments contemplated by [Section 704\(c\)](#) should include (i) treating any gain allocated to the [Section 704\(c\)](#) Partner as [Section 704\(b\)](#) gain TO THE EXTENT there is book gain recognized in the [Section 1031](#) exchange and (ii) treating any taxable gain in excess of the book gain as [Section 704\(c\)](#) gain allocated to the [Section 704\(c\)](#) Partner in order to reduce book and tax disparities. These principles can be illustrated as follows:

EXAMPLE NO. 3(c)

[52] As the [Section 704\(c\)](#) Partner, A contributes nondepreciable property with an adjusted basis of zero and a fair market value of \$ 1,000 and B and C each contribute cash in the amount of \$ 1,000 to the ABC Partnership ("ABC"). A, B and C are equal one-third partners. The \$ 2,000 in cash is expended by ABC to pay costs that are required to be capitalized and which increase the adjusted basis of the [Section 704\(c\)](#) property owned by the ABC to \$ 2,000. After the expenditures, the fair market value of the [Section 704\(c\)](#) property is \$ 5,000.

[53] ABC is using the traditional method under [Treas. Reg. section 1.704-3\(b\)\(1\)](#).

[54] ABC decides to dispose of the [Section 704\(c\)](#) property in a [Section 1031](#) exchange for

like kind replacement property in a transaction in which no book or tax gain or loss is recognized. Under such circumstances, the replacement property with a fair market value of \$ 5,000 and adjusted basis of \$ 2,000 will be treated as [Section 704\(c\)](#) property and A will continue as the [Section 704\(c\)](#) Partner with respect to the \$ 1,000 of built in gain.

[55] If, alternatively, ABC disposes of the [Section 704\(c\)](#) property in a partially taxable exchange for replacement property with a fair market value of \$ 3,000 and cash of \$ 2,000, \$ 2,000 of book gain and an equal amount of taxable gain would be recognized by ABC as follows: The book gain recognized on the exchange is \$ 2,000 (i.e., the lesser of the book gain realized \$ 2,000 (amount realized of \$ 5,000 minus book basis of \$ 3,000) or the boot received which is \$ 2,000), and the tax gain recognized is \$ 2,000 (i.e., the lesser of the tax gain realized \$ 3,000 (amount realized of \$ 5,000 minus tax basis of \$ 2,000) or the boot received \$ 2,000). Since the book gain recognized and the tax gain recognized are equal, the entire \$ 2,000 of tax gain must be allocated under [Section 704\(b\)](#) in the same manner that the book gain is allocated. Because there is no difference between the tax and book gain recognized, this is not an appropriate occasion to take into account any of the book/tax disparity attributable to A. The adjusted basis of the replacement property would be \$ 2,000, and the full \$ 1,000 of potential [Section 704\(c\)](#) gain would be preserved.

#### EXAMPLE 3(d)

[56] A and B form a "50-50" partnership ("AB"). A contributes business property with an adjusted basis of \$ 4,000 and a fair market value of \$ 10,000 reflecting built in gain of \$ 6,000. The property's book value to the partnership following the contribution is thus \$ 10,000. B contributes cash in the amount of \$ 10,000. AB adopts the traditional method. The [Section 704\(c\)](#) property depreciates for book purposes at an annual rate of 10% (\$ 1,000 per year), and all of the tax depreciation (i.e., \$ 400) is allocated to B. AB disposes of the [Section 704\(c\)](#) property contributed by A at the beginning of the second year of AB (when the adjusted basis in the property is \$ 3,600) in a cash sale for \$ 10,000, and AB thereby realizes taxable gain of \$ 6,400 and book gain of \$ 1,000. \$ 5,400 of the tax gain must be allocated to A to account for A's built-in gain. The remaining \$ 1,000 of gain is allocated equally between A and B. [Treas. Reg. section 1.704-3\(b\)\(2\)](#) example (1)(iii).

[57] If the sale had been for cash of \$ 9,000, there would have been no book gain and all of the \$ 5,400 tax gain would be allocated to A.

[58] In contrast, assume AB disposes of the [Section 704\(c\)](#) property in a [Section 1031](#) exchange at the beginning of its second year when its value is \$ 9,000, and AB receives replacement property with a value of \$ 8,000 and cash in the amount of \$ 1,000. AB realizes and recognizes \$ 1,000 of taxable gain in the exchange, and no book gain is recognized (i.e., the value of the consideration received in the exchange is equal to the book value of the relinquished property of \$ 9,000). The replacement property has an adjusted basis of \$ 3,600. After the exchange, the excess of the fair market value of the replacement property over its adjusted basis is sufficient to account for all of A's remaining "built in gain." However, the \$ 1,000 of taxable gain must be allocated solely to A because such allocation reduces A's book/tax capital account disparity. After such an allocation, the book capital accounts of A and B would continue to be \$ 9,500 each (i.e., original \$ 10,000 less 50% of \$ 1,000 book depreciation). The tax capital account of A would be increased from \$ 4,000 to \$ 5,000. The tax capital account of B would be \$ 9,600 (i.e., \$ 10,000 decreased by \$ 400 of depreciation).

Q-4 When a partnership engages in a [Section 1031](#) deferred exchange that is not completed until after the end of the partnership's tax year, is any temporary reduction or a "gap" in

the amount of partnership liabilities required to be treated as a "distribution of money to the partners" under [Section 752\(b\)](#), if upon completion of the deferred exchange the amount of liabilities encumbering the replacement property is equal to or greater than the debt encumbering the relinquished property?

A-4 No, the temporary reduction in the amount of debt does not result in a constructive distribution of money under [Section 752\(b\)](#) even if the deferred exchange straddles two tax periods.

[59] Where each party to the exchange either assumes a liability of the other party or acquires property subject to a liability, the so-called "liability netting rule" provides that consideration given in the form of an assumption of a liability or a receipt of property subject to a liability (or, for that matter, cash or other property) is offset against consideration received in the form of an assumption of a liability or a transfer of property subject to a liability. Under this rule, a taxpayer who receives boot (i.e., a taxpayer whose liability is assumed or who transfers property subject to liability) by surrendering property can offset the boot by any boot given, including cash, but a taxpayer who receives cash consideration (to equalize net values) cannot offset the cash boot received by boot given in the form of providing mortgage relief by assuming or receiving mortgaged property subject to existing debt. [Treas. Reg. section 1.1031\(d\)-2](#), examples (1) and (2). The tax consequences of the liability netting rule are the same for simultaneous and deferred exchanges. [Treas. Reg. section 1.1031\(k\)-1\(j\)\(3\)](#), Example 5.

[60] Under [Treas. Reg. section 1.752-1\(f\)](#), only the net decrease in a partner's share of liabilities is treated as a distribution from the partnership when a partner incurs both an increase and a decrease in liabilities as a result of a "single transaction." A deferred exchange should be treated as a "single transaction" for purposes of [Section 752\(b\)](#), with the result that a temporary "gap" in the amount a partner's share of liabilities attributable to the relinquished property and the replacement property should not result in a constructive distribution of money under [Section 752\(b\)](#).

Q-5 When a partnership engages in a [Section 1031](#) deferred exchange, does [Section 465\(e\)](#) trigger the realization of income because of a "gap" or temporary reduction in the amount the taxpayer has at risk, if upon completion of the deferred exchange the amount the taxpayer has at risk is equal to or greater than the amount at risk immediately before the transfer of the relinquished property?

A-5 No. [Section 465\(e\)](#) requires the recapture of previously allowed losses when the amount a taxpayer has at risk in an activity is reduced below zero. To the extent the amount at risk is reduced below zero, the taxpayer recognizes income. However, a temporary reduction in the amount at risk does not trigger income recognition under [Section 465\(e\)](#) because a deferred exchange is treated as an integrated or single transaction, notwithstanding the fact that the deferred exchange straddles two tax periods.

[61] Under [Section 465](#), the amount at risk cannot be less than zero. Losses are suspended after the amount at risk reaches zero. Distribution of cash, reductions in liabilities and various other events that would otherwise result in a negative at risk amount trigger income recognition under [Section 465\(c\)\(1\)\(B\)](#). This income recognition is intended to recapture previously deducted losses.

[62] The recapture of income under [Section 465\(e\)](#) generates a suspended loss in the same amount, which has the effect of placing the taxpayer in the same place if the losses had originally been suspended because the at risk amount had reached zero.

[63] The at risk rules are applied to the separate "activities" of a taxpayer. The general rule is that activities are not aggregated. However, if a taxpayer actively participates in the management of a trade or business, then all activities comprising the trade or business are aggregated for purposes of the at risk rules, as provided by [Section 465\(c\)\(3\)\(B\)\(i\)](#), (2)(B)(ii). /8/

[64] The determination of a taxpayer's at risk amount on a separate activity basis is not addressed under regulations in the context of an exchange. The appropriate treatment should be that the replacement property should be considered the continuation of the same activity, and a partnership level exchange should not be treated as an event that triggers income under [Section 465](#).

#### FOOTNOTES

/1/ All references are to the Internal Revenue Code of 1986, as amended. References in this report to a "partnership" refer to any unincorporated organization that is treated as a partnership for income tax purposes, including a limited liability company that does not elect to be treated as an association taxable as a corporation.

/2/ [Section 1031\(a\)\(1\)](#) provides for nonrecognition of gain or loss when property held for productive use in a trade or business or for investment is exchanged solely for like-kind property to be held for either productive use in a trade or business or for investment. The statutory phrase "held either for productive use in a trade or business or for investment" is referred to in this Report as the "qualified use" requirement.

/3/ Bolker and Maloney involved corporate liquidations. A corporation is always considered an entity separate from its shareholders. A partnership, however, is a pass-through entity and in many contexts is considered an aggregation of individual partners rather than an entity separate from its partners. For example, the partners of a general partnership may elect under [Section 761\(a\)](#) to be taxed as owners of undivided interests in the underlying assets of the partnership. No such election is available to a corporation or its shareholders. Under [Section 701](#), "persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." Certain elections under [Section 703](#) are also made at the individual partner level, rather than at the partnership level. [Section 731](#) generally allows tax free distributions from a partnership; no similar provision exists for corporations. Given the aggregate nature of a partnership, the rationale that the taxpayer is merely continuing its investment in another form is more convincing in the partnership context than in the corporate context.

/4/ For example, in [Fred S. Wagensen v. Commissioner, 74 T.C. 653 \(1980\)](#), a valid [Section 1031](#) exchange was recognized where the taxpayer had no "current plans" to make a gift, which occurred approximately 9 months after the exchange. In contrast, in [Click v. Commissioner, 78 T.C. 253 at 234 \(1982\)](#), a gift made soon after an exchange invalidated the exchange because the Tax Court held that the taxpayer had acquired the replacement property to convert it to a personal use. In [124 Front Street, Inc. v. Commission, 65 TC 6 \(1975\)](#), the taxpayer borrowed funds from an unrelated corporation and used the loan proceeds to acquire a property upon exercise of an option. The taxpayer transferred the recently acquired property to the unrelated corporation, which had provided the loan, in an exchange for like-kind real property within approximately six months after the option property was acquired. The Tax Court rejected the government's argument that the exchange was not governed by [Section 1031](#)

/5/ For the reasons stated in the first section of this Report, the "new" partnership should be viewed as continuing the entity level investment in the like-kind property. The fact that A and B "cashed out" in a taxable sale should not affect the partnership level treatment.

/6/ In [Long v. Commissioner, 77 TC 1045 \(1981\)](#), the court stated in footnote 25 that a termination under [Sec. 708](#) prior to an exchange should not cause the exchange to fall outside of [Section 1031](#). The court stated that "we consider this to be the correct result especially in view of the statement contained in sec. 1.708-1(b)(1)(iv), Income Tax Regs."

/7/ This Report refers to the partner contributing [Section 704\(c\)](#) property as the "704(c) Partner".

/8/ The classification of activities under [Section 469](#) may be different than their classification under [Section 465](#).

END OF FOOTNOTES

## **APPENDIX B**

### **1995 ABA TAX SECTION REPORT ON OPEN ISSUES**

Mrs. Margaret M. Richardson  
Commissioner, Internal Revenue  
1111 Constitution Avenue, NW  
Room 3000  
Washington, DC 20224

Re: Comments Concerning Open Issues in Section 1031 Like-Kind Exchanges

Dear Ms. Richardson:

I am enclosing comments on the above noted report as prepared by members of the Committees on Sales, Exchanges and Basis and Real Estate. This report was reviewed by members of our Committee on Government Submissions.

This report represents the individual views of the members who prepared it and does not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

Thomas D. Terry  
Chair, Section of Taxation  
American Bar Association  
Washington, D.C.

Enclosure

cc: Leslie B. Samuels, Assistant Secretary for Tax Policy, Department of Treasury

Stuart L. Brown, Chief Counsel, Internal Revenue

## COMMENTS CONCERNING OPEN ISSUES IN SECTION 1031 LIKE-KIND EXCHANGES

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committees on Sales, Exchanges and Basis and on Real Estate of the Section of Taxation. Principal responsibility was exercised by Louis S. Weller and Adam M. Handler. Substantive contributions were made by Michael L. Cook, Joe Vault Crockett III, Francesco A. Ferrante, Lewis M. Horowitz, Howard J. Levine, Ronold P. Platner, David Shechtman, Ronald A. Shellan, Charles M. Thompson and Mary Foster Vrbanac. The Comments were reviewed by Richard E. Marsh, Jr. of the Section's Committee on Government Submissions.

Although many of the members of the Section of Taxation who participated in the preparation of this report necessarily have clients affected by federal taxation, including the federal tax rules applied in the subject areas addressed by this report, no such member (or the firm of such member) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matters of these Comments.

Contact Persons: Adam M. Handler (310) 556-5586  
Louis S. Weller (415) 434-0400

Date: April 11, 1995

### INTRODUCTION

*Section 1031 of the Internal Revenue Code* of 1986, as amended (the "Code"), /1/ provides that no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a like kind which is to be held either for productive use in a trade or business or for investment. This provision has remained largely intact since the earliest years of the income tax and has spawned numerous court cases defining its core concepts: (1) what is an exchange; and (2) what is like-kind property?

*Section 1031* was amended in 1984 to allow deferred exchanges under narrowly defined conditions and again in 1989 to restrict exchanges between related persons or involving non-U.S. real property. A smaller change, applying to partnerships electing out of Subchapter K under Code *Section 761(a)*, was made in 1991. Also in 1991 Final regulations were issued covering deferred exchanges and exchanges of multiple and personal property. In 1992, regulations covering deferred exchanges and installment sales were proposed. Despite this relatively recent flurry of activity, a number of interpretive issues remain unclear.

The purpose of this Report is to propose answers to a number of open questions which we have identified. The list is not exhaustive and does not include several areas in which reports have been issued. /2/ Nevertheless, it is our hope that this report will help the Internal

Revenue Service (the "Service") to create priorities and issue guidance addressing areas of concern to taxpayers attempting to understand and either qualify under or avoid mandatory application of *Section 1031*.

We believe that like-kind exchanges under *Section 1031* are undertaken regularly by taxpayers of relatively modest means. Our experience indicates that the most common use of *Section 1031* is the exchange of a small rental property. As a result, there is a need for practical guidance. The recent regulations published by the Service under *Section 1031* have shown that the Service understands this need and we hope that future guidance continues in the same vein. A majority of the issues discussed in this Report represent questions which arise in everyday practice but which have not been definitively resolved by published guidance.

#### QUESTIONS AND ANSWERS GROUP A -- GENERAL ISSUES

Q-1. HOW DO YOU ACCOUNT FOR SELLING EXPENSES IN A LIKE-KIND EXCHANGE?

Q-1a. ARE SELLING EXPENSES TAXABLE AS BOOT?

A-1a. The only authorities dealing with the treatment of selling expenses are *Rev. Rul. 72-456, 1972-2 C.B. 468*, and *G.C.M. 34895* (June 5, 1972). The ruling and the General Counsel Memorandum indicate that cash received by a taxpayer in an exchange is offset by commissions paid in computing amount realized and gain recognized, and the amount of the commissions is also added in determining the basis of the replacement property. This guidance only deals with commissions, but we believe that its principles can be expanded to all selling and "exchange" expenses incurred in either the disposition of the relinquished property or the acquisition of the replacement property. Accordingly, any selling expenses paid out of the exchange balance would not result in taxable boot to the taxpayer. We believe that such expenses should include all those that are typically deducted by the seller from the gross sales proceeds in a taxable sale under *Section 1001*, or capitalized by a buyer and added to the basis of the property acquired under *Section 1012*. Such expenses typically include commissions, finder's fees, inspection and testing fees, title insurance premiums, escrow fees, transfer taxes, recording fees and legal fees. These expenses will be referred to as "selling expenses."

Expenses such as the proration of rents, property taxes, utilities and property insurance premiums debited against the taxpayer out of the exchange balance are not selling expenses and should be taxable as ordinary income to the taxpayer outside of the *Section 1031* rules to the extent they are not netted against amounts credited to the taxpayer for these items. If there is a net credit for these amounts that is used to acquire replacement property, such credit should, additionally, be treated as cash paid by the taxpayer and thus either increase the basis of the replacement property or reduce the gain recognized.

Loan fees, points, loan application fees, mortgage insurance, lender's insurance, assumption fees and other costs related to the acquisition of a loan for the replacement property should also not be treated as selling expenses because these costs generally are treated as part of the cost of obtaining a loan rather than the cost of obtaining the property, and do not increase the

basis of the replacement property. Therefore, if those loan-related expenses are paid out of the exchange balance, they should constitute taxable boot in the form of cash received by the taxpayer. These expenses can, however, be offset by cash boot paid by the taxpayer and would be amortized over the term of the loan.

**Q-1b. HOW SHOULD EXCHANGE RELATED INTERMEDIARY AND ESCROW OR TRUSTEE FEES BE TREATED?**

A-1b. These fees are directly related to the exchange and therefore should be treated the same as other selling expenses under Q&A-1a.

**Q-1c. WHEN CAN SELLING EXPENSES BE PAID FROM THE EXCHANGE BALANCE?**

A-1c. In general, selling expenses can be paid at any time during the exchange period without affecting any of the safe harbors under *Reg. section 1.1031(k)-1(g)* if they are transactional items under *Reg. section 1.1031(k)-1(g)(7)*; otherwise, they must be paid in accordance with the limitations set forth in *Reg. section 1.1031(k)-1(g)(6)*. We believe that all of the expenses described in Q&A-1a and Q&A-1b should be treated as transactional items under *Reg. section 1.1031(k)-1(g)(7)*.

**Q-1d. HOW ARE THE RULES FOR SELLING EXPENSES COORDINATED WITH THE MULTIPLE-PROPERTY EXCHANGE RULES?**

A-1d. The multiple-property exchange rules do not address the allocation of selling expenses among the assets. For consistency purposes, selling expenses could be treated similarly to liabilities under the multiple-property exchange regulations. Selling expenses relating to a particular item of property could be specially allocated to that property's exchange group. This alternative would have the advantages of allocating gain and basis consequences of the expenses to the property to which they most closely relate. Expenses that relate to the exchange as a whole could be allocated among exchange groups, but not to the residual group, in proportion to the aggregate fair market value of the relinquished properties.

As an alternative, selling expenses could be allocated among exchange groups, but not to the residual group, in proportion to the aggregate fair market value of the relinquished properties. Selling expenses would then reduce the value of the relinquished property in each exchange group to determine whether there is an "exchange group surplus" or an "exchange group deficiency." This would have the effect of reducing any gain realized and recognized within any exchange group by the amount of the deductible selling expenses allocated to that exchange group.

**Q-2. WHAT ARE THE CONSEQUENCES OF REFINANCING BEFORE AND AFTER EXCHANGES?**

A-2. The issue created by refinancings is whether proceeds received by a taxpayer which exceed existing debt encumbering relinquished property prior to an exchange or debt encumbering replacement property immediately following an exchange constitute "boot." The analysis is somewhat different for pre-exchange and post-exchange refinancings.

## A-2a. PRE-EXCHANGE REFINANCINGS.

Existing authority indicates that where a preexchange refinancing is completed as part of an integrated transaction which includes the exchange, cash received by a taxpayer from a lender will be treated as cash received on disposition of the relinquished property. See, e.g., *Long v. Commissioner*, 77 T.C. 1045 (1981). Assume that A is transferring unencumbered Property 1 (worth \$ 200X) in an exchange with B, who will transfer encumbered Property 2 (worth \$ 200X, encumbered by a \$ 100X mortgage). As part of the exchange, but immediately prior to conveying title to Property 1, A obtains a new \$ 100X loan secured by Property 1. A and B exchange and each takes subject to (or assumes) the loans encumbering the properties. In effect A has "cashed out" in the amount of \$ 100X, but if the rules of *Reg. section 1.1031(b)-1(c)* are strictly construed, A has recognized no gain since A took Property 2 subject to debt which equaled the debt relief obtained. See, e.g., *Fredericks v. Commissioner* T.C. Memo 1994-27 *CCH Dec 49,629 (M)*.

Notwithstanding this apparent rule, the Service is likely to assert that A has recognized gain of \$ 100X because the cash received from the refinancing should be viewed as part of the consideration given by B on acquisition of Property 1. This principle is sometimes referred to as the "in anticipation of exchange" concept. The Service attempted formally to include this concept in the *Section 1031* regulations by proposing an amendment to *Reg. section 1.1031(b)-1(c)* in 1990 and referring to this as a clarification of existing law. However, protests from practitioners and the public led the Service to conclude the proposed rule "could create substantial uncertainty in the tax results of exchanges." The proposal was withdrawn in the final regulations adopted in 1991. Although the proposal was withdrawn, the Service has not formally stated whether it still adheres to the proposition. This was its position in *Fredericks*, cited above.

Where a pre-exchange refinancing is clearly part of the exchange, doctrines such as step-transaction and substance over form should be sufficient to allow the Service to prevent taxpayers from receiving cash upon transfer of relinquished properties without having the cash treated as non-like kind property. We do not believe that a bright line test defining a specific period of "taint" for pre-exchange financings should be adopted. From a policy perspective, the key distinction should be whether the taxpayer ever bore the risk of repayment of a debt so as to permit the normal non-realization treatment of refinancing transactions. /3/ If the debt "came to rest," i.e., became the taxpayer's liability for more than the time needed to close subsequent parts of an exchange, then the usual non-realization treatment should apply and the existing boot-netting rules should apply to the debt. Thus, "true" refinanced debt will be offset either by debt assumed or taken subject to or by cash paid by the taxpayer. From the taxpayer's perspective, this means that refinancings should occur as separate, independent transactions from the exchange. Another factor, considered in the *Fredericks* case, is whether the refinancing occurs for reasons independent of the exchange, such as pending maturity of debt. Refinancing should not be conditioned on completion of a relinquished property transfer nor should it be part of the same escrow or settlement process. If credit evaluation is involved, it should be the taxpayer's credit, not the relinquished property acquirer's credit which is relevant.

## A-2b. POST-EXCHANGE REFINANCINGS.

Post-exchange refinancings should be of less concern from a tax perspective than pre-exchange refinancings. Here the integration of the refinancing with the acquisition of replacement property should not matter. Even where a new loan is obtained at the time or immediately following a taxpayer's acquisition of replacement property in an exchange, receipt of cash by the taxpayer should not be treated as boot.

There is, however, virtually no authority addressing this issue. The key to the distinction between pre- and post-exchange refinancings is that the taxpayer will remain responsible for repaying a post-exchange replacement property refinancing following completion of the exchange whereas the taxpayer by definition will be relieved from the liability for a pre-exchange relinquished property refinancing upon transfer of the relinquished property. A fundamental reason why borrowing money does not create income is that the money has to be repaid and therefore does not constitute a net increase in wealth. This is clearly the case in a post-exchange refinancing and there is no analytic reason to characterize such financings as being in lieu of fictitious payments by the seller of replacement property. Thus, we encourage the publication of a revenue ruling which indicates that money received in a post-exchange refinancing will not constitute "boot" in an exchange.

## Q-3. HOW DO THE LIABILITY NETTING RULES WORK WHEN THE LOAN ON A RELINQUISHED PROPERTY IS PAID OFF AND A NEW LOAN IS OBTAINED TO FINANCE THE ACQUISITION OF THE REPLACEMENT PROPERTY?

A-3. The existing regulations have long provided that consideration received in the form of an assumption of a liability (or a transfer of property subject to a liability) is to be treated as "other property or money" (a/k/a "boot") for purposes of *Section 1031(b)*. *Reg. section 1.1031(b)-1(c)*. However, where each party to the exchange either assumes a liability of the other party or acquires property subject to a liability, the so-called "liability netting rule" provides that consideration given in the form of an assumption of a liability or a receipt of property subject to a liability (or, for that matter, cash or other property) is offset against consideration received in the form of an assumption of a liability or a transfer of property subject to a liability. Under this rule, a taxpayer who receives boot (i.e., a taxpayer whose liability is assumed or who transfers property subject to liability) by surrendering property can offset the boot by any boot given, including cash, but a taxpayer who receives cash consideration (to equalize net values) cannot offset the cash boot received by boot given in the form of providing mortgage relief by assuming or receiving mortgaged property subject to existing debt. *Reg. section 1.1031(d)-2*, examples (1) and (2).

In many multi-party exchanges, whether simultaneous or deferred, the exchanging taxpayer will use proceeds from the first disposition to satisfy the liability attaching to the relinquished property. The same taxpayer will also borrow additional amounts to finance the acquisition of the replacement property. Thus, technically, no liabilities are "assumed" or "taken subject to." Analytically, the tax result ought to be the same regardless of whether the exchange involves (i) the relief from a liability attaching to the relinquished property netted against assumption of liabilities attaching to the replacement property or (ii) relief from a liability attaching to the relinquished property upon retirement of the liability using the buyer's funds

followed by the creation of new indebtedness used to acquire replacement property. In fact, the Service has held that acquisition indebtedness incurred directly by the taxpayer is netted against liabilities relieved in the exchange because such indebtedness is treated either as liabilities assumed or cash paid by the taxpayer. *TAM 8003004* (Sept. 19, 1979). See also *Commissioner v. North Shore Bus Co.*, 143 F.2d 114 (2d Cir. 1944); *Barker v. Commissioner*, 74 T.C. 555, 568-569 (1980).

The tax consequences for simultaneous and deferred exchanges ought to be the same. The Service agrees that this is the case where debts on both the relinquished property and the replacement property are assumed. See *Regulations section 1.1031(k)-1(j)(3)*, Example 5. However, the result is not entirely clear where relinquished property debt is retired and new financing is obtained on replacement property because *Reg. section 1.1031(d)-1(c)* literally requires that each party to the exchange either assumes a liability of the other party or acquires property subject to a liability. In a deferred exchange the buyer of relinquished property and the seller of replacement property typically have nothing to do with each other and an integrated escrow which conceptually ties them together is not required.

Despite the literal language of the cited regulation, the broader reading of the regulations evidenced in the TAM and the North Shore Bus and Barker cases is consistent with the purpose of the netting rule. Guidance should be issued, indicating that these concepts apply to all exchanges, whether simultaneous or deferred.

#### Q-4. HOW AND WHEN DO YOU COMBINE A LIKE-KIND EXCHANGE WITH A SECTION 1033 NONRECOGNITION REINVESTMENT TRANSACTION?

A-4. *Section 1033* allows for gain to be rolled over if the taxpayer reinvests in qualifying property (and certain other conditions are met). There is, however, no requirement that an exchange be set up or that the cash proceeds be traced to the replacement property.

If a taxpayer desires to combine a like-kind exchange with a *Section 1033* rollover, all that is necessary is for cash (or other property) to be added to the exchange balance. For example, Property 1 with an adjusted basis of \$ 10,000 is transferred under threat of condemnation on January 10, 1994, and Taxpayer receives \$ 100,000 of condemnation proceeds. On February 14, 1994, Taxpayer exchanges Property 2 (which has an adjusted basis of \$ 25,000) and \$ 100,000 cash for Property 3. Provided that Property 3 is both of a like kind to Property 2 and similar or related in service or use to Property 1 (taking *Section 1033(g)* into account), then, at the election of Taxpayer, Property 3 either has a basis of \$ 35,000 and both the *Section 1031* and 1033 gain has been rolled over, or a basis of \$ 125,000 and then *Section 1033* rollover is still available with respect to another property. This results from the mandatory application of *Section 1031* contrasted to the elective character of deferral under *Section 1033*. The taxpayer may choose to defer the election until another property is acquired within the periods allowed by *Section 1033(a)(2)(B)(i)* or 1033(g)(4).

**Q-5. IS A LEASEHOLD OR UNDIVIDED INTEREST IN PERSONAL PROPERTY OF A LIKE KIND WITH OUTRIGHT OWNERSHIP?**

A-5. Yes. An undivided interest in personal property is of a like kind with outright ownership. Whether a leasehold interest in personal property is of a like kind with outright ownership depends on the facts and circumstances. In general, so long as the lease is for substantially all (i.e. more than 80%) of the remaining useful life of the personal property, the leasehold interest should be of a like kind with outright ownership.

**Q-6. WHEN ARE LEASEHOLD IMPROVEMENTS OF A LIKE KIND WITH FEE INTERESTS IN REAL ESTATE?**

A-6. Provided that the leasehold improvements are treated as real property under local law, they should be of a like kind with land or any other real property interest. See *Reg. section 1.1031(a)-1(b)*. However, if the leasehold improvements are subject to an underlying land lease which has a remaining term of less than 30 years, then they will generally not be of a like kind with land (although they may still be of a like kind with other improvements). See *Reg. section 1.1031(a)-1(c)*.

**Q-7. HOW DO THE SECTION 1245 AND 1250 RECAPTURE RULES APPLY IN THE CASE OF AN EXCHANGE OF MULTIPLE PROPERTIES?**

A-7. The answer is unclear. The multiple property exchange rules of *Reg. section 1.1031(j)-1* are computational rules that are meant to simplify the basis and gain computations for such exchanges. They do not purport to modify the existing rules and make no reference to either *Section 1245(b)(4)* or *Section 1250(d)(4)* (which provide the rules for the recognition or deferral of recapture income in the case of a like-kind exchange where the relinquished property consists of either *Section 1245* or *Section 1250* property).

In the absence of guidance, taxpayers could use one of three methods for determining recapture income in the case of a multiple property exchange: (1) a property-by-property basis; (2) an exchange group basis; or (3) an exchange group basis with adjustments.

The first method should be rejected. It would require recapture computations that are completely separate from the basis and gain rules for multiple property exchanges and thus could lead to inconsistent results. It would also be inconsistent with the underlying theory of the multiple property exchange rules which is to match up properties so as to reduce the amount of gain recognized.

Applying *Sections 1245(b)(4)* and *1250(d)(4)* on an exchange group basis would be both relatively easy and consistent with the multiple property exchange rules. With respect to each exchange group, the taxpayer would apply the recapture rules immediately after determining the amount of gain recognized with respect to the exchange group. The total recapture income recognized on the exchange would then be the sum of the amount recognized with respect to each exchange group (and the residual group). The amount of deferred recapture income would then be allocated among the properties received in the exchange group, in accordance with the relative fair market values of the *Section 1245* or *Section 1250* property (as the case may be) received in such exchange group.

The third method offers a further refinement. Under this method, if insufficient *Section 1245* or *1250* property were received in a particular exchange group, taxpayers could look to other exchange groups with *Section 1245* or *1250* property and reapply the recapture rules.

Although the third method results in the least amount of current taxation, we believe that it would be overly complex. Both the recapture rules and the multiple property exchange rules are already quite complicated and their interaction should be made as simple as possible. For these reasons, we believe that the Service should publish guidance adopting the second method and thus apply the recapture rules on an exchange group basis.

**Q-8. MAY A LIKE-KIND EXCHANGE BE USED TO DEFER GAIN WHICH WOULD OTHERWISE BE RECOGNIZED ON FORECLOSURE OF PROPERTY WHICH IS SUBJECT TO A MORTGAGE WHOSE UNPAID PRINCIPAL AMOUNT EXCEEDS THE PROPERTY'S ADJUSTED BASIS AND ITS FAIR MARKET VALUE?**

**A-8.** Yes. The issue is whether it is possible to exchange property in which the taxpayer has no "equity." A typical structure would involve transfer of an encumbered property to a qualified intermediary immediately prior to its sale at the lender's foreclosure auction. The intermediary would receive no proceeds from this sale and would not be obligated to spend any funds to acquire replacement property, but would be required to acquire replacement property subject to existing debt equal to the foreclosed debt, if the taxpayer could identify such property. The taxpayer would have the normal *Section 1031(a)(3)* time periods to identify and complete acquisition of replacement property.

There is nothing intrinsic about "equity" which relates to qualification of an exchange under *Section 1031*. Well established rules determine the amount realized on disposition of encumbered property: either the full amount of the debt (where the debt is non-recourse) or the fair market value of the property (where the debt is recourse). The relinquished property is not valueless; its value is pledged to secure a debt which exceeds the value. The normal recognition and non-recognition rules of *Section 1031(b)* and the Regulations work regardless of outside value, although in the case of recourse debt the undersecured portion may still result in net cancellation of indebtedness income to the taxpayer under the principles of *Rev. Rul. 90-16, 1990-1 C.B. 12*.

As a practical matter, the taxpayer attempting to utilize a like-kind exchange to defer income which otherwise would be recognized on a foreclosure would have to take on debt of equal or greater magnitude or put up the taxpayer's own capital in order to create offsetting boot given in the exchange. If the taxpayer is able to do so in a manner which is not a sham, there seems to be no policy reason to treat a "workout" driven exchange differently from any other exchange.

## GROUP B -- DEFERRED EXCHANGES

Q-9. WHEN ARE TWO OR MORE EXCHANGES PART OF THE "SAME EXCHANGE" FOR THE PURPOSES OF THE DEFERRED EXCHANGE REGULATIONS?

A-9. This would depend on the facts and circumstances of each situation. Neither the Code nor the existing regulations provide clear guidance. There are a number of factors which should be considered, including intent of the taxpayer, character of the relinquished properties, structure of the transactions, identity of the parties and timing.

Q-9a. WHAT PROBLEMS ARISE FROM HAVING TWO OR MORE EXCHANGES TREATED AS THE SAME EXCHANGE?

A-9a. A taxpayer may increase the number of replacement properties which may be identified by using multiple exchanges. For each separate exchange regardless of the number of relinquished properties, multiple replacement properties may be identified under the three-property rule or 200 percent rule of *Reg. section 1.1031(k)-1(c)(4)*. However, if the exchanges are determined to be the "same exchange," the result may be that the taxpayer may violate the identification rules by identifying an excess number (or value) of replacement properties. This will have the effect of disqualifying the exchange except where some replacement properties are acquired within the identification period. Splitting the exchange into multiple exchanges can reduce these timing problems.

Also, where multiple relinquished properties are exchanged, either for single or for multiple replacement properties, timing problems may arise either in identifying or completing acquisition of all the replacement properties within the identification or exchange period (as deemed in *Reg. section 1.1031(k)-1(b)(2)*). If there is a single exchange, the identification period and exchange period commence on the date the first relinquished property is transferred. It may be difficult or impossible to satisfy the identification requirements if, for example, transfers of multiple relinquished properties which are more than 45 days apart are treated as part of the same exchange.

In addition, whether or not the multiple property exchange rules of *Reg. section 1.1031(j)-1* apply may depend on whether there is a single exchange instead of multiple exchanges. Taxpayers need to know whether these rules apply, particularly where the allocation of excess liabilities assumed among exchange groups may be required under *Reg. section 1.1031(j)-(b)(2)(ii)(B)*.

Q-9b. IS INTENT TO CREATE TWO OR MORE EXCHANGES A FACTOR?

A-9b. Yes. This intent can be documented by using separate exchange agreements, one for each exchange.

Q-9c. WILL SEPARATE EXCHANGE AGREEMENTS ALWAYS BE SUFFICIENT TO ESTABLISH SEPARATE EXCHANGES?

A-9c. Not always. The underlying facts may nevertheless indicate that there was really only a single exchange which was attempted to be converted in multiple exchanges by the

use of multiple exchange agreements. Other factors may include use of the same escrow or settlement agent, transfer to the same purchaser, initial use of a single purchase/sale contract for multiple properties, and character of the properties (e.g., interdependence of two adjacent parcels being transferred to the same buyer). However, use of separate exchange agreements for exchanges of noncontiguous properties to different acquirers should generally be sufficient to establish that the exchanges are separate.

**Q-9d. DO MULTIPLE RELINQUISHED PROPERTIES INDICATE MULTIPLE EXCHANGES?**

A-9d. Where there are multiple relinquished properties, the taxpayer should be able to enter into multiple exchanges, one for each relinquished property. For example, if there are three relinquished properties, the taxpayer, under most circumstances, would be permitted to undertake a separate exchange with respect to each relinquished property. To do so, the taxpayer should execute a separate exchange agreement with respect to each such property. If the exchange is a deferred exchange, and if the proceeds from sale of the relinquished properties will be held in escrow or trust, there should be separate qualified escrows or trusts with respect to each exchange undertaken. It is not necessary that a separate qualified intermediary be utilized for each exchange, provided that each exchange is treated and accounted for separately and, if a qualified escrow or trust arrangement is used, the funds in each exchange are held in a separate escrow or trust.

**Q-9e. WHAT ARE THE FACTORS FOR DETERMINING WHETHER THERE ARE MULTIPLE RELINQUISHED PROPERTIES RATHER THAN A SINGLE RELINQUISHED PROPERTY?**

A-9e. Generally, properties in different locations which are not contiguous to one another and which can be separately described will be treated as different properties. Two adjacent lots or parcels which are subdivided and can be conveyed and used separately and independently of each other will be deemed separate properties. For example, two adjacent lots, each containing improvements consisting of a duplex, and each of which can be conveyed separately to separate buyers by separate deeds, will constitute separate relinquished properties. However, if there are two such lots with improvements consisting of one building situated partly on one lot and partly on the other, the lots will not constitute separate relinquished properties because the use of one property is dependent upon the use of the other. Similarly, if one lot contains improvements such as a restaurant or office building, and an adjacent lot contains a parking lot which can be used solely in connection with the adjacent restaurant or office building and not independently (either because of restrictive covenants, because of physical limitations on the use of that parking lot such as access, or because the parking lot provides the sole source of parking which is necessary for the other lot) then such properties will constitute a single relinquished property.

The rules described above will be easy to apply and fair in the majority of cases. However, taxpayers should also be permitted to treat separate legal lots as a single property. For example, an apartment building should be permitted to be treated as a single property even if it has been condominiumized. Similarly, contiguous parcels should be permitted to be treated as a single property. /4/

**Q-9f. DOES THE FACT THAT MULTIPLE RELINQUISHED PROPERTIES ARE EXCHANGED FOR A SINGLE REPLACEMENT PROPERTY INDICATE THAT THERE WAS ONLY A SINGLE EXCHANGE?**

A-9f. If each exchange involved separate relinquished properties, utilized a separate exchange agreement and a separate escrow or trust for holding the exchange proceeds, and were otherwise treated as a separate exchange, the fact that a single property is used as the replacement property for each relinquished property will not cause the separate exchanges to be treated as a single exchange. In such a case, the single replacement property must have been properly identified as such in each of the separate exchanges.

**Q-9g. WILL THE FACT THAT THE TWO PROPERTIES ARE ENCUMBERED BY A SINGLE MORTGAGE OR DEED OF TRUST PRECLUDE UTILIZING THOSE PROPERTIES AS SEPARATE RELINQUISHED PROPERTIES IN SEPARATE EXCHANGES?**

A-9g. No. Provided that (A) the two properties are of such a character that they can be separately exchanged, and (B) the exchange is properly structured through separate exchange agreements and adherence to other requirements for non-recognition under *Section 1031*, the fact that they are encumbered by a single mortgage will not require that they be aggregated into a single exchange.

**Q-9h. IF A TAXPAYER HAS SET UP A SINGLE EXCHANGE AS TO TWO OR MORE RELINQUISHED PROPERTIES AND HAS EXECUTED AN EXCHANGE AGREEMENT WITH RESPECT TO THAT EXCHANGE, MAY THE TAXPAYER LATER CONVERT THE TRANSACTIONS INTO TWO OR MORE EXCHANGES?**

A-9h. Yes, provided that each of the exchanges would otherwise qualify as separate exchanges. In such a case, the conversion into separate exchanges may be made by a written amendment to the exchange agreement setting forth the fact that the single exchange is to be separated into more than one exchange and otherwise modifying the exchange agreement so as to treat the exchanges as separate. The amendment must be executed on or prior to the date that the first relinquished property is transferred.

**Q-9i. IF TWO OR MORE TAXPAYERS OWN A SINGLE RELINQUISHED PROPERTY AS TENANTS IN COMMON, UNDER WHAT CIRCUMSTANCES WILL THEY BE TREATED AS ONE TAXPAYER ENGAGING IN A SINGLE**

A-9i. Only under circumstances showing a clear intent to be treated as one taxpayer will co-owners be treated as such. Otherwise, the nature of the ownership of the property will control. The multiple taxpayers may have entered into a partnership agreement through which they account for profit and loss from the property, take depreciation and other property-related deductions, and file partnership tax returns showing the property as a partnership asset. Such factors may be an indication that the owners intend the property to be held by a partnership. It should be noted, however, that it is possible for land to be held and owned by individual co-owners (and income and expenses accounted for separately by the co-owners), and for the improvements thereon to be owned by a partnership (in income, expenses,

depreciation, etc. accounted for separately by the partnership). Such a situation would require two separate exchanges, one as to the land and the other as to the building.

**Q-10. DO THE THREE-PROPERTY AND 200-PERCENT IDENTIFICATION RULES APPLY ON AN EXCHANGE GROUP BY EXCHANGE GROUP BASIS IN THE CASE OF A MULTIPLE PROPERTY EXCHANGE?**

A-10. No. *Reg. section 1.1031(k)-1(c)(4)* provides that the three-property and 200-percent rules apply "[r]egardless of the number of properties transferred by the taxpayer as part of the same deferred exchange." Thus, so long as the multiple properties exchanged are exchanged as part of the "same deferred exchange," the three-property and 200-percent rules will apply to the multiple property exchange as a whole and not on an exchange group by exchange group basis.

The practical result is that in the case of a true multiple property exchange (or an exchange of a business), only the 200- percent rule can be used. It should be noted, however, that most real estate exchanges which also happen to be multiple property exchanges (due to the inclusion of small amounts of personal property) can still use the three-property rule if the identified replacement properties satisfy the incidental property rule contained in *Reg. section 1.1031(k)-1(c)(5)*.

**Q-11. WHAT IS THE RELEVANT TEST, WITH RESPECT TO REAL ESTATE THAT IS NOT TO BE PRODUCED, TO DETERMINE WHETHER THE ACTUAL REPLACEMENT PROPERTY IS "SUBSTANTIALLY THE SAME PROPERTY AS IDENTIFIED" UNDER *REG. SECTION 1.1031(k)-1(d)(i)*?**

A-11. In order to be considered "substantially the same property as identified," for purposes of *Reg. section 1.1031(k)-1(d)(i)*, the following safe harbor test should be adopted: (A) either the replacement property must be part of the property that was identified, or the identified property must be part of the replacement property; (B) the fair market value of the replacement property on the date of receipt should be no less than 75 percent, -- nor more than 125 percent, of the fair market value of the identified property on the date of identification; and (C) the "nature and character" of the replacement property, as that phrase is used in *Reg. section 1.1031(a)-2(b)*, must be the same as that of the identified property. /5/ The reason for adopting a safe harbor approach rather than a bright line test is to account for the possibility that replacement properties which fall outside the 75 percent/125 percent value test will still be, for practical purposes, "substantially the same" as identified.

**Q-12. WHAT IS THE SCOPE OF LEGAL SERVICES THAT CAN BE RENDERED UNDER *REG. SECTION 1.1031(k)-1(k)(2)(i)* WITHOUT AN ATTORNEY BECOMING A "DISQUALIFIED PERSON"?**

A-12. If an attorney has provided legal services unrelated to like-kind exchanges within two years prior to an exchange, then under *Reg. section 1.1031(k)-1(k)(2)*, the attorney is a disqualified person.

An attorney who has not previously represented the taxpayer should be able to provide services that relate to the disposition of the relinquished property. These services would

be those that would normally be associated with the disposition of property which is of a like kind to the relinquished property. In the context of real estate, this would include negotiation of the sale and exchange agreement on behalf of the taxpayer, the clearing of title issues, the resolution of other real property and financing issues which directly relate to the disposition of the property, rendering tax advice on the disposition and any other activity which directly relates to the disposition of the relinquished property.

In addition, the attorney should be able to provide legal services that relate to the acquisition of the replacement property. For real estate, these services would include the negotiation of an acquisition or exchange agreement for the replacement property, the ordering of title insurance or attorney's title opinion, providing an opinion of title, negotiating financing, negotiating with existing tenants to secure estoppels, subordinations to financing and extensions of leases, preparation of documents that directly relate to the acquisition or financing of the replacement property, attending settlement or engaging in the closing of the escrow, providing tax advice and assistance, clearing title and negotiating any additional real property concerns which must be addressed to effectuate the sale.

These disposition and acquisition issues are clearly delineated as services performed in conjunction with the exchange and these services would not be performed unless the exchange were taking place. Acquisition services within the contemplated scope of permitted "exchange related" services would not include representing the taxpayer in obtaining subdivision or zoning approval which may be a condition of acquisition, since this goes well beyond the scope of acquisition.

Services performed that are outside the scope of the disposition and acquisition of real estate, such as representation in the purchase or sale of a business unrelated to the real property exchange would be construed as providing legal services outside the scope of representation for the disposition and acquisition of real property and, therefore, would result in the attorney being a disqualified person.

Services provided by an attorney for the disposition and acquisition of real property in an exchange would not disqualify the attorney from representing a party in the same or similar capacity in connection with other property(s) to be exchanged, even if provided within a two-year period prior to the newest exchange transaction. The attorney, under these circumstances, could provide the same or other permitted services as rendered in the previous transactions. Any other legal services rendered by the attorney during the two-year period following representation in the disposition and acquisition of exchange property would disqualify that attorney from acting as the intermediary in a subsequent transaction.

**Q-13. WHAT IS THE SCOPE OF "ROUTINE FINANCIAL, TITLE INSURANCE, ESCROW, OR TRUST SERVICES" THAT CAN BE RENDERED UNDER REG. SECTION 1.1031(k)-1(k)(1)(ii) WITHOUT THE PERSON BECOMING A "DISQUALIFIED PERSON"?**

**A-13.** Any services rendered in the ordinary course of business of a bank, thrift, title insurance company, escrow company, trust company or other entity entitled to serve as a qualified escrow, trust or intermediary will be "routine" for purposes of this section of the

Regulations. Ms means that banks can have depositor and creditor relationships with a taxpayer and still serve as the taxpayer's intermediary; title insurance companies are not precluded from serving despite having written title insurance in favor of a taxpayer, escrow companies may serve despite involvement in past or present escrows and so on. This provision is intended to recognize that the conduct of ordinary business between a taxpayer and a qualified escrow, trust or intermediary does not result in the taxpayer's gaining such control over the other party that the "independence" which the Regulations' safe harbors seek to assure is compromised.

The prohibitions against control or ownership of entities (*Reg. section 1.1031(k)-1(k)(3)* and *-1(k)(4)*) will serve to prevent most abuses which could arise in the case of institutions or entities for whom the "routine" services safe harbor is a question. There may be facts and circumstances involving special services provided to a taxpayer, clearly outside the ordinary course of business, which evidence an unusual degree of control by the taxpayer over the otherwise "qualified" entity or individual. The Service already has the authority to address such abuses under the "otherwise obtain the benefits" language of *Reg. section 1.1031(k)-1(g)(6)*.

**Q-14. MAY A TRUST OR ESCROW ACT AS A QUALIFIED INTERMEDIARY?**

A-14. A trust may act as a qualified intermediary provided that the trustee of the trust is not a disqualified person and no beneficiary of the trust is a disqualified person. However, a qualified trust is merely a security device. Thus, a deferred exchange secured by a qualified trust will also need to involve an exchange between the taxpayer and the buyer of relinquished property or a qualified intermediary.

An escrow is a person who may only take actions specified in instructions to the escrow. An escrow is a security device and not a party to the transaction. Thus, a deferred exchange secured by a qualified escrow will also require an exchange between the taxpayer and the buyer of relinquished property or a qualified intermediary.

**Q-15. IN A DEFERRED EXCHANGE, CAN THE TAXPAYER FUND THE EXCHANGE BALANCE WITH ADDITIONAL CASH DURING THE EXCHANGE PERIOD?**

A-15. Yes. Any additional funds deposited during the exchange period will be treated as cash boot paid by the taxpayer and will not affect the safe harbors under *Reg. section 1.1031(k)-1(g)* because depositing additional funds does not result in actual or constructive receipt of the exchange balance during the exchange period. Funds may be deposited in a qualified escrow or trust, deposited with a qualified intermediary, or paid to the seller of replacement property directly or through a settlement agent.

**Q-16. IN A DEFERRED EXCHANGE, HOW SHOULD THE INTEREST EARNED ON THE EXCHANGE BALANCE BE TAXED?**

**Q-16a. IN WHOSE ACCOUNT NAME AND TAXPAYER IDENTIFICATION NUMBER SHOULD THE ACCOUNT BE HELD?**

A-16a. The agreement between the taxpayer and other parties to the exchange will determine the identity of any account in which funds representing an exchange balance is placed and held and the tax identification number associated with such account. So long as applicable agreements affecting the exchange (A) limit the taxpayer's right to receive, pledge, borrow or otherwise obtain the benefits of any money or other property in such account to the circumstances provided in *Reg. section 1.1031(k)-1(g)(6)(ii)* or (iii) and (B) the exchange otherwise complies with the safe harbor requirements of *Reg. section 1.1031(k)-1(g)(2)*, (3) or (4), then the use of the taxpayer's name or tax identification number on such account will be disregarded in determining whether the taxpayer is in actual or constructive receipt of money or property which is not of a like kind to the relinquished property.

**Q-16b. WHAT IS THE PROPER WAY FOR A QUALIFIED INTERMEDIARY OR OTHER PARTY TO REPORT INTEREST INCOME TO THE TAXPAYER?**

A-16b. If the qualified intermediary or other party (A) receives interest from a depository, (B) is obligated to pay a growth factor or interest equivalent to a taxpayer, (C) is not expressly identified as taxpayer's agent in applicable agreements between them, and (D) meets the requirements otherwise applicable to filing a Form 1099, the other party or qualified intermediary should file a Form 1099-INT with respect to each exchange in which a taxpayer receives interest income, showing the taxpayer as the recipient of the interest income.

**Q-16c. WHEN SHOULD INTEREST INCOME ON AN EXCHANGE BALANCE BE REPORTED AS INCOME BY A TAXPAYER?**

A-16c. The interest income should be reported by the taxpayer based on its normal tax accounting method. Thus, a cash basis taxpayer must report the interest income in the year it is actually or constructively received.

The first cash or non-qualified property a cash basis taxpayer receives will be deemed to include interest income to the extent of the interest earned on the exchange balance to the date of the receipt. If the cash or non-qualified property a taxpayer receives in the exchange is less than the interest income earned on the exchange balance, any remaining interest earned will be deemed received by the taxpayer on the termination of the exchange.

## GROUP C -- ISSUES CREATED BY I.R.C. SECTION 1031(f) AND (g)

Section 7601 of the Omnibus Budget Reconciliation Act of 1989, Pub L. 101-239 restricted certain like-kind exchanges between related parties by adding *Section 1031(f)* and (g). This statutory change was prompted by the perceived abuse associated with "basis shifting" in related party exchanges of high basis property for low basis property in anticipation of the sale of the formerly low basis property. It also was feared that basis shifting could be used to accelerate a loss on the sale of the exchange property. Committee Reports accompanying the 1989 legislation state that a related party exchange followed shortly thereafter by a disposition of either exchange property should be viewed as the "cashing out" of an investment in like-kind property, such that the original exchange should not be accorded non-recognition treatment.

*Section 1031(f)* generally establishes a two-year holding period for like-kind property given or received in a like-kind exchange involving related persons. *Section 1031(g)* suspends the running of the two-year period during any period when an exchange party's risk of loss is substantially diminished through certain contractual arrangements, such as a put. *Section 1031(f)* also includes broad "anti-abuse" language intended to prevent taxpayers from structuring transactions in order to avoid the related party rules. The language of *Section 1031(f)* and (g) is modeled after similar provisions found in *Section 453(e)*, which governs related party installment sales.

**Q-17. WHERE A TAXPAYER AND A RELATED PARTY EXCHANGE PROPERTIES WHICH EACH OWNED PRIOR TO THE EXCHANGE AND WITHIN TWO YEARS THE RELATED PARTY SELLS THE PROPERTY IT ACQUIRED IN THE EXCHANGE, WHAT HAPPENS?**

A-17. The exchange is not accorded nonrecognition treatment because the related party disposed of the relinquished property within two years after the property was acquired from the taxpayer. Both the taxpayer and the related party are required to recognize any gain realized in the exchange but only in the year in which the disposition of the property occurs.

**Q-18. IS NONRECOGNITION TREATMENT LOST IF, FOLLOWING AN EXCHANGE OF PROPERTIES BETWEEN THE TAXPAYER AND A RELATED PARTY, THE RELATED PARTY SELLS THE RELINQUISHED PROPERTY PURSUANT TO A MARITAL DISSOLUTION DECREE?**

A-18. Dispositions following death and certain other specific events are disregarded. See *Section 1031(f)(2)(A)*. However, the existing list of categories of dispositions that are disregarded does not include a disposition occasioned by a divorce or other personal emergency. We believe, however, that any event constituting a genuine change in personal or commercial circumstances (such as a divorce) should be sufficient to establish that the disposition did not have as one of its principal purposes the avoidance of federal income tax. See *Section 1031(f)(2)(C)*. The Service should illustrate the application of the non-tax avoidance safe harbor set forth in *Section 1031(f)(2)(C)* through published rulings or by promulgating a revenue procedure that would provide taxpayers with an opportunity to establish in advance the non-tax-avoidance circumstances of a subsequent disposition.

Any disposition within the two-year period that is itself a nonrecognition transaction, e.g., another *Section 1031* exchange, a *Section 351* or *721* contribution, a *Section 1041* transfer or a gift, should automatically satisfy the non tax-avoidance standard, as suggested in the Committee Reports.

**Q-19. WILL A TAXPAYER BE ENTITLED TO RECOGNIZE A LOSS REALIZED WHEN THE BASIS OF RELINQUISHED PROPERTY TRANSFERRED BY THE TAXPAYER TO A RELATED PARTY IS GREATER THAN ITS VALUE AND THE RELINQUISHED PROPERTY IS SOLD BY THE RELATED PARTY PRIOR TO TWO YEARS FROM THE DATE OF THE EXCHANGE?**

A-19. No. Application of *Section 267* results in shifting the tax loss realized by a taxpayer to the related party. *Section 267(a)(1)* provides that no deduction will be allowed in respect to any loss from the direct or indirect sale of property between related persons. Consequently, even though the nonrecognition provisions of *Section 1031* are inapplicable to the exchange because of the related party rule of *Section 1031(f)*, the taxpayer is not allowed to recognize the realized loss. Instead, pursuant to *Section 267(d)*, any gain that the related party subsequently realized upon the disposition of the received property is reduced to the extent of the unrecognized loss realized by the taxpayer.

**Q-20. WHAT IS THE RESULT IF, IN A DEFERRED EXCHANGE, A TAXPAYER TRANSFERS RELINQUISHED PROPERTY TO A QUALIFIED INTERMEDIARY WHICH SELLS THE PROPERTY TO A RELATED PARTY FOR CASH AND SUBSEQUENTLY ACQUIRES REPLACEMENT PROPERTY FROM A PARTY NOT RELATED TO THE TAXPAYER AND TRANSFERS THE REPLACEMENT PROPERTY TO TAXPAYER?**

A-20. Acquisition of relinquished property for cash from the qualified intermediary does not subject the exchange to the rules of *Section 1031(f)* even though the relinquished property is purchased by a related party.

Not every transaction "touched" by a related party is a related-party exchange. If the replacement property is never owned by a related party, its transfer to a taxpayer via a qualified intermediary should not be affected by a related party's purchase of relinquished property. There is no abusive basis shift because the related party's purchase involves creation of a new cost basis rather than a carryover.

**Q-21. MAY A TAXPAYER ARRANGE FOR AN UNRELATED PARTY (INCLUDING A QUALIFIED INTERMEDIARY) TO ACQUIRE REPLACEMENT PROPERTY OWNED BY A RELATED PARTY AND COMPLETE AN EXCHANGE IN WHICH THE TAXPAYER'S RELINQUISHED PROPERTY IS TRANSFERRED TO THE UNRELATED PARTY OR INTERMEDIARY IN EXCHANGE FOR THE REPLACEMENT PROPERTY INITIALLY OWNED BY THE RELATED PARTY?**

A-21. No. The Senate Finance Committee Report states that non-recognition treatment will not be accorded to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of the related party rules. The Senate Report further

states that if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within two years of the previous transfer in a transaction otherwise qualifying under *Section 1031*, the related party will not be entitled to non-recognition treatment under *Section 1031*. Here, the transaction is merely a rearrangement of the steps described in the Senate Finance Committee Report, and thus is covered by the antiabuse language of *Section 1031(f)(4)*.

**Q-22. WHERE A PARTY RELATED TO A TAXPAYER OWNS NO PROPERTY AT THE COMMENCEMENT OF AN EXCHANGE, BUT SERVES AS AN INTERMEDIARY IN THE EXCHANGE, WILL THE APPLICATION OF *SECTION 1031(f)* DENY NONRECOGNITION TREATMENT TO THE EXCHANGE BECAUSE THE RELATED PARTY HAS ACQUIRED AND TRANSFERRED PROPERTY IN THE EXCHANGE AS PART OF ITS ROLE AS INTERMEDIARY?**

A-22. No. *Section 1031(f)(2)(C)* provides that the rule of *Section 1031(f)* will not apply to exchanges between related parties where there is no tax avoidance motive. Use of a related party intermediary does not result in any basis shift or other consequence which *Section 1031(f)* is intended to address. However, use of a related party as an intermediary will mean that the exchange falls outside the safe harbor for qualified intermediaries established by *Reg. section 1.1031(k)-1(g)(4)* since a party related for purposes of *Section 1031(f)* will be a disqualified person under *Reg. section 1.1031(k)-1(k)*. Thus, the taxpayer may bear the burden of proof that the intermediary is not the taxpayer's agent or that the taxpayer is not otherwise in constructive receipt of proceeds from the sale of the relinquished property.

#### FOOTNOTES

/1/ Unless otherwise indicated, all statutory references are to sections of the Code.

/2/ These areas are: reverse exchanges, deferred exchanges and installment sales, exchanges involving foreign persons and the *Section 752* and minimum gain chargeback consequences of exchanges by partnerships.

/3/ By risk of repayment, we do not mean to imply that the debt must be recourse, but merely that the lender expects the taxpayer (and not the acquirer of the relinquished property) to repay the debt.

/4/ Rules such as these are of more importance in the application of the three-property rule for identifications of replacement property.

/5/ Example 3 of *Reg. section 1.1031(k)-1(d)(2)* provides that, where the identified property was a barn and two acres of land and the received property consists of the barn and the underlying land, the taxpayer has not received substantially the same property as identified because what was identified differs in "basic nature or character" from what was received. However, pursuant to *Reg. section 1.1031(a)-1(b)*, whether or not real estate is improved relates only to its grade or quality not its nature or character. This example should therefore be rewritten to change either its conclusion or the basis for its conclusion. (This example and example 4 also contain a math error which should be corrected.)

END OF FOOTNOTES