Banker Exchange

Like-Kind Exchanges Under Section 1031

Banker Exchange, LLC
777 Lowndes Hill Rd
Bldg 3, Suite 110
Greenville, SC 29607

Member

FEDERATION OF
EXCHANGE ACCOMMODATORS

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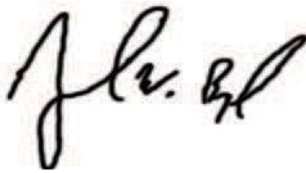
THE BASICS OF SECTION 1031

LIKE-KIND EXCHANGES INTRODUCTION

In April 1992, Banker Exchange, LLC (formerly Boyd Corporation) opened its doors as the first, full-service qualified intermediary in the state of South Carolina. Banker Exchange, LLC has assisted CPAs, attorneys, real estate professionals and their clients nationwide by providing a full range of qualified intermediary services for tax-deferred exchanges under Section 1031 of the Internal Revenue Code.

In general, IRC §1031 provides that no gain or loss is recognized (and therefore no income tax is due) on the disposition of property held for productive use in a trade or business or for investment, provided that the property is exchanged solely for property of a like-kind to be held for the same purpose. Although on the surface this seems to be a very straightforward process, nothing is simple with the IRS. There is an abundance of administrative requirements and strict rules regarding IRC §1031 exchanges. At Banker Exchange, LLC, we have a combined quarter-century of experience with tax-deferred exchanges, and have researched the IRS Regulations intensively, developing procedures and documents which help to ensure that the transactions will withstand IRS scrutiny.

While we recognize this information is not an exhaustive treatment of like-kind exchanges, we believe it will serve as a good starting point for any issues you may confront. We thank you for your participation in today's seminar and welcome the opportunity to discuss the benefits that may be available to you through a tax-deferred exchange. If we can provide any assistance or information on a particular exchange, please do not hesitate to call on us.



John W. Boyd
CEO

TABLE OF CONTENTS

Page

I. Exchange Definitions 1

II. Explanation of Tax-Deferred Exchange 3
Types of §1031 Exchanges 3

III. "Tax-Free" vs. "Tax-Deferred" 5

IV. Types of Property Qualifying for IRC §1031 Treatment 6
Application of §1031 to Real Property 6
Properties That Do Not Qualify for §1031 Treatment 7
Exchange Proceeds Used to Improve Currently Owned Property 8

V. Receipt of Proceeds from the Sale of Relinquished Property 9
Role of the Qualified Intermediary 9
Release of Exchange Proceeds 9

VI. Time Restrictions on Location and Acquisition of Replacement Property 11

VII. Identifying Replacement Property 12
Form of Identification 12
Rules for the Number of Replacement Properties Which May be Identified 12

VIII. Selling Multiple Relinquished Properties in One Exchange 14

IX. Same Taxpayer Requirement 15
Relinquished Property Issues 15
Replacement Property Issues 15

X. Reverse Exchanges 16
Revenue Procedure 2000-37 16
Non-Compliant Reverse Exchanges 18

XI. Related Party Rules 20

XII. Relinquished Property Subject to Mortgage 24

XIII. Property Located in Different States 24

TABLE OF CONTENTS (continued)

Page

XIV. Addendum A – Section 1031 25

XV. Addendum B – Treasury Regulations §1.1031.0 et. Seq. 26

XVI. Addendum C – Revenue Procedure 2000-37 27

XVII. Addendum D - Revenue Procedure 2004-51 28

XVIII. Addendum E - Revenue Procedure 2005-14 29

XIX. Addendum F - Revenue Procedure 2002-22 30

XX. Addendum G – Revenue Procedure 2004-86 31

EXCHANGE DEFINITIONS

Any valuable discussion of topics found in the Internal Revenue Code begins with the basic definitions associated with the transactions involved. We have tried to provide a list of the most common terms and phrases used in the context of like-kind exchange. These will be used throughout the materials.

Basis - The net worth allocated to the property being sold by the taxpayer. A simple calculation of basis is the amount paid for the property, less any depreciation, plus any improvements.

Boot – Any cash or non-qualifying property received by the taxpayer in an exchange. Any debt relieved at the sale of the relinquished property that is not replaced in full on the replacement property, either by new debt or by cash brought from an outside source unrelated to the exchange, will be considered boot and taxable to the extent of the capital gain inherent for the entire transaction. Any other non-qualifying property, such as a promissory note, that is not fully reinvested in the replacement property, will be taxable to the same extent.

Code - The Internal Revenue Code of 1986, as amended, or the IRC.

Constructive Receipt – Having indirect possession or control of the proceeds from the sale of relinquished property or receiving the economic benefit from such proceeds or assets prior to the end of the exchange period. A taxpayer's constructive receipt of the proceeds leads to the same result as the actual receipt of the proceeds by a taxpayer; the loss of any possibility for the taxpayer to utilize Section 1031 to defer tax in an exchange.

Exchange Period - The time period within which the taxpayer must acquire replacement property in an exchange. The exchange period begins on the date of transfer of the relinquished property. In an exchange involving multiple relinquished properties, the period begins on the transfer of the first property. The exchange period ends on the earlier of (a) 180 days after the transfer date of the first relinquished property, or (b) the due date of the taxpayer's tax return, including validly filed extensions.

Identification Period - The time period in which the taxpayer must identify replacement property in an exchange. The identification period is 45 calendar days in length, begins on the date of transfer of the relinquished property, ends at midnight of the 45th day thereafter, and runs concurrently with the exchange period.

Like-Kind Property - "Like-kind" refers to the nature or character of property, and not to its grade or quality. Under Section 1031, all real property is generally of a like-kind to all other real property.

Proceeds - The cash or other property received from the sale of relinquished property in the exchange.

Qualified Intermediary - The facilitator of the IRC §1031 tax-deferred exchange. The qualified Intermediary acts throughout the transaction on behalf of the taxpayer pursuant to Section 1.1031(k)-1(g)(6) of the Regulations. Also referred to as "Accommodator" or "QI".

Regulations – The rules and requirements for conducting a tax-deferred exchange as promulgated by the Treasury Department and published at 26 C.F.R. §§1.1031-0 et. seq. See Addendum B.

Relinquished Property - The property or properties sold by the taxpayer in an exchange.

Replacement Property - The property or properties acquired by the taxpayer in an exchange. May also be called the "acquisition property".

Service - The Internal Revenue Service, or IRS.

Tax-Deferred Exchange - Section 1031 of the Code provides for the exchange of property held for: (i) business use; or (ii) investment solely for property of a like-kind without recognizing income on the exchange.

Taxpayer - The owner of property utilizing an IRC §1031 tax-deferred exchange to defer the capital gains tax consequence on the sale of investment property. Also called an "Exchangor".

Value Requirement - The amount that a taxpayer must reinvest into replacement property to completely defer the income tax on a transaction. The calculation of this amount includes all cash received as well as any debt relieved from the transfer of the relinquished property.

EXPLANATION OF TAX-DEFERRED EXCHANGE

A "tax-deferred exchange" is a transaction involving a sale and a purchase of investment property or property held for productive use in trade or business which meets the requirements of Section 1031 of the Code and qualifies for nonrecognition of gain or loss. These transactions come in a variety of formats and fact patterns, but the basic concept of changing one's investment assets without changing the underlying investment methods or goals remains constant.

The language regarding exchanges was drafted into the Code in 1921, just three years after the Code's implementation in 1918. For a long period, the idea was long thought to cover only simultaneous trades of property, or "swaps". This notion that all exchanges must occur simultaneously was challenged by an individual named T. J. Starker and his family. In Starker v. United States, 602 F.2d 1341 (9th Cir., 1979), the Court held the Code contained no requirement that an exchange be a simultaneous transfer of property between two owners. As a result of the outcome of Starker, the essential definition of a deferred exchange as we know it today was added to the Code in 1984.

Significant expansion to this understanding came when the Service promulgated the first set of Regulations that govern IRC §1031 tax-deferred exchanges effective June 10, 1991. These Regulations approved the concept of a deferred exchange within certain limitations and address the majority of questions which arise in common deferred transactions. The final major expansion to governmental guidance came in the form of Revenue Procedure 2000-37, which set forth a safe harbor for taxpayers wishing to purchase replacement property prior to selling relinquished property while still being able to complete a Reverse Exchange.

Types of §1031 Exchanges

Simultaneous: An exchange where the relinquished property and replacement property are transferred concurrently.

Deferred: An exchange that begins the date relinquished property is transferred if replacement property is identified within 45 days and acquired no later than the end of the 180- day exchange period. A deferred exchange is the most common type of exchange. A qualified intermediary or similar safe harbor as described in Section 1.1031(k)-1(g) of the Regulations must be involved in the transaction for it to be eligible for tax deferral.

Construction: An exchange in which the replacement property desired by the taxpayer includes improvements to be constructed on property the taxpayer intends to purchase. These may include repairs or remodeling of an existing structure, or construction of a new building on raw land. These may not include construction of improvements on property already owned by the taxpayer.

Reverse: An exchange in which a taxpayer wishes to acquire the replacement property prior to the sale of the relinquished property. There are many reasons why this may happen. The taxpayer may have lost or not yet located a buyer for the relinquished property, or perhaps she is in a position to lose favorable financing or a substantial earnest money deposit if she fails to close on the replacement property by a specified date. These transactions require the involvement of an

accommodating titleholder who steps in and takes title to either the relinquished or the replacement property on the taxpayer's behalf. There are several additional requirements for a Reverse Exchange than for the more common deferred exchange process.

“TAX-FREE” VS. “TAX-DEFERRED”

Exchanges under Section 1031 are “tax-deferred”, not “tax-free”, because the gain deferred in the transaction will be recognized on the ultimate sale of the replacement property received in the exchange. The basis of the property sold in the exchange will transfer to the replacement property purchased, thus “rolling” the gain within the transaction. This deferral is not limited to one transaction, and the taxpayer may continue to exchange properties so long as she increases the value of the replacement property received each time. If the taxpayer ever sells outright replacement property originally received in an exchange, then gain will be calculated and taxes paid on the sale based on the lower carryover basis from the relinquished property plus the value of any new equity injected or debt incurred in the purchase of such property.

EXAMPLE:

	Relinquished Property:		Replacement Property:
	FMV: $400,000		FMV: $500,000
	A/B*: $100,000		A/B: $200,000
Taxable Gain Deferred	$300,000		
			($100,000 Carryover A/B)
			($100,000 New Equity)
		Potential Taxable Gain in Property	$300,000

Under certain circumstances, the tax on the gain may never be realized. One such instance occurs if the replacement property is held by an individual taxpayer until death. If her estate is properly structured and does not exceed certain limitations, a full “step-up” in basis can be achieved without any tax being due on the property.

*A/B = Adjusted Basis

TYPES OF PROPERTY QUALIFYING FOR IRC §1031 TREATMENT

If a taxpayer holds relinquished property "for investment" or "for productive use in a trade or business," then, except for certain exceptions listed below, it may be exchanged for property of a like-kind. The taxpayer must purchase property with the intent of holding it for a similar use in order to take advantage of a tax-deferred exchange. The purpose for which the property is held is determined at the time of the transaction.[1] Finally, a taxpayer may exchange investment property for business use property and business use property for investment property within one exchange.

Application of §1031 to Real Property

The term like-kind refers to the character of the real property and not to its grade or quality.[2] All real property held for the proper purpose is potentially of a like-kind to all other real property. Some good examples of real properties which qualify for exchange treatment are:

- Raw land
- Vacant lot
- Commercial property
- Retail property
- Farm land
- Industrial property
- Residential rental
- Commercial/office rental
- Delaware Statutory Trust
- Leasehold interest of 30 years or more

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1 Rev. Rul. 57-244, 1957-1 CB 168; Klarkowski v. C.I.R., T.C. Memo. 1965-328, decision aff'd, 285 F.2d 398 (7th Cir. 1967) and recommendation of acquiescence, I.R.S. 1968.

2 Treas. Reg. §1.1031(a)-1(b).

Properties That Do Not Qualify for §1031 Treatment

Certain properties will never qualify for Section 1031 exchange.[3] The Code and Regulations do not allow the following properties to be exchanged:

- Primary residences
- Second/Vacation homes
- Stock in trade or inventory
- Property held for resale
- Stocks, bonds or notes
- Partnership interests
- Certificates of trust or beneficial interests
- Other personal property

[3] I.R.C. §1031(a)(2).

Exchange Proceeds Used to Improve Currently Owned Property

Exchange proceeds from the sale of a relinquished property **cannot** be used to improve upon or relieve debt on a currently owned property. The Regulations state that an actual exchange of property must occur, and that investment property must be sold and new property purchased. A taxpayer cannot sell an investment property, use the proceeds to improve or build upon another currently owned investment property, pay down any debt on the property, or pay off any debt they owe otherwise to complete a valid §1031 exchange.

RECEIPT OF PROCEEDS FROM THE SALE OF RELINQUISHED PROPERTY

Role of the Qualified Intermediary

The IRS does not permit tax-deferral to a taxpayer who receives, directly or indirectly, the cash proceeds from the sale of relinquished property. The need to avoid constructive receipt of the proceeds led to the creation of the qualified intermediary and similar safe harbors described in the Regulations.[4] Although it is not possible to predict all situations that taxing authorities will consider actual or constructive receipt of proceeds, exchanges structured correctly with a qualified intermediary have proven successful in avoiding any question of constructive receipt.

Most exchanges begin with the net closing proceeds on the sale of the relinquished property being paid directly to a qualified intermediary by the closing agent. The proceeds from the sale should be placed directly into an account maintained by a QI. This direct payment avoids most issues of constructive receipt so long as the QI has a written exchange agreement with the taxpayer in place prior to the closing, as required by Regulation Section 1.1031(k)-1(g)(6). The exchange agreement should provide protection for the taxpayer from unlawful use and disbursement of the proceeds, as well as compliance with restricting the taxpayer's use or access to funds under §1.1031k-1(g)(6).

Because Section 1031 is not an "all or nothing" statute, a taxpayer may choose to receive cash or debt relief boot in an exchange. The amount of cash or other property paid at closing to the taxpayer is boot and is not included in the exchange value requirement. All such boot will be subject to capital gains tax as of the date of sale. If a taxpayer desires to intentionally take cash boot at the closing, it must be done at closing on the relinquished property because of the restrictions placed on the net sales proceeds once they are received by the Qualified Intermediary.[5] Additionally, a taxpayer may choose to purchase property with all of the cash proceeds through a QI, but not to replace debt relieved in the sale of the relinquished property. Such debt relief in also boot and will be taxable as of the date of the sale of the relinquished property.

Release of Exchange Proceeds

Once a taxpayer has begun an exchange with a QI, the circumstances under which the exchange proceeds or remainder thereof may be released to the taxpayer are rather firm. The agreement between the QI and taxpayer governs the exchange, and that agreement must limit the taxpayer's access to the funds to prevent a determination that the taxpayer had constructive receipt. The following list outlines the accepted conditions under which a taxpayer may receive the proceeds from an exchange[6]:

1. If the taxpayer fails to identify replacement property within the identification period, or if the taxpayer identifies replacement property in such a way as to disqualify the identification as defined within IRC §1031, the exchange will terminate, and the qualified intermediary may pay the exchange proceeds to the taxpayer after the end of the identification period, so long as no replacement property has been identified by way of purchase as of that date.

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[4] Treas. Reg. 1.1031(k)-1(g)(6).

[5] Id.

[6] Id

2. If the taxpayer has timely identified replacement property, then funds may be released after the taxpayer has received (purchased) all of the identified replacement property to which the taxpayer is entitled. One caveat with this section is that, if the taxpayer does not purchase all the replacement properties identified, then the exchange proceeds cannot be released until after the exchange period expires. This is due to the IRS' position that, if there are properties left on the taxpayer's identification that were not purchased, they are still considered to be properties "to which the taxpayer is entitled", and thus the exchange will not be complete until the tolling of the 180th day of the exchange period.

3. If the taxpayer has timely identified replacement property, then after the expiration of the identification period and prior to the expiration of the Exchange Period, funds may be released subsequent to the occurrence of a material and substantial contingency that: (i) relates to the deferred exchange; (ii) is provided for in writing; and (iii) is beyond the control of the taxpayer and of any disqualified person as defined in Treasury Regulation §1.1031(k)-1(k). However, a decision by the taxpayer not to complete the exchange or not to purchase all property identified does not entitle the taxpayer to terminate the exchange and receive the exchange proceeds prior to the expiration of the 180-day exchange period.

4. Otherwise, the taxpayer may only take possession of any remaining exchange proceeds at the end of the 180-day exchange period.

TIME RESTRICTIONS ON LOCATION AND ACQUISITION OF REPLACEMENT PROPERTY

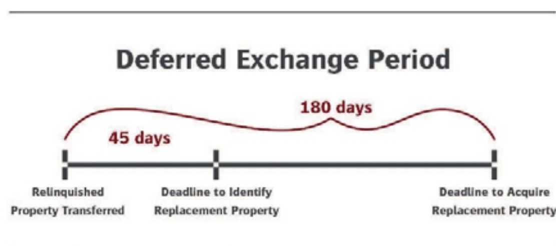
When structuring a deferred §1031 exchange, there are two critical time limitations: the period of time during which the taxpayer must identify their replacement property, and the period of time during which the taxpayer must acquire their replacement property[7]. The replacement property must be:

(a) Identified within 45 calendar days after the date of the sale of the relinquished property (the identification period)[8]; and

(b) Acquired on or before the earlier of (a) midnight on the 180th calendar day after the date of the transfer of the relinquished property; or (b) midnight on the due date of the taxpayer's tax return, including extensions, for the year in which the transfer of the relinquished property occurred (the exchange period)[9].

Note: The 45-day identification period and the 180-day exchange period run concurrently.

The dual rule determining the length of the Exchange period means that if an individual taxpayer's relinquished sale closes on October 18th or thereafter[10], she may not have the entire 180-day exchange period to locate and acquire suitable replacement property unless she files an extension for her individual income tax return.



The tax deferral rules applicable to like-kind exchanges will not apply to the transaction if these requirements are not met. There are almost no extensions of the 45-day and 180-day periods, including no allowance for Saturdays, Sundays or holidays. Generally, no hardship or other mitigating factors will excuse a failure to satisfy these requirements. The only exceptions to this rule are an extension for presidentially declared disaster areas which include a specific extension for Section 1031 exchanges and the presence of taxpayers in certain combat zones.[11]Consequently, if the 45-day identification period or the 180-day exchange period expires on July 4th, the taxpayer is responsible for ensuring the property is identified or acquired prior to midnight on that day.

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7 I.R.C. §1031(a)(3).

8 Treas. Reg. §1.1031(k)-1(b)(1)(i).

9 Treas. Reg. §1.1031(k)-1(b)(1)(ii).

10 This date will fluctuate depending on the actual due date of the taxpayer's return.

IDENTIFYING REPLACEMENT PROPERTY

The Regulations set forth strict guidelines for the identification of replacement property under §1031.

Form of Identification

Under the Regulations, replacement property is treated as identified for purposes of §1031 only if its designation as replacement property is contained in a written document: (i) signed by the taxpayer; (ii) hand delivered, mailed, faxed, or otherwise sent; (iii) before the end of the identification period; and (iv) to the person obligated to transfer the replacement property or to any person involved in the exchange other than the taxpayer or a disqualified person[12].

The replacement property must generally be unambiguously described in a written document[13]. One exception to that basic rule is that if a taxpayer actually receives replacement property within the forty-five (45) day identification period[14]. For example, a real property identification is considered unambiguous if it is listed by legal description, street address, or identifiable name. However, if a taxpayer desires to identify the Holmes Apartment Building, and the city in which it is located is a large one, there may well be several Holmes Apartments within the city. Therefore, it is best to always provide as much detail regarding the property as possible, including city, state and zip code for street addresses, and amount of acreage, intersection, city, state, zip code, and identifying parcel numbers for raw land. Tenant-In-Common interest should be identified consistently with their description in the offering memorandum.

Though the Regulations state that identifications may be hand-delivered, it is wise for a taxpayer to send its identification by facsimile and by certified mail in order to have substantiated proof of delivery in a timely manner to protect the exchange.

Rules for the Number of Replacement Properties Which May be Identified

The Regulations place certain restrictions on the number of properties which may be identified during the identification period. There are three rules for identifying property, of which the taxpayer must meet at least one. They are:

1. The "3-Property Rule"[15]: A taxpayer may identify up to three properties without regard to the fair market values of the properties;

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[11] Rev. Proc. 2005-27, 2005-20 I.R.B. 1050; provides for the extension of Section 1031 exchange time periods for the lists contained in §§7508 and 7508A.

[12] Treas. Reg. §1.1031(k)-1(c).

[13] Treas. Reg. §1.1031(k)-1(c)(3).

[14] Treas. Reg. §1.1031(k)-1(c)(1).

2. The “200% Rule”[16]: A taxpayer may identify any number of properties, as long as their aggregate fair market value as of the end of the identification period does not exceed 200% of the aggregate fair market value of the relinquished property sold; or

3. The “95% Rule”[17]: If a taxpayer fails to meet either of the first two tests but ultimately purchases property constituting at least 95% of the aggregate fair market values of all identified replacement properties before the end of the exchange period, then the identification will have been valid.

If, by the end of the identification period, the taxpayer has identified more properties than permitted by the 3-property rule, whose value is in excess of 200% of the sales price of the relinquished property, then they will be deemed to automatically fall under the 95% rule. If they then do not purchase at least 95% of all properties identified, they will be judged to have not identified at all, and their exchange will become void, terminating at midnight on the last day of the exchange period, causing a taxable event.

Revocation of Identification

A taxpayer may revoke her identification at any time prior to the end of the identification period. The revocation will only be valid if it is in writing, signed by the taxpayer, and delivered to the person to whom the identification of replacement property was originally made on or before midnight of the 45th day of the identification period.

[15] Treas. Reg. §1.1031(k)-1(c)(4)(i)(A).
[16] Treas. Reg. §1.1031(k)-1(c)(4)(i)(B).
[17] Treas. Reg. §1.1031(k)-1(c)(4)(ii)(B).
[18] Treas. Reg. §§1.1031(k)-1(c)(5)(i)(A) & (B)

SELLING MULTIPLE RELINQUISHED PROPERTIES IN ONE EXCHANGE

A taxpayer may transfer more than one relinquished property within the same exchange transaction[19]. Some details for structuring this type of exchange are:

(a) The identification period and exchange period are determined by the date of transfer of the first relinquished property;

(b) All replacement properties purchased prior to the sale of other relinquished properties in the exchange cannot be dependent upon proceeds from the later relinquished property sales; and

(c) All relinquished properties sold within the same exchange transaction must all be owned by the same taxpayer.

For example, regarding item (b) above, the taxpayer could not purchase a replacement property on November 3rd, sell an additional relinquished property on December 12th, and use the proceeds from that sale to pay down any debt used to acquire the previous replacement property. The taxpayer should either postpone the closing of the replacement property until after the sale of the additional relinquished property or ensure there are additional replacement properties identified for purchase in the exchange.

[19] Treas. Reg. §1.1031(j)-1.

SAME TAXPAYER REQUIREMENT

Relinquished Property Issues

Although it is not stated explicitly in §1031, it is implied and documented in numerous tax cases that the replacement property in an exchange must be purchased by the same taxpayer who held title to the relinquished property.[20] Thus, if a relinquished property is owned solely in a husband's name, then the husband will be the exchangor, and must purchase the replacement property solely in his name. Also, if ABC, LLC sells a relinquished property, then ABC LLC must acquire the replacement. Multiple relinquished properties may be sold in one exchange, but all must be owned in the same name or they cannot be included in the same exchange.

For example, John and Jane own two properties as joint tenants with right of survivorship, and John and Jane own one property in the name of 123 Co. Only the properties owned by John and Jane individually may be included in the same exchange. 123 Co must effect a separate exchange on its sale. In the event of the death of a taxpayer during an exchange, the taxpayer's estate or trustee may complete the exchange.[21]

Replacement Property Issues

Several exchanges may be utilized to allow each taxpayer to acquire ownership of a portion of one property. A taxpayer looking to consolidate property by selling multiple properties owned by different tax entities, or two or more taxpayers wishing to pool resources to purchase one property may obtain undivided interests in replacement property. The transactions would look like the following:

(a) John and Jane, as husband and wife, own 555 Main Street, a rental home. XYZ LLC, of which John and Jane are the only members, owns a rental home at 100 Side Avenue. John and Jane find a rental home at the coast for which they wish to exchange. The sales price of Main Street is $100,000; the sales price of Side Avenue is $75,000; and the purchase price of the rental home at the coast is $175,000. John and Jane exchange Main Street for a 53% interest in the coastal home, and XYZ LLC exchanges Side Avenue for the remaining 47% interest in the coastal home.

(b) John and Jane, as husband and wife, own 555 Main Street as a rental home. Their friends, Bill and Betsy, own 333 Back Road as a rental home, as husband and wife. The two couples wish to purchase a rental cabin in the mountains together and find one suitable. The sales price of Main Street is $50,000; the sales price of Back Road is $50,000; and the purchase price of the rental cabin in the mountains is $100,000. John and Jane exchange Main Street for a 50% interest in the cabin, and Bill and Betsy exchange Back Road for the remaining 50% interest in the cabin.

[20] Chase v. C.I.R., 92 T.C. 874 (1989).

[21] In Re Goodman's Estate, 199 F.2d 895 (3d Cir. 1952)

REVERSE EXCHANGES

In September of 2000, the Internal Revenue Service promulgated Revenue Procedure 2000-37 and created a safe harbor structure for transactions known as reverse exchanges. These transactions were commonly known as parking arrangements because a third party "parks" either the taxpayer's relinquished property or her replacement property to facilitate the exchange[22]. Prior to the issuance of the Revenue Procedure, taxpayers were required to try and structure a reverse exchange in which the facts and circumstances indicated that there was an arm's length relationship between the taxpayer and the parking agent. The Revenue Procedure provides relief from that uncertainty. Reverse Exchanges conducted in compliance with Rev. Proc. 2000-37 are referred to as "compliant" or "safe harbor" reverse exchanges. Although most reverse exchanges are compliant, the Revenue Procedure states very clearly that it is a safe harbor only and that no negative presumption is to be drawn from a transaction being conducted outside that safe harbor. Those transactions falling outside the safe harbor are referred to as "non-compliant" or "non-safe harbor" reverse exchanges.

Revenue Procedure 2000-37

Made effective September 15, 2000, Revenue Procedure 2000-37 acknowledges the fact that taxpayers have been entering into so-call parking arrangements in order to create a structure which fits into the requirements of the Regulations for deferred exchanges. In general, a taxpayer who has located suitable replacement property, but has a delay in closing on relinquished property will hire a third party to hold either the relinquished or the replacement property until such time as they can be exchanged in the proper order. This third party is referred to in the Revenue Procedure and in common practice as an "Exchange Accommodation Titleholder" or "EAT"[23].

The reason for the creation of a safe harbor was to regulate the use of EATs and to provide the taxpayer a mechanism whereby they could maintain sufficient control over both pieces of property in the transaction. Without the safe harbor provisions, the EAT must maintain the benefits and burdens of ownership, and its relationship to the taxpayer must be "arm's length." Alternatively, in a compliant exchange, no such arm's length relationship must exist.

In order to have a compliant exchange, the taxpayer must meet certain requirements. First, the taxpayer must hold the property in a Qualified Exchange Accommodation Arrangement ("QEAA"). The requirements of the QEAA are as follows:

1. Qualified indicia of ownership must be held by a person who is not the taxpayer or a disqualified person (this is the EAT);
2. Taxpayer must have a bona fida intent to complete an exchange with the property;
3. Within five (5) days of the EAT taking title, the EAT and the taxpayer must enter a written agreement providing for the following:
    a. the agreement is entered into pursuant to Section 1031 and the Revenue

[22] Rev. Proc. 2000-37, §1, 2000-40 I.R.B. 308, as modified by Rev. Proc. 2004-51, 2004-33 I.R.B. 294 (July 20, 2004).
[23] Id.

Procedure and that all parties will report pursuant to the Revenue Procedure; and

b. that the EAT will be treated as the beneficial owner for tax purposes;

4. No later than 45 days after the acquisition of replacement property by the EAT, the relinquished property must be identified in a manner consistent with Section 1.1031(k)-1(c) of the Regulations;
5. No later than 180 days after the acquisition of property by EAT: (a) replacement property must be transferred to the taxpayer and (b) relinquished property must be transferred to a person who is not the taxpayer or a disqualified party; and
6. The combined time period that relinquished and replacement property is held by EAT does not exceed 180 days.

The key benefit to entering into a compliant exchange is that the Revenue Procedure allows for a relaxed relationship between the EAT and the taxpayer. The EAT may not be a disqualified person, but may be the QI in the transaction[24]. The taxpayer may enter into one or more of the following agreements with the EAT without IRS scrutiny of the treatment of the EAT as beneficial owner:

1. The taxpayer or a disqualified person may guarantee the acquisition indebtedness;
2. The taxpayer or a disqualified person may loan the acquisition funds to the EAT;
3. The EAT may lease the property on less than fair market value terms to the taxpayer;
4. The taxpayer may manage the property, supervise construction of improvements or otherwise provide service to the EAT;
5. The taxpayer may indemnify the EAT from any loss on the property and the EAT may allow the taxpayer to benefit from any gain on the property during the time the EAT holds title; and
6. The taxpayer and EAT may enter into puts and calls on the property for a period not in excess of 185 days from the date of acquisition by the EAT.

If a taxpayer complies with the provisions of Revenue Procedure 2000-37, then the Service will not investigate where the true benefits and burdens on ownership of the property lies, and thus will not question the qualification of the relinquished or replacement property as qualified on those grounds. However, it is important to remember that the remaining rules surrounding Section 1031 still must be met for the exchange to qualify.

Improvements may be constructed on parked property during a reverse exchange. In safe harbor reverse exchanges, the EAT obtains construction funding from either the taxpayer or a third-party lender, and constructs improvements during the 180-day period. For a more complete description of how an improvement exchange is completed see the construction exchange section below.

As originally drafted, the Revenue Procedure did not prohibit an EAT from purchasing property from the taxpayer, constructing improvements on the property, and then transferring the property back to the taxpayer as replacement property.

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[24] Rev. Proc. 2000-37, §4.03(1), 2000-40 I.R.B. 308.

This omission served to grant the taxpayer a method for constructing improvements on its own property. In 2004 the IRS promulgated Revenue Procedure 2004-51 which supplemented the original revenue procedure by adding a prohibition on these types of arrangements[25]. Specifically, the Service will not apply the safe harbor to property owned by the taxpayer within the 180-day period prior to the transfer of the qualified indicia of ownership to the EAT. This basically prevents the taxpayer, either directly or through a qualified intermediary, from transferring property to the EAT for the construction of improvements on its own land.

Non-Compliant Reverse Exchanges

As stated in Revenue Procedure 2000-37, no negative inference is to be drawn from a taxpayer's decision to enter into an arrangement for the parking and subsequent exchange of property outside of the safe harbor. The qualification of property involved in these "non-compliant" arrangements becomes subject to IRS scrutiny and is dependent upon the specific facts and circumstances surrounding each transaction. The basic structure of property being held by a parking agent is the same, but the parking agent must take not only qualified indicia of ownership but must also bear the benefits and burdens of ownership with all facts taken into account.

The difficulty in creating an arrangement which provides the EAT with all of the benefits and burdens of ownership is twofold. First is the general apprehension of an accommodating title holder with respect to taking the benefits and burdens of too many properties, and the risk of being left with those properties in the event of a taxpayer collapse. The second is a taxpayer's desire to maintain control over the property throughout the transaction, which was the intention of the transaction from the beginning.

The two main attacks on the structure of non-compliant reverse exchanges rest in the areas of failure of the EAT to take true tax ownership of the property and the treatment of the EAT as an agent of the taxpayer. Only one case has been decided on the agency issue[26]. In DeCleene, the Court held that the accommodating party was acting as the agent of the taxpayer and that the improvements constructed on the relinquished property were tantamount to improvements constructed on property owned by the taxpayer. DeCleene did not have many taxpayer friendly facts and is a case which showcases the need for careful planning on the front end of any non-compliant exchange. The court focused on the prior ownership of the property by the taxpayer, and the inability to show a true divestiture of the property during the parking time period.

Other non-exchange scenarios have addressed the agency issues and been determined in favor of taxpayers. Additionally, at least one Private Letter Ruling exists which addresses the specifics of a reverse exchange and its qualification under Section 1031 using an agency relationship analysis. PLR 200111025 provides the clearest "roadmap" to what the IRS may consider to be a true arm's length transaction. However, it is important to note that private letter rulings may not be relied upon for precedence by anyone other than the requesting taxpayer. Also, several more recent and similarly weighted promulgations from the IRS result in a

[25] Rev. Proc. 2004-51, 2004-33 I.R.B. 294 (July 20, 2004).

[26] Decleene v. C.I.R., 115 T.C. 437 (2000).

different outcome based on the tax ownership issue[27].

In the PLR the requesting taxpayer arranged his transaction with the following specifics:

1. The EAT took title to the property and borrowed funds from a third-party lender with full recourse;
2. EAT paid the taxpayer a fair market value guarantee fee to guarantee the loan;
3. Eat borrowed the down payment from taxpayer in an arm's length loan transaction;
4. The property was net leased back to the taxpayer;
5. Taxpayer had an 18-month option to purchase the property;
6. EAT assigned underlying leases to taxpayer; and
7. EAT reported the property as its own for all tax purposes.

The author of the PLR focused on the agency relationship between the parties, and ultimately determined that because no agency relationship existed, the transaction qualified for non-recognition treatment.

In FAA 20050203F, the Service focused on the "benefits and burdens" of the transaction. The EAT did not invest any initial capital, but rather borrowed all of the purchase and construction funds from a third-party lender. It then net leased the property to the taxpayer. Because all expenses were paid by the taxpayer under the lease, the EAT had no capital investment, and the taxpayer had a 24-month fixed price option, the Service determined that the taxpayer and not the EAT bore the economic risk in the transaction. It is interesting to note that the Service cites certain cases for the agency argument and other, unrelated cases for support of the benefits and burdens test.[28]

In light of the uncertainty surrounding non-compliant reverse exchanges, significant care should be taken to structure the parking arrangement in a truly arms-length fashion and with the benefits and burdens of the transaction resting with the EAT. Whenever possible, the taxpayer should not loan purchase or construction funds, and when such a loan is made it should be at prevailing market rates with proper security taken back. Any lease to the taxpayer should be at fair market value rates and on commercially reasonable terms. The taxpayer should not guarantee any loans, and if such a guarantee is required it should be in exchange for a commercially reasonable guarantee fee. Finally, any options or other price fixing mechanisms in favor of the taxpayer should be of a short duration and should be paid for by the taxpayer.

[27] FAA 20050203F.

[28] Compare DeCleene, supra and Grodt & McKay Realty, Inc. v. C.I.R., 77 T.C. 1221 (1981) with National Carbide Corp. v. C.I.R., 336 U.S. 422 (194

RELATED PARTY RULES

The related party rules were introduced to the Code and Regulations in 1989[29]. Code Section 1031(f) was intended to prevent taxpayers from using exchanges under §1031 to effectively shift tax basis between properties owned by related parties, thereby allowing them to reduce the gain on the sale of one of the properties.

For purposes of Section 1031, the definition of a "related person" or related party is any person who has a relationship to the taxpayer described in §267(b) or §707(b)(1) of the Code. This includes:

1. Family members (siblings, spouse, ancestors, and lineal descendants);

2. An individual and a corporation, where more than 50% in value of the stock is owned directly or indirectly by or for said individual;

3. Two corporations that are part of the same control group;

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

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

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

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

8. An individual and a §501 organization (tax-exempt), if the organization is controlled by that person or that person's family;

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

10. An S-corp. and another S-corp. or a C-corp., if the same people own more than 50% of the value of the stock of each corporation;

11. A partnership and an individual who owns more than 50% of the capital interests or profits interests in such partnership, directly or indirectly;

12. Two partnerships wherein the same people own more than 50% of the capital interests or profits interests, directly or indirectly; and

[29] Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239

13. An executor of an estate and the beneficiaries of the estate.

The most simplistic related party transaction is the direct swap between related parties. In the direct swap scenario, neither party is required to recognize gain so long as they each hold the replacement property received for a minimum of two years[30]. The two year time period is calculated from the date of the last transfer that is a part of the transaction[31]. In direct swap transactions, there is no investigation into whether basis-shifting has occurred. The transaction may be tax-motivated as long as the bright-line two-year test is respected.

There are also certain exceptions to the two-year holding period requirement. These include involuntary conversion and similar circumstances, as well as transfers caused by the death of a taxpayer[32]. An additional exception from Section 1031(f) related party rules is when a transaction has a substantial business purpose and no tax avoidance purpose[33]. There is no specific list of transactions which qualify for the no tax avoidance exception, and the burden of proof in such a situation lies with the taxpayer; however, there are some examples in the legislative history of Section 1031(f)[34].

Several recent Private Letter Rulings have clarified the Service's position on family partitions which are generally direct swap transactions. If one parcel is partitioned among several heirs then no exchange has occurred[35]. If multiple properties are exchanged among co-owners who have inherited property so that each heir ultimately holds fee simple title to a property rather than an undivided interest in multiple properties, an exchange has occurred[36]. The Service has taken the position that if all heirs inherited the property at the same time, there is no basis shifting and the initial exchange will be respected regardless of the holding period after the exchange[37].

The next related party transaction commonly seen is the transfer of relinquished property to a related party and the purchase of replacement property from a third party. These transactions are generally respected by the Service, and the relinquished property may be sold by the related party without regard to the two-year holding period[38]. Another recent ruling has held that these transactions may also be conducted in the form of a reverse exchange in compliance with the provisions of Revenue Procedure 2000-37[39].

The most heavily publicized type of related party transaction is the sale of relinquished

[30] Note that I.R.C. §1031(g) tolls the two year period during certain periods that a taxpayer involved in a related party exchange is not at risk with respect to its property.

[31] I.R.C. §1031(f)(1).

[32] I.R.C. §1031(f)(2)(A)&(B).

[33] I.R.C. §1031(f)(2)(C).

[34] H.R. Conf. Rep. No. 101-386 (1989). The examples include, transactions in which (1) no basis shifting occurs, (2) attempts by tenants-in-common to unify title of multiple properties into individual names, and (3) dispositions in non-recognition transactions.

[35] PLR 200411022.

[36] Rev. Rul. 57-24, 1957-1 CB 247.

[37] PLR 200706001.

[38] PLR 200709036.

[39] PLR 200712013.

property to an unrelated third party and the purchase of replacement property from a related party. This type of transaction is rife with potential for abuse and the Service recently won a victory in the Tax Court with respect to these types of transactions[40].

When Section 1031(f) was first adopted many practitioners were under the misperception that the rules would not apply to an exchange in which the taxpayer sold low basis property to an unrelated third party, had the proceeds transferred directly to a qualified intermediary, who subsequently purchased high basis replacement property from a related party and transferred it to the taxpayer in completion of the exchange. In Revenue Ruling 2002-83, the Service indicated that the use of qualified intermediary to complete an otherwise disallowed transaction would not wash the transaction[41]. The Service points out that the transaction described above nets the same result as if the related parties had exchanged their properties and then the related party had sold the low basis property to the third party. IF the transaction were recast as an exchange followed by the sale, the Service indicates it would not meet the two-year rule and would have successfully allowed for basis shifting between related parties. Because of the form over substance nature of the transaction, the Revenue Ruling finds the transaction is one of a series of transactions intended to avoid Section 1031(f) and disallows the exchange[42].

The Service has been very particular in enforcing these rules and has recently won support from the Tax Court. In Teruya Bros., The taxpayer sold a series of properties to a third party through the use of a qualified intermediary. The taxpayer then instructed the qualified intermediary to purchase replacement properties from a related corporation. The related party actually recognized more gain on the sale than Teruya Bros. would have recognized, but it had significant net operating loss carryovers that it used to absorb the impact of the tax liability[43]. Ultimately, no income tax was paid to the Service and the only impact of the transaction was a loss of NOL carryover to subsequent tax years for the related party. The Tax Court ruled that the non-tax avoidance exception was applicable to the type of transaction conducted, but that in the particular fact pattern presented, the main motive was tax avoidance. The Court held that the related party incurred no additional tax, and tax avoidance was the main motivational factor in structuring the transaction[44]. This decision seems to nullify the importance of tax attributes like NOL carryovers and has been appealed to the taxpayer friendly Ninth Circuit.

The main exceptions to the tax avoidance restrictions found in Section 1031[45] include partitions (discussed above), dispositions in a non-recognition transaction, and transactions in which no basis shifting occurs. Teruya Bros. indicates a situation in which no basis shifting occurs, and likely would have been decided in the taxpayer's favor, but for the NOL applied by the related party.

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40 Teruya Bros. Ltd., and Subsidiaries v. C.I.R., 124 T.C. 45 (2005).

41 Rev. Rul. 2002-83, 2002-2 CB 927.

42 Id.

43 Supra No. 42.

44 Id.

45 §1031(f)(2)(C).

The disposition of property by a related party in a non-recognition event has recently been the topic of several Private Letter Rulings[46]. In these rulings the Service has confirmed that if the related party exchanges its property for like-kind property then the transaction will not be a tax-avoidance transaction. As an example, if party A sells through the use of a qualified intermediary property with a $0 basis and fair market value of $150,000, and the intermediary purchases replacement property from Party B (a related party to A with a $100,000 basis in its property) for $150,000, then the tax avoidance provisions of Section 1031(f)(2) would apply. However, if Party B sells the replacement property to A through the use of a qualified of its own and purchase replacement property for itself from an unrelated third party, then the transaction would have no tax avoidance purpose and would be respect for purposes of Section 1031[47]. Finally, these rulings addressed the fact that some taxable boot in either exchange would not frustrate the entire exchange but would create a tax liability to the party undertaking that particular leg of the transaction[48].

[46] PLR 200440002 and PLR 200616005.

[47] Id.

[48] Id.

RELINQUISHED PROPERTY SUBJECT TO MORTGAGE

If the relinquished property is subject to a mortgage, then the replacement property should be subject to an equal or greater mortgage. In an exchange, a reduction in debt may be offset with additional cash or "new money" from an outside source equal to or greater than the mortgage relieved on the relinquished property. However, the taxpayer cannot reduce the equity in the property by offsetting it with an increase in debt. At that point, net mortgage relief occurs and creates mortgage boot.

When debt relief is present in a transaction, there will be a recognizable gain in the amount of the lesser of the gain on the disposition or the net mortgage relief. In these instances when the gain on the disposition is greater than the net mortgage relief, partial tax-deferred treatment may be granted. For example, a taxpayer sells property for $100,000, receives (in an Exchange Account) $50,000 in cash and $50,000 in debt relief. The property has a $20,000 basis, thus creating an $80,000 potential gain from the sale. The taxpayer then purchases a replacement property in an exchange for $100,000, but only reinvests $40,000 of the cash and acquires a new mortgage of $60,000. The taxpayer receives $10,000 of exchange proceeds after the exchange and realizes a capital gains tax event on the $10,000 received as boot. The taxpayer may defer the taxes on the $40,000 of cash reinvested and $50,000 of the new mortgage but will owe taxes on the $10,000 cash not reinvested. If the net mortgage relief is greater than the gain, no tax deferral will occur.

PROPERTY LOCATED IN DIFFERENT STATES

The Internal Revenue Service recognizes all real property within the United States as being "like-kind" and consequently grants deferred treatment to exchanges of any such property. The term "United States", when used in a geographical sense, is applicable only to the actual fifty states and the District of Columbia. Property located outside the United States or located in U.S.-held principalities is considered outside the scope of §1031 and not like-kind.[49]

However, some state taxing authorities do not recognize property outside the state's borders as being of like-kind to property within the state. Although each situation is different, many states do not grant deferral treatment for replacement properties outside their boundaries. This simply means that additional taxes or other costs may be incurred at the closing of the sale of relinquished property; it does not mean that you cannot effect an exchange for property in different states.

[49] There are a few exceptions, such as certain property in the U.S Virgin Islands.

ADDENDUM A

SECTION 1031

ADDENDUM B

TREASURY REGULATIONS
§1.1031.0 ET. SEQ.

ADDENDUM C

REVENUE PROCEDURE
2000-37

ADDENDUM D

REVENUE PROCEDURE 2004-51

ADDENDUM E

REVENUE PROCEDURE 2005-14

ADDENDUM F

REVENUE PROCEDURE 2002-22

ADDENDUM G

REVENUE PROCEDURE
2004-86