

# 1031 Exchange Topics

Reference Guide to 1031 Exchanges



**§1031 Exchange Solutions Nationwide**

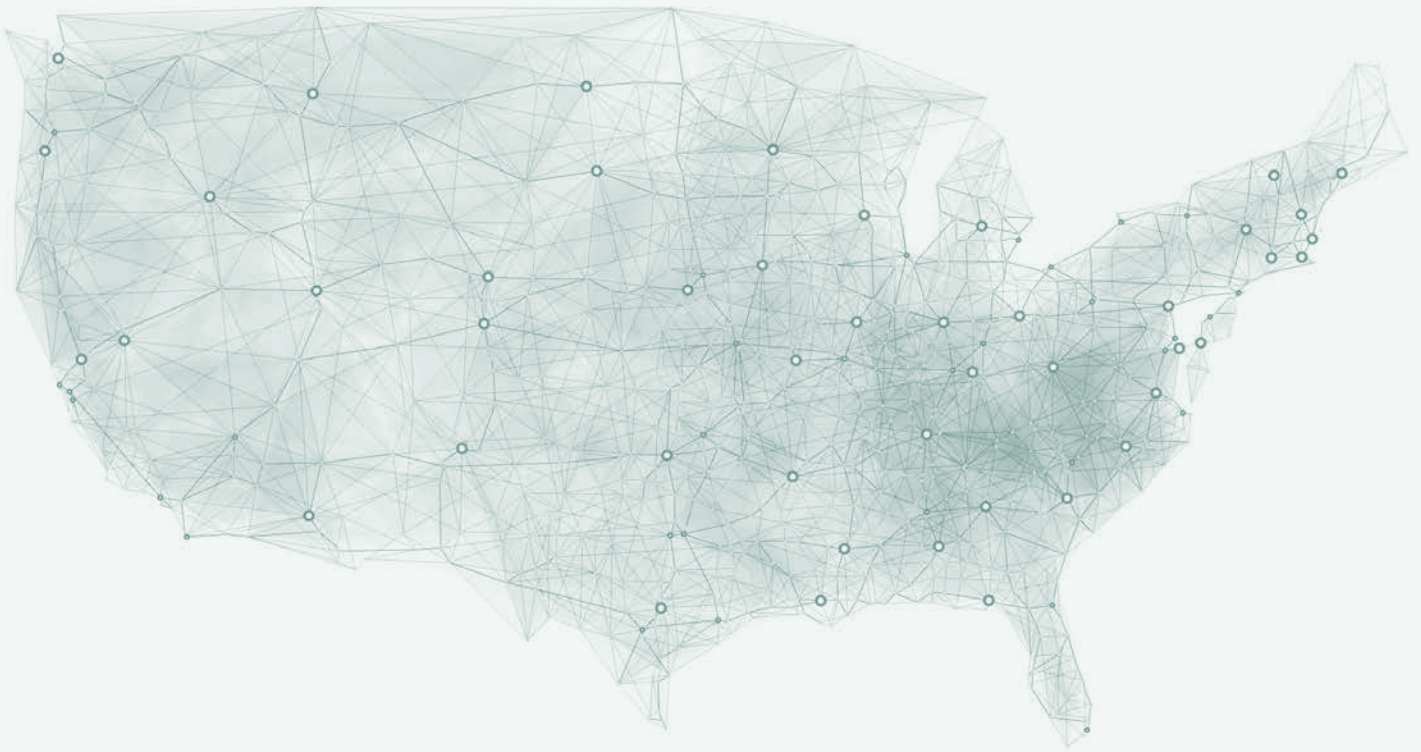
**Investment Property Exchange Services, Inc.**

a Fidelity National Financial Company FORTUNE 500



# 1031 Exchange Topics

Reference Guide to 1031 Exchanges



**Offices Nationwide**

**[www.ipx1031.com](http://www.ipx1031.com)**

# Introduction

## Investment Property Exchange Services, Inc. (IPX1031) is a professional Qualified Intermediary for IRC §1031 tax deferred exchange transactions.

IPX1031 has been assisting clients with their tax deferred exchanges since 1988. Through our national network of regional offices and our knowledgeable, experienced staff, we have consistently demonstrated a commitment to unsurpassed service with integrity. We provide clients with an unparalleled professional team which has earned an outstanding reputation as the industry leader in IRC §1031 Qualified Intermediary services.

IPX1031 is a subsidiary of Fidelity National Financial, Inc. (NYSE:FNF), a Fortune 500 company and a leading provider of title insurance, mortgage services and diversified services. FNF is the nation's largest group of title companies and title underwriters – Fidelity National Title, Chicago Title, Commonwealth Land Title, Alamo Title, Lawyers Title and Ticor Title – that collectively issue more title insurance policies than any other title company in the United States. Our corporate strength permits IPX1031 to offer the highest level of financial security in the industry to ensure the safety of our clients' exchange funds. Exchange accounts held by IPX1031 are protected with a \$100 million fidelity bond, a \$50 million written third party corporate performance guarantee, and a \$30 million professional liability insurance policy.

IPX1031 facilitates thousands of tax deferred exchange transactions every year. Our substantial expertise in facilitating exchanges, combined with the industry's most experienced team of exchange specialists, brings multidimensional insights to structuring even the most challenging exchanges. We handle all types of Section 1031 like-kind exchanges including simultaneous, delayed and exchange accommodation titleholder transactions for reverse and build-to-suit exchanges.

Each of our regional offices is managed by staff experienced in handling all phases of exchange transactions. While we do not provide legal or tax advice in our role as Qualified Intermediary, we expertly guide our clients through the exchange process, providing information about exchange requirements, generating exchange documents, and safely handling exchange funds.

Our staff of trained professionals regularly conducts accredited continuing education courses throughout the country. Many of the country's most respected real estate companies, law firms and accounting firms consistently rely upon IPX1031 as a valuable educational resource. IPX1031 is active in the Federation of Exchange Accommodators (FEA), the national industry trade association representing Qualified Intermediary companies, serving on the Board of Directors for more than a decade. As a member of the FEA, IPX1031 continually participates in new industry developments and legislation regarding tax deferred exchanges and tax related issues.

In our continuing effort to bring value to our clients, we provide this booklet that explains the key requirements and issues concerning IRC §1031 tax deferred exchanges. These short chapters are intended to provide a technical overview and an understanding of the advantages of utilizing a tax deferred exchange as an investment strategy for acquiring and disposing of investment or business-use assets. For recent updates and additional Exchange Topics, please visit our web site at [www.ipx1031.com](http://www.ipx1031.com).

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# The Tax Deferred Exchange

The tax deferred exchange, as defined in §1031 of the Internal Revenue Code, offers taxpayers one of the last great opportunities to build wealth and save taxes. By completing an exchange, the Taxpayer (Exchanger) can dispose of investment or business-use assets, acquire Replacement Property and defer the tax that would ordinarily be due upon the sale. To fully defer the capital gain or recapture tax, the Exchanger must (a) acquire “like kind” Replacement Property that will be held for investment or used productively in a trade or business, (b) purchase Replacement Property of equal or greater value, (c) reinvest all of the equity into the Replacement Property, and (d) obtain the same or greater debt on the Replacement Property. Debt may be replaced with additional cash, but cash equity cannot be replaced with additional debt. Additionally, the Exchanger may not receive cash or other benefits from the sale proceeds during the exchange.

Effective January 1, 2018, IRC §1031 applies only to real estate assets. It does not apply to exchanges of stock in trade, inventory, or property held for sale, such as property acquired and developed or rehabbed for purposes of resale.

An exchange is rarely a swap of properties between two parties. Most exchanges involve multiple parties: the Exchanger, the buyer of the Exchanger’s old (Relinquished) property, the seller of the Exchanger’s new (Replacement) property, and a Qualified Intermediary. To create the exchange of assets and obtain the benefit of the “Safe Harbor” protections set out in Treasury Regulations 1.1031(k)-1(g)(4) which prevent actual or constructive receipt of exchange funds, prudent taxpayers use a professional Qualified Intermediary, such as Investment Property Exchange Services, Inc. (IPX1031).

## The Exchange Process

Timing is important. Certain actions must be taken in sequence and exchanges must be completed within strict time limits.

1. Prior to closing the sale of the Relinquished Property, the Exchanger and IPX1031, as Qualified Intermediary, must enter into an Exchange Agreement which requires the Qualified Intermediary to (a) acquire the Relinquished Property from the Exchanger and transfer it to the buyer (by direct deed from Exchanger to buyer), and (b) to acquire the Replacement Property from the seller and transfer it to the Exchanger (by direct deed from seller to Exchanger).
2. Also prior to closing the sale of the Relinquished Property, the Exchanger must assign rights under the Relinquished Property sale contract to the Qualified Intermediary and provide notice of assignment to the buyer.
3. At closing, net proceeds from the Relinquished Property sale (exchange funds) are paid directly to IPX1031, as Qualified Intermediary, to be held in a separate account for the benefit of the Exchanger until used to purchase Replacement Property.
4. The Exchanger has 45 days, from the date the Relinquished Property is transferred, to identify potential Replacement Properties. Identification must be specific and unambiguous, in writing, signed by the Exchanger, and delivered to the Qualified Intermediary or another party to the transaction as permitted by Treas. Reg. §1.1031(k)-1(c)(2) prior to the end of the 45-day Identification Period. The list of identified potential Replacement Properties cannot be changed after the 45th day; the Exchanger may only acquire from the list of identified properties. If no property is identified, the exchange funds will be returned to the Exchanger after the 45th day.
5. Prior to closing the sale of the Replacement Property, the Exchanger must assign rights under the Replacement Property purchase contract to the Qualified Intermediary and provide notice of assignment to the seller.
6. The Exchanger authorizes IPX1031, as Qualified Intermediary, to wire funds directly to the seller or closing agent for purchase of Replacement Property, and the seller transfers title directly to the Exchanger, completing the exchange.
7. Purchase of Replacement Property must be completed by the earlier of the 180th day after transfer of the first Relinquished Property or the due date (including extensions) for filing Exchanger’s tax return. Any unspent exchange funds will be returned to the Exchanger at termination of the exchange.

# The Role of The Qualified Intermediary

The use of a Qualified Intermediary is essential to completing a successful IRC §1031 tax deferred exchange. **Investment Property Exchange Services, Inc. (IPX1031)**, as a professional Qualified Intermediary, performs several vital functions in an exchange and operates under the “safe harbor” set out in Treas. Reg. 1.1031(k)-1(g)(4). Although the process of completing an exchange is relatively simple, the rules are complicated and filled with potential pitfalls. IPX1031 has developed a national reputation as the industry leader for Qualified Intermediary services due to our substantial exchange experience and our unyielding commitment to our clients. We work closely with all parties involved to ensure a smooth §1031 exchange transaction. When choosing a Qualified Intermediary, the two most critical factors for evaluation are safety and security of exchange funds and competency of staff.

## Acts as a “Qualified” Intermediary

A person who has acted as the taxpayer’s employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two year period preceding the date of the transfer of the Relinquished Property by the Exchanger is treated as an agent of the Exchanger and is specifically disqualified from being a Qualified Intermediary.

## Creates the Exchange of Properties

The IRS stipulates that a reciprocal trade or actual exchange must take place in each exchange transaction. This means the Exchanger must assign to the Qualified Intermediary (1) their interest as seller of the Relinquished Property and (2) their interest as buyer of the Replacement Property. Because the Qualified Intermediary becomes an actual principal in the transaction, a reciprocal trade is created, even when the Exchanger is purchasing the Replacement Property from someone other than the buyer of their Relinquished Property. For IRC §1031 purposes, the Qualified Intermediary is treated as acquiring the Relinquished and Replacement Properties when the Exchanger assigns their rights in the respective purchase and sale contracts to the Qualified Intermediary. It is not necessary for the Qualified Intermediary to be in the chain of title.

## Holds Exchange Funds

The Exchanger is prohibited from having actual or constructive receipt of the proceeds from the sale of the Relinquished Property (exchange funds), or the ability to pledge, borrow or otherwise obtain the benefits of the exchange funds during the exchange or those proceeds will be taxable as boot. Treas.Reg. 1.1031.(k)-1(g)(6). IPX1031, as Qualified Intermediary, will hold the exchange funds **in a separate bank account for the benefit of the Exchanger** until the funds are used to purchase the Exchanger’s Replacement Property.

## Prepares Exchange Documents

Proper documentation is necessary for a successful exchange. IPX1031, as the Qualified Intermediary, will prepare an Exchange Agreement, Assignments of Purchase and Sale Agreements, Notices of Assignment to the respective buyer and seller, and provide a blank Replacement Property Identification Notice, among other form documents.

# Safety & Security for Exchangers

When selecting a Qualified Intermediary, the Exchanger must feel confident that their Qualified Intermediary is a professional company with the competence and commitment to provide high quality service and security for exchange funds. Through our national network of offices, IPX1031 has developed a reputation as the industry leader in IRC §1031 Qualified Intermediary services.

## Security

Safety and security of exchange funds is a matter of paramount importance. IPX1031 routinely provides customers with the following superior safety and security controls for exchange funds:

- \$100 million Fidelity Bond
- \$50 million third party corporate performance guarantee
- \$30 million in Errors & Omissions insurance
- Exchange funds are held in segregated bank accounts for the benefit of the named Exchanger, using the Exchanger's taxpayer identification number
- Disbursement of exchange funds requires written authorization from the Exchanger
- Disbursements require dual authorization and are controlled by our separate Banking Division; sales and administrative staff have no authority or ability to transfer funds
- Regular reconciliation of exchange fund balances by our Banking staff and our parent company
- As part of a large publicly-traded corporation, we are subject to audits, controls and a level of financial transparency about the entire organization that is not required of privately held businesses

## Expertise & Service

Our depth of technical expertise and practical experience has developed over many years. Additionally, our professionalism and commitment to our customers are demonstrated every day by the following:

- Regional attorneys and experienced staff familiar with all types of exchanges, including delayed, simultaneous, improvement, and reverse exchanges
- Sales Executives located throughout the country available for accredited continuing education seminars and complimentary exchange consultations
- Efficient preparation of exchange documents
- Member and leadership role in the Federation of Exchange Accommodators (FEA), the national trade association of 1031 Qualified Intermediaries

## Strength

IPX1031 is a wholly owned subsidiary of Fidelity National Financial, Inc. (NYSE:FNF) which is a leading provider of title insurance, mortgage services and diversified services. FNF is the nation's largest title insurance company through its title insurance underwriters - Fidelity National Title, Chicago Title, Commonwealth Land Title, Alamo Title and National Title of New York - that collectively issue more title insurance policies than any other title company in the United States.

# Planning Ahead for a Successful Exchange

A successful IRC §1031 exchange transaction requires planning, expertise, and support. Investment Property Exchange Services, Inc. (IPX1031) assists our clients by explaining the various types of exchanges, discussing the options that may minimize or eliminate any negative tax impact, providing exchange documents, and safeguarding the exchange funds. Laying the proper groundwork before entering into an exchange will avoid unnecessary obstacles and lead to a smooth transaction.

- STEP 1. Contact IPX1031.** In advance of the closing date, as soon as escrow is opened, or after entering into the purchase and sale agreement, advise us of your intent to do an exchange. IPX1031 will prepare the appropriate Exchange Agreement, Assignments, and other documents that must be executed prior to closing on the Relinquished Property being sold.
- STEP 2. Instruct your real estate agent or attorney to include an “Exchange Cooperation Clause”** in the purchase and sale agreement.
- STEP 3. IPX1031 encourages you to engage your legal and tax advisors to counsel you throughout the exchange and the underlying real estate transactions.** An exchange is a complex legal and tax transaction. IPX1031 can make the exchange process smooth, but we cannot provide you with tax or legal advice. **Consult your tax advisor before starting your exchange if you used your Relinquished Property at any time for personal use** (primary residence, vacation home, or used by friends/family), or you plan some personal use for the Replacement Property.
- STEP 4. Tell IPX1031 if you plan to 1) use Exchange Funds to make improvements to the Replacement Property, or 2) acquire the Replacement Property before you sell your Relinquished Property.** Unlike a typical forward exchange, this type of exchange requires a different form of Exchange Agreement under which we must set up a title-holding entity to acquire the Replacement Property.
- STEP 5. Start searching** for acceptable Replacement Property immediately to ensure that you can meet the strict time frame for the 45-day Identification Period.

## Exchange Cooperation Clauses for Contracts

### Relinquished Property Sale Contract

“Notwithstanding anything to the contrary, Buyer hereby acknowledges that it is the intent of Seller to effect an IRC §1031 tax deferred exchange, which will not delay the closing or cause additional expense to Buyer. Seller’s rights under this agreement may be assigned to Investment Property Exchange Services, Inc. (IPX1031), as Qualified Intermediary, for the purpose of completing such an exchange. Buyer agrees to cooperate with Seller and IPX1031 in a manner necessary to complete the exchange.”

### Replacement Property Purchase Contract

“Notwithstanding anything to the contrary, Seller hereby acknowledges that it is the intent of Buyer to effect an IRC §1031 tax deferred exchange, which will not delay the closing or cause additional expense to Seller. Buyer’s rights under this agreement may be assigned to Investment Property Exchange Services, Inc. (IPX1031), as Qualified Intermediary, for the purpose of completing such an exchange. Seller agrees to cooperate with Buyer and IPX1031 in a manner necessary to complete the exchange.”



# Tax Deferred Exchange Terminology

As with any other specific area of law, tax deferred exchanges under IRC §1031 have their own language, which may be confusing to those who are unfamiliar with these transactions. The following are some of the exchange terms and phrases that are often used with their “plain-English” interpretations.

**Basis (Adjusted Basis):** The amount paid for a property taking into consideration added value for capital improvements and decreased by the amount of depreciation taken (or allowable); it is the value of a property for tax purposes.

**Boot:** The fair market value of any non-qualified property received in an exchange. While receipt of boot will not necessarily disqualify the exchange, an Exchanger who receives boot in an exchange transaction generally recognizes gain to the extent of the value of the boot received. Some common examples of boot are: cash, debt relief that is not offset with new debt, property intended for personal use, and property which is not like-kind to the Relinquished Property.

**Constructive Receipt:** A term referring to the control or ability to receive proceeds by an Exchanger even though funds may not be directly in the Exchanger’s possession.

**Exchange Accommodation Titleholder:** The person or entity used to facilitate a “reverse” or “improvement” exchange. The Exchange Accommodation Titleholder (EAT) will hold (park) title to either the Relinquished or the Replacement Property during the exchange.

**Exchange Period:** The period during which the Exchanger must acquire Replacement Property in the exchange. The Exchange Period starts on the date the Exchanger transfers the first Relinquished Property and ends on the earlier of the 180th day thereafter or the due date (including extensions) for filing the Exchanger’s tax return for the year of the Relinquished Property transfer.

**Exchanger or Taxpayer:** The property owner seeking to defer capital gain, recapture or other income tax by utilizing a IRC §1031 exchange.

**Forward Exchange:** The most common form of exchange transaction in which the exchange begins with the sale of the Relinquished Property to a buyer and concludes with purchase of Replacement Property from a seller (typically a third party).

**Identification Period:** The period during which the Exchanger must identify Replacement Property in the exchange. The Identification Period starts on the day the Exchanger transfers the first Relinquished Property and ends at midnight on the 45th day thereafter.

**Improvement Exchange:** An exchange in which improvements are made to the Replacement Property prior to acquisition by the Exchanger, either using exchange funds or funds lent by the Exchanger (or lender) to the Exchange Accommodation Titleholder.

**Like-Kind Property:** Properties having the same or similar nature or character, regardless of differences in grade or quality. Generally, all real property located within the United States is considered to be “like-kind” to all other U.S. real property as long as the Exchanger’s intent is to hold the properties as an investment or for productive use in a trade or business.

**Qualified Intermediary:** The person or entity that facilitates the exchange for the Exchanger. Although the Treasury Regulations use the term “Qualified Intermediary,” other common terms are “exchange facilitator” or “exchange accommodator”. To be a Qualified Intermediary, the exchange facilitator must meet certain criteria spelled out in Treas. Reg. 1.1031(k)-1(g)(4).

**Realized Gain:** The amount realized from the sale of property which is potentially subject to tax; it equals the gross sales price minus the closing costs minus the adjusted basis.

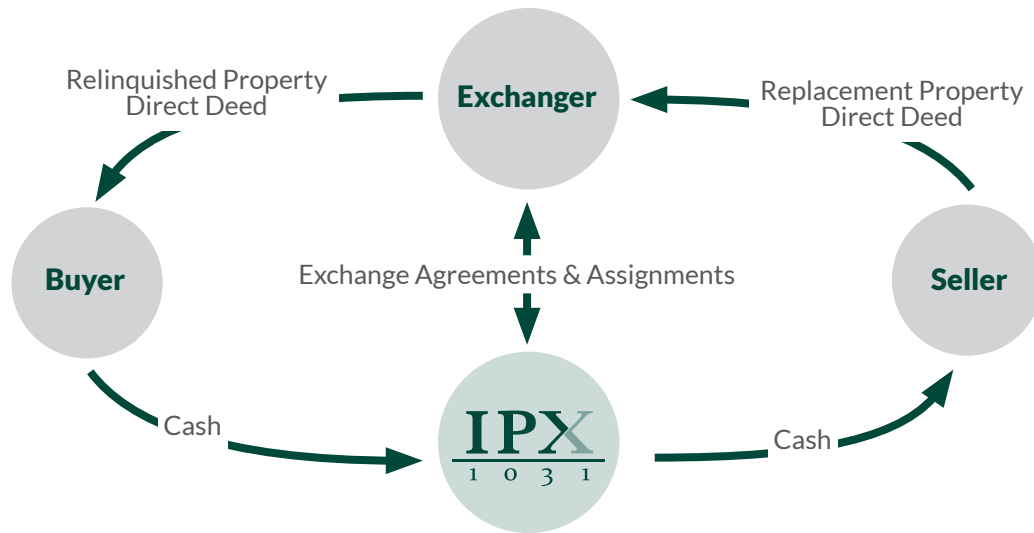
**Recognized Gain:** The amount of the realized gain that is subject to tax. In a taxable sale (no 1031 exchange) the realized gain is all recognized. In a fully deferred 1031 exchange, no gain is recognized; the realized gain is deferred.

**Relinquished Property:** The “old” property divested (sold) by the Exchanger.

**Replacement Property:** The “new” property acquired (purchased) by the Exchanger.

**Reverse Exchange:** An exchange involving an Exchange Accommodation Titleholder (EAT) when it is necessary for the Replacement Property to be acquired before the Relinquished Property can be sold to a Buyer, or when improvements must be made to the Replacement Property before it can be acquired by the Exchanger.

# Exchanges with Qualified Intermediary



In a simultaneous exchange, the old Relinquished Property and the new Replacement Property are transferred concurrently between the two trading parties. In a delayed exchange, the Exchanger transfers Relinquished Property to a buyer, and acquires Replacement Property from a third party seller at a subsequent time. Investors performing exchanges without the benefit of a Qualified Intermediary may risk losing the tax deferred status of the transaction, especially if there is any delay in receipt of Replacement Property or multiple parties are involved.

The Tax Court in *Keith K. Klein v. Commissioner*, 66 T.C.M. 1115 (1993), determined that one simultaneous three party exchange was a fully taxable sale. Mr. Klein's closing escrow instructions simply assigned his rights to the proceeds from the sale of his Relinquished Property directly to the second closing for the purchase of his Replacement Property. The Tax Court stated that Mr. Klein had unrestricted control over, and thus had constructive receipt of, the exchange funds in his transaction. Klein argued that the provision in his earnest money agreement stated that the buyer would cooperate in structuring a tax deferred exchange. He believed that the funds in escrow were already assigned to the seller of the Replacement Property and therefore, he had no control over the funds. The Court indicated that the cooperation clause would not control the constructive receipt issue. **Unwary taxpayers who do not utilize a Qualified Intermediary may be surprised to discover their transaction does not qualify for tax deferral.**

Use of a Qualified Intermediary acting under an Exchange Agreement insulates the Exchanger from constructive receipt issues on the proceeds. Although the Qualified Intermediary does not hold any proceeds in a simultaneous exchange, it serves the important function of creating a reciprocal trade since the Qualified Intermediary is deemed to have received and transferred the Relinquished Property and subsequently acquired and transferred the Replacement Property to the Exchanger to complete the exchange. The Qualified Intermediary also controls the flow of the exchange funds.

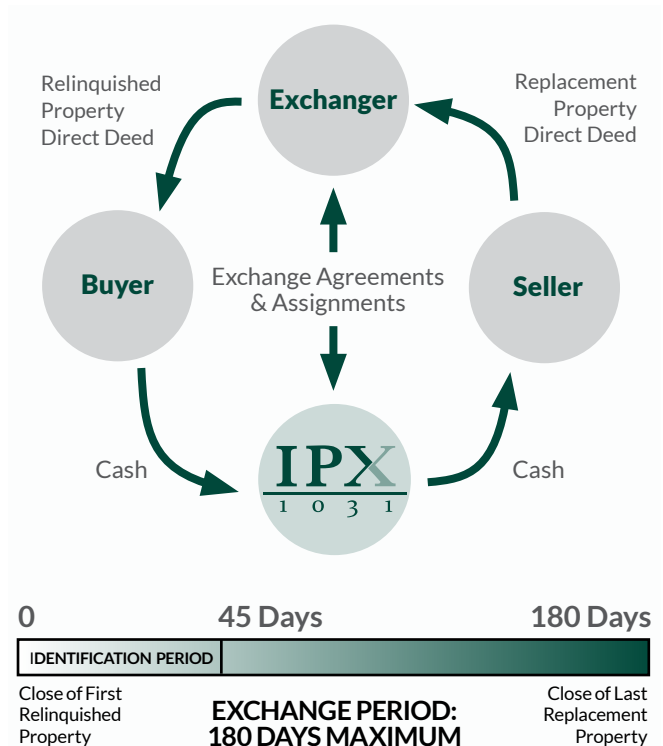
# The Delayed Exchange and Identification Requirements

## Delayed Exchange Deadlines and Identification Requirements

The most common exchange structure is the delayed “forward” exchange in which the Relinquished Property is sold, the proceeds (Exchange Funds) are delivered to the Qualified Intermediary, and are subsequently used to acquire Replacement Property from a third party seller. Two critical requirements in a delayed exchange are that the Replacement Property must be properly identified within the Identification Period and acquired before the end of the Exchange Period. IRC §1031(a)(3); Treas. Regs. §1.1031(k)-1(b)-(e).

### There are two key deadlines that the Exchanger must meet to have a valid exchange:

- **Identification Period:** Within 45 calendar days of the transfer of the first Relinquished Property, the Exchanger must identify the Replacement Property to be acquired.
- **Exchange Period:** The Exchanger must receive the Replacement Property within the earlier of 180 calendar days after the date on which the Exchanger transferred the first Relinquished Property, or the due date (including extensions) for the Exchanger’s tax return for the tax year in which the transfer of the first Relinquished Property occurs.
- The time periods for the 45-day Identification Period and the 180-day Exchange Period are very strict and cannot be extended even if the 45th day or 180th day falls on a Saturday, Sunday or legal holiday. They may, however, be extended by up to 120 days if the Exchanger qualifies for a disaster extension under Rev. Proc. 2007-56.



### Replacement Property must be identified within the Identification Period by at least one of the following methods:

- Completed the purchase of the Replacement Property within the Identification Period; or
- Identified in a written document (Identification Notice), signed by the Exchanger, and delivered prior to the end of the Identification Period (by midnight of the 45th day), to the Qualified Intermediary or other permissible party to the exchange that is not a “disqualified person” or agent of the Exchanger. Treas. Reg. §1.1031(k)-1(c). Other allowable recipients of the Identification Notice include the seller of the Replacement Property or the settlement agent. Delivery to the Exchanger’s attorney or broker would not qualify as these parties are agents of the Exchanger. Best practice is to send the Identification Notice to the Qualified Intermediary prior to close of business on the last business day prior to the end of the Identification Period, so that the Exchanger can confirm timely delivery and receipt.

# The Delayed Exchange and Identification Requirements (CONT.)

## Requirements for a Proper Identification Notice:

- Must include a specific and unambiguous description of the Replacement Property
- Must be signed by the Exchanger
- For real property, the Identification Notice must include
  - a. the legal description,
  - b. a street address, or
  - c. a distinguishable name (i.e. “Empire State Building”)
- For property to be produced, such as raw land to be acquired after improvements have been constructed, the Identification Notice should include a description of the underlying real estate and as much detail regarding the improvements as is practical, for example, *100 S. Main St., Gotham City, IL, improved with a 6 unit apartment building.*
- When identifying Replacement Property, it is not necessary to separately identify any incidental property included in the purchase that has a value of less than 15% of the total value of the Replacement Property and that is typically transferred with the larger asset. This does not change the rule that only like kind properties qualify for exchange treatment. The value of the non like-kind property may not be attributed to the identified Replacement Property for purposes of deferring gain. For example, Relinquished Property is a rental house valued at \$200,000, with \$195,000 allocated to real estate and \$5,000 allocated to appliances. If the sole Replacement Property is a rental condominium unit valued at \$200,000, with \$190,000 allocated to real estate and \$10,000 allocated to appliances, the Exchanger would recognize \$5,000 of boot, notwithstanding that only the condominium unit needs to be identified, and it is not necessary to separately identify the appliances. For purposes of the Three Property Rule, the condominium unit and appliances are treated together as one identified property.
- An identification of Replacement Property may be revoked prior to the end of the Identification Period. The revocation must be in writing, signed by the Exchanger and delivered to the same person to whom the original Identification Notice was sent. No changes or revocations may be made to the Identification Notice after the end of the Identification Period.

## Exchangers have flexibility to identify multiple and alternate Replacement Properties.

- **Three Property Rule:** The Exchanger may identify as potential Replacement Property any three properties, without regard to their fair market value.
- **200% Rule:** The Exchanger may identify as potential Replacement Property any number of properties, provided the aggregate fair market value (*as of the end of the Identification Period*) of all of the identified properties does not exceed 200% of the aggregate fair market value of all of the Relinquished Properties.
- **95% Exception:** If the Exchanger identifies more potential Replacement Properties than allowed under either the Three Property or the 200% Rules, the Exchanger will be treated as if **no** Replacement Property was identified unless the Exchanger actually receives Replacement Property by the end of the Exchange Period worth at least 95% of the aggregate fair market value of all of the identified Replacement Properties. For this purpose, fair market value of the aggregate Replacement Property is determined *as of the earlier of the date the property is received by the Exchanger or the last day of the Exchange Period.*

# The Build-To-Suit Exchange

The build-to-suit exchange, also referred to as a construction or improvement exchange, gives the Exchanger the opportunity to use Exchange Funds for construction, renovations or new improvements, to the Replacement Property. In the most common type of build-to-suit exchange, the Exchanger sells the Relinquished Property through a Qualified Intermediary in a delayed exchange, and then acquires the Replacement Property after it has been improved using the Exchange Funds from the Relinquished Property sale. Note that any improvements made to the Replacement Property after the Exchanger takes title are not considered “like-kind”. Treas. Reg. §1.1031(k)-1(e). To qualify for inclusion in the exchange, any improvements to the property must occur before the Exchanger takes title. *Bloomington Coca-Cola Bottling Company v. Commissioner*, 189 F.2d 14 (CA7 1951). Any unused Exchange Funds may be taxable as boot. Only funds disbursed for material actually in place and services actually performed will count toward the exchange value. Exchange Funds in an escrow “holdback” for post-closing improvements will not qualify even if the funds are deposited before the Exchanger takes title.

If the Exchanger wishes to include construction on the Replacement Property as part of the exchange, one option is to contract with the seller to have the construction completed before the transaction closes and the Exchanger takes title to the property. For a variety of reasons, this is often not a viable option. Rev. Proc. 2000-37 provides a “safe harbor” for structuring a build-to-suit exchange using an Exchange Accommodation Titleholder (EAT) to hold title to the Replacement Property pending completion of the improvements. Time limitations and all other rules of IRC §1031 apply to build-to-suit exchanges. The Identification Notice in a Build-To-Suit Exchange should include a description of the underlying real estate and as much detail regarding the improvements as is practical. To avoid boot, the Exchanger must ultimately acquire Replacement Property with a value equal to or greater than the value of the Relinquished Property, and use all of the exchange equity in the acquisition of the improved Replacement Property.

As in a typical delayed exchange, the build-to-suit exchange involves a Qualified Intermediary and begins when the Exchanger sells the Relinquished Property. Prior to closing on the purchase of the Replacement Property, the Exchanger enters into a Qualified Exchange Accommodation Agreement (QEAA) with the EAT and assigns its rights in the purchase contract to the EAT. The EAT then acquires title to the Replacement Property. IPX1031 holds all parked properties in a separate special purpose holding entity (typically a single member LLC) for each exchange (the EAT and holding entity are jointly referred to as the EAT). The Exchanger or its designated representative is authorized by the EAT to act as its project manager to oversee all aspects of the construction. During the 180-day exchange period, the Exchanger, as project manager, sends construction invoices to the EAT for payment. The EAT must make payments directly to the vendors.

Build-to-suit exchanges are less complicated when the improvements can be paid for with cash loaned to the EAT by the Exchanger or with Exchange Funds advanced by the Qualified Intermediary. If a construction loan from an institutional lender is required, the Exchanger should seek lender approval prior to beginning the exchange, since the EAT, as titleholder to the Replacement Property, may be required to be the “borrower” on the loan. To protect the EAT from liability in the event of default by the Exchanger, the EAT will require the loan to be non-recourse as to itself. Lenders typically require the Exchanger to guarantee a loan made to the EAT.

On the earlier of the end of the 180-day Exchange Period or completion of construction on the Replacement Property, the EAT will transfer the Replacement Property to the Exchanger to complete the exchange. Depending upon the Exchanger’s preference, the Replacement Property is often transferred to the Exchanger by assignment of the sole membership interest in the holding entity rather than by a deed. Selecting the appropriate method for transfer of title should be determined after review of transfer tax and other legal issues by the Exchanger’s tax and legal advisors. If a third party lender is involved, the Exchanger typically will assume the construction loan upon the conclusion of the exchange. Any construction to be included in the exchange must be completed and paid for prior to the holding entity’s transfer of the Replacement Property to the Exchanger.

Rev. Proc. 2000-37 also permits the Exchanger to use an EAT to close on the purchase of the Replacement Property and commence construction of improvements, prior to the sale of the Relinquished Property. In reverse build-to-suit exchanges, since the Relinquished Property has not yet sold, the Exchanger or a third-party lender must loan funds to the holding entity to acquire and improve the Replacement Property.

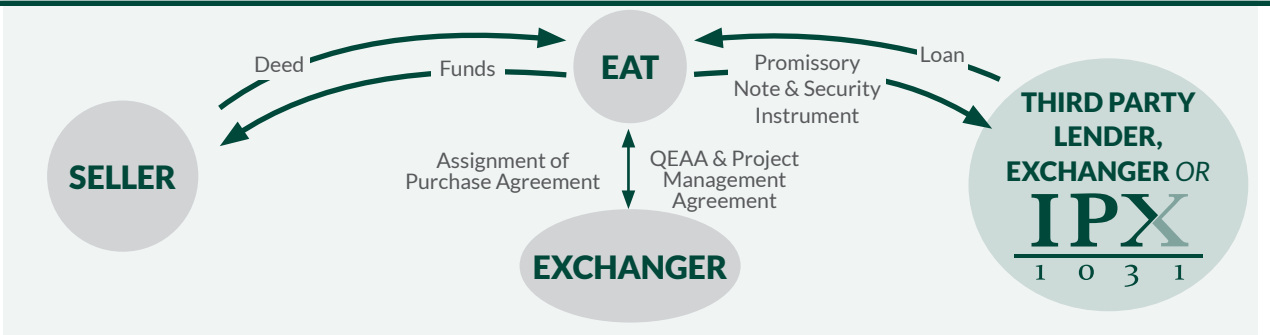


# The Build-To-Suit Exchange (CONT.)

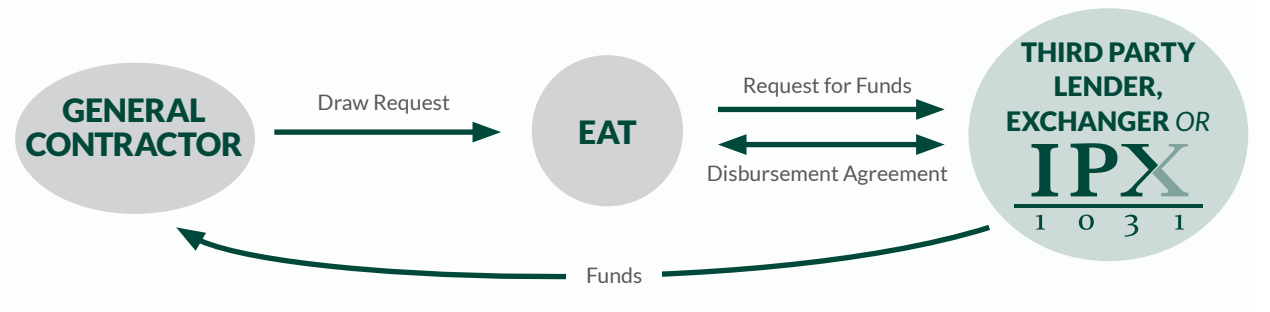
## Phase I - Qualified Intermediary Facilitates Disposition of Relinquished Property



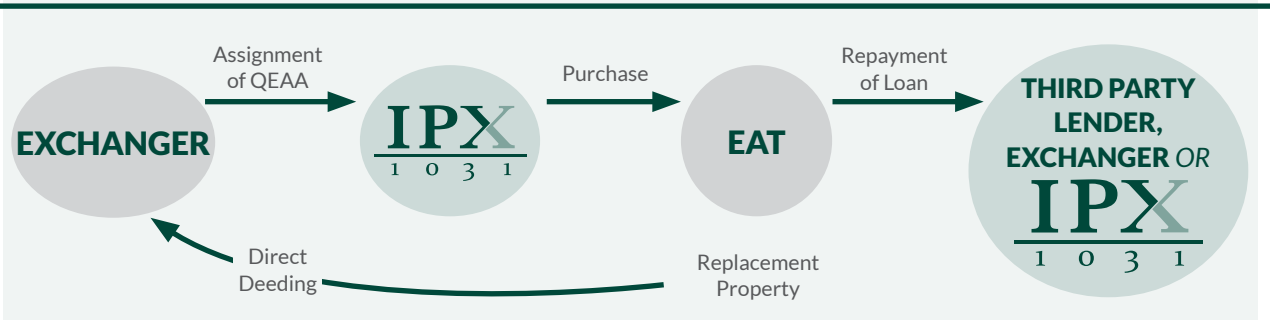
## Phase II - Holding Entity (EAT under Rev. Proc. 2000-37) Acquires Title to Replacement Property



## Phase III - Construction of Improvements



## Phase IV - Qualified Intermediary Facilitates Transfer of Improved Replacement Property to Exchanger



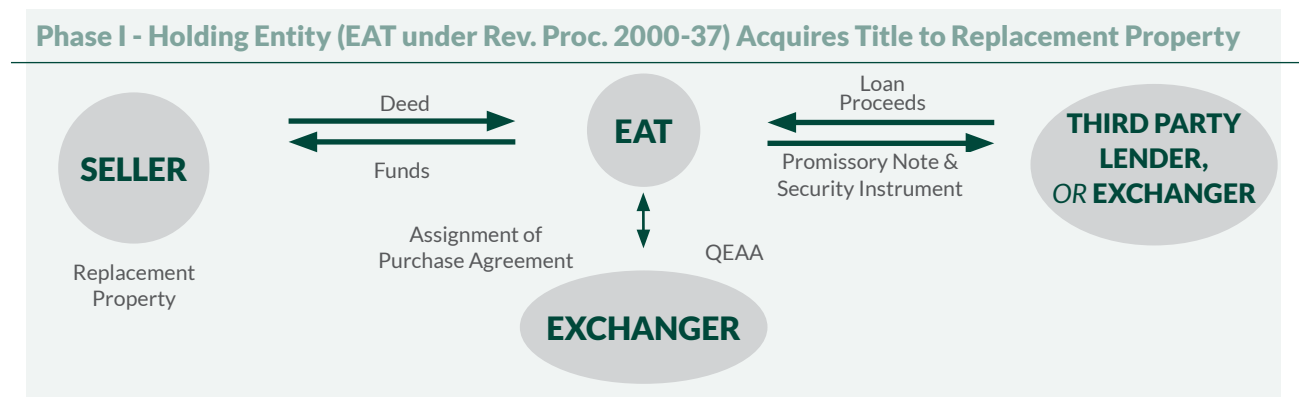
# The Safe Harbor Reverse Exchange

A “reverse” exchange occurs when the taxpayer acquires the replacement property before transferring the relinquished property. A “pure” reverse exchange, where the taxpayer owns both the relinquished and replacement properties at the same time, is not permitted. The IRS has provided guidance on structuring a reverse exchange, offering a safe harbor under Rev. Proc. 2000-37. An Exchange Accommodation Titleholder (EAT), acquires and holds the target property (the parked property) in a separate special purpose entity, typically a single member LLC (the EAT and LLC are jointly referred to as “EAT”). To complete a reverse exchange, the EAT will take title to either the Relinquished Property or the Replacement Property under a “Qualified Exchange Accommodation Arrangement” (QEAA).

**Time Periods:** The same 45 day Identification Period and 180 day Exchange Period deadlines of IRC §1031 apply to a safe harbor reverse exchange under Rev. Proc. 2000-37, with a slight tweak. If the EAT has begun the exchange by acquiring the Replacement Property, then the Exchanger must identify within 45 days after the EAT’s acquisition of the parked property, one or more Relinquished Properties to be exchanged for the Replacement Property. The identification rules require that written identification be delivered to another party to the exchange, such as the EAT or the Qualified Intermediary, identification permitted under the three property or 200% rules.. The identified Relinquished Property must be sold, and the parked Replacement Property transferred to the Exchanger to complete the exchange within 180 days of parking the Replacement Property with the EAT.

## Replacement Property Parked Reverse Exchange

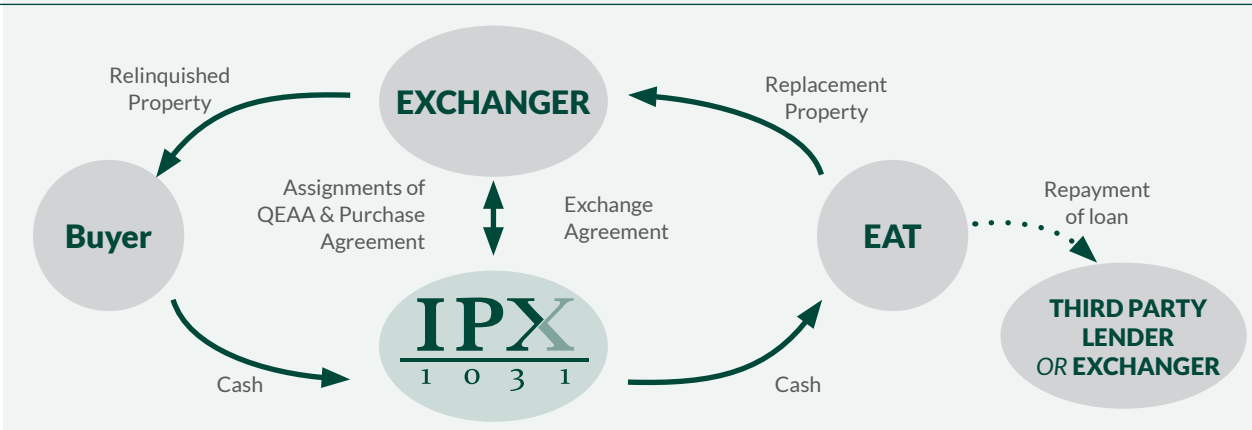
**Replacement Property Parked - Phase I:** In the most common type of reverse exchange, the EAT acquires and parks legal title to the Replacement Property. The Exchanger or a third party lender loans the funds necessary for the EAT to purchase and take title to the Replacement Property. The EAT leases the property to the Exchanger under a triple net lease. This permits the Exchanger to receive the economic benefits and burdens of the property during the time that it is held by the EAT.



**Replacement Property Parked - Phase II:** When the Exchanger sells the identified Relinquished Property, title is transferred directly to the buyer through direct deeding. The cash proceeds of the sale go to the Qualified Intermediary, which uses these Exchange Funds to acquire the Replacement Property from the EAT. Upon receipt, the EAT will first repay the loan from the Exchanger and then use remaining Exchange Funds to pay down the third-party loan on the Replacement Property prior to transferring the parked property to the Exchanger. If the Relinquished Property sale yields more Exchange Funds than necessary for the Qualified Intermediary to acquire the parked property, the Exchanger may identify additional Replacement Property within 45 days of the transfer of the Relinquished Property, and complete the additional acquisition within 180 days of the Relinquished Property transfer.

# The Safe Harbor Reverse Exchange (CONT.)

## Phase II - Simultaneous or Delayed Exchange



**Replacement Property Parked - Loans to EAT:** This type of reverse exchange works best when the Exchanger can pay all cash for the Replacement Property, or when the seller is providing the financing. If the Exchanger is working with a third-party institutional lender, the Exchanger should seek lender approval prior to beginning the reverse exchange. The EAT, as the titleholder of the property, may be required to be the borrower on the loan. Many lenders are not familiar with reverse exchanges, so involving them early in the process will ensure a smoother transaction. To protect the EAT from liability in the event of default by the Exchanger, the EAT will require the loan to be non-recourse as to itself. Lenders typically require the Exchanger to guarantee a loan made to the EAT.

## Relinquished Property Parked Reverse Exchange

An alternative to parking the Replacement Property is to park the Exchanger's Relinquished Property with the EAT.

**Relinquished Property Parked - Loans to EAT - Phase I:** Since the EAT does not have its own funds to purchase the Relinquished Property, it must borrow the money. Typically the consideration consists of (1) the EAT taking the Relinquished Property "subject to" any existing third-party financing, and (2) a purchase money loan from the Exchanger for the balance. For a fully deferred exchange, the loan from the Exchanger should equal the equity the Exchanger has in the Relinquished Property.

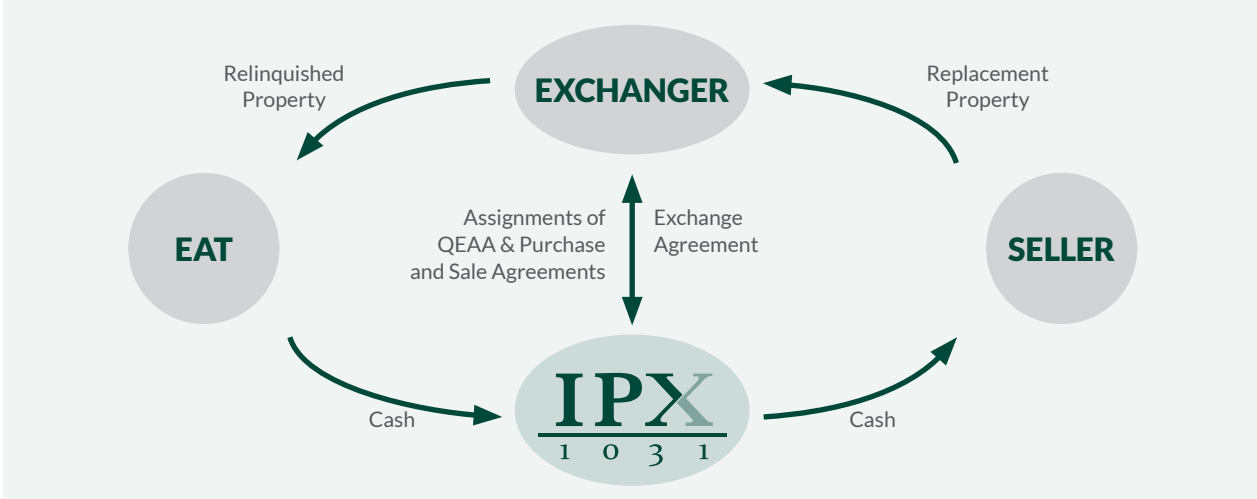
## Phase I - Holding Entity (EAT under Rev. Proc. 2000-37) Agrees to Purchase Relinquished Property



# The Safe Harbor Reverse Exchange (CONT.)

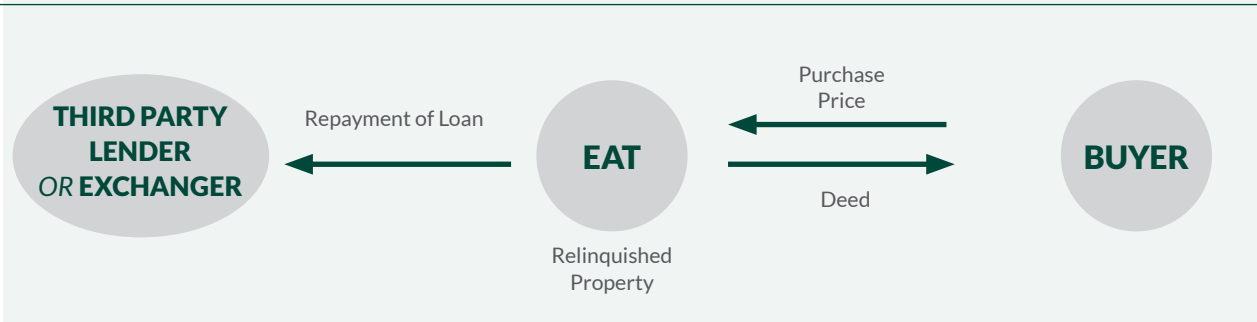
**Relinquished Property Parked - Phase II:** A Relinquished Property parked reverse exchange begins with a simultaneous exchange involving the Exchanger, the EAT, the seller of the Replacement Property, and the Qualified Intermediary. The Exchanger transfers the Relinquished Property to the EAT and simultaneously receives the Replacement Property from the seller. Both transfers occur through the Qualified Intermediary and the use of direct deeding. The funds the EAT borrowed from the Exchanger will be used to pay closing costs, with any balance flowing through the exchange and being applied toward the purchase of the Replacement Property.

## Phase II - Simultaneous Exchange



**Relinquished Property Parked - Phase III:** When the Relinquished Property is sold to the ultimate buyer, the cash proceeds from the sale go to the EAT and are used first to retire any existing third party debt the EAT took subject to, then to repay the Exchanger for the original loan to the EAT. If the price paid by the EAT for the parked property differs from the actual price paid by the ultimate buyer, the Exchanger and the EAT will enter into a purchase price adjustment agreement to increase or decrease the original purchase price and loan amount as necessary to reflect the final purchase price.

## Phase III - EAT Sells Relinquished Property



# Non-Safe Harbor Reverse Exchanges

A “reverse” exchange occurs when the taxpayer acquires the Replacement Property before transferring the Relinquished Property. A “pure” reverse exchange, where the taxpayer owns both the Relinquished and Replacement Properties at the same time, is not permitted. As a workaround, enterprising taxpayers structured “parking” transactions. An accommodation party (AP) would acquire and hold the Replacement Property until the taxpayer could transfer the Relinquished Property in a customary forward exchange. A major challenge of the parking arrangement was to give the AP enough benefits and burdens of the Parked Property to be treated as the owner for federal income tax purposes.

Revenue Procedure 2000-37 was issued by the IRS to provide taxpayers with a “safe harbor” to qualify their parking transactions under §1031. If the conditions of the safe harbor are met, the IRS will treat the AP as the beneficial owner of the Parked Property. Also, the IRS will not question whether the Parked Property qualifies as “Replacement” or “Relinquished” for purposes of §1031.

One condition of the safe harbor is that the AP can only hold the Parked Property for 180 days. That time requirement is an impediment to transactions where the Replacement Property needs improvements that will take more than 180 days to complete, or where the Relinquished Property takes longer to sell. As a result, some taxpayers choose to stay outside the safe harbor, in a “non-safe harbor exchange”. Outside the safe harbor the IRS has historically applied a benefits and burdens test to determine whether the true owner of the Parked Property is the AP or the taxpayer.

Whether inside or outside the safe harbor, the structure and documentation of the reverse exchange is very similar. The difference lies in the protections provided by the safe harbor.

Safe Harbor	Non-Safe Harbor
Accommodator Treated as the Owner	No Presumption as to Ownership
45 Days to Identify Relinquished Property	No Identification Requirement
180 Day Maximum Parking Period	No Time Limit on Parking
Tax Reporting Required	Tax Reporting Advisable
Accommodator Can Be Taxpayer’s Agent for Transfer Tax Purposes	Accommodator Should Not Be Taxpayer’s Agent

The landscape changed for non-safe harbor transactions with the 9th Circuit Tax Court’s decision in *Estate of George H. Bartell, Jr. v. Commissioner*, 147 T.C. No. 5 (2016). In that case the AP held the property for 17 months. The AP had no appreciable benefits or burdens of ownership. The IRS argued that under a benefits and burdens test the taxpayer was the true owner, not the AP. The Court disagreed, holding that the AP may hold title solely for the purpose of an exchange. The AP was not required to have any benefits or burdens of ownership of the Parked Property to have a valid exchange. Also, the AP could be contractually insulated from risk by the taxpayer. An important factor in the Court’s decision was that the AP was not the agent of the taxpayer.

*Bartell* makes it easier for a taxpayer to structure a non-safe harbor exchange, since the AP no longer needs to have benefits and burdens of ownership. There is some tax risk, as the IRS may not follow *Bartell* outside the 9th Circuit. Some state courts may also be reluctant to adopt the *Bartell* opinion. Taxpayers should consult their tax professionals when contemplating a non-safe harbor exchange. For a better understanding of how this case may benefit you, please contact your IPX1031 representative. We will be happy to work with you and your tax professionals to craft a solution that will best fit your needs.



# Closing Costs and The Tax Deferred Exchange

There is little authority in the Internal Revenue Code or Treasury Regulations as to how to treat the variety of expenses and closing costs which may be associated with the sale or purchase of an exchanged asset. Given the general rule that an Exchanger must transfer all equity in the Relinquished Property to the Replacement Property, the issue is whether payment of typical sale and purchase settlement expenses out of the Relinquished Property sale proceeds (exchange funds) will result in taxable “boot” to the Exchanger.

There is an open issue as to whether the Qualified Intermediary’s use of exchange funds to pay for costs and expenses to close on the Replacement Property affect the safe harbor restrictions of Treas. Reg. §1.1031(k)-1(g)(6). Treasury Regulations provide that payment of transactional items related to sale or purchase of the exchanged properties that typically appear on closing statements as the responsibility of a buyer or seller, such as broker’s commissions, prorated property taxes, recording fees, transfer taxes and title company fees, may be paid from exchange funds and will not be construed as constructive receipt of funds by the Exchanger. Treas. Reg. §1.1031(k)-1(g)(7). Following this rationale, other typical closing costs customarily appearing on settlement statements that may generally be paid without concern of breaching the safe harbor include qualified intermediary fees, direct legal fees, costs of surveys, and environmental inspections related to the exchanged properties.

Prorations and closing costs may still affect the calculation of basis or gain, or may constitute boot to the Exchanger if they either are not offset, or are deemed to be not directly related to the sale or acquisition. **Revenue Ruling 72-456** provides some guidance regarding the impact of transactional costs. It specifies that real estate brokers’ commissions paid are offset against cash received in computing gain, and are added to the basis of the Replacement Property. For example, Broker’s commissions paid on Relinquished Property reduce gain and offset boot. If they are paid on Replacement Property (not very common) they increase the basis of the Replacement Property (as do Qualified Intermediary fees).

Certain costs may create taxable boot because they are seen as expenditures for benefits other than acquiring the Replacement Property. Loan fees, points, prorated mortgage insurance, loan appraisal fees and any other lender mandated inspections not otherwise required under the purchase and sale contract are generally considered to be costs of obtaining a new loan, rather than direct costs of acquisition of the Replacement Property. An easy test is to ask if the expense would exist if the transaction was cash only.

Prorated property taxes, insurance payments, rents and security deposits are usually considered to be outside of the exchange, but because they customarily appear on closing statements, the payment of these typical items should not interfere with the safe harbor. The Exchanger may wish to consider prorated property tax payments or security deposits credited to the buyer of the Relinquished Property as the equivalent of non-recourse debt from which the Exchanger was relieved. While this treatment initially creates mortgage boot received, this payment can be netted against liabilities assumed (mortgage boot paid) on the purchase of the Replacement Property. See TAM 8328011 regarding prorated rent payments.

Use of exchange proceeds for expenses unrelated to the direct purchase or sale of the exchanged properties can create significant issues. In addition to potentially creating taxable boot, it can be deemed to be receipt of exchange funds (or a benefit therefrom) in violation of Treas. Reg. §1.1031 (k)-1(g)(6), causing the exchange to fail. Exchange funds should not be used to pay off debt unrelated to the Relinquished Property, such as a line of credit, credit card debt, or other debt that is not secured by the Relinquished Property.

Because of these issues and the lack of clear guidance in the law, an Exchanger should always discuss treatment of closing costs with their tax advisor prior to the respective closing.

# Vesting Issues

For an exchange to satisfy IRC §1031, the taxpayer that will hold the title to the Replacement Property must be the same taxpayer that held title to the Relinquished Property. However, business considerations, liability issues, and lender requirements may make it difficult for the Exchanger to keep the same vesting on the Replacement Property. Exchangers must anticipate these vesting issues as part of their advanced planning for the exchange.

There are some exceptions to this rule when dealing with entities that are disregarded for federal income tax purposes. For example, the following changes in vesting usually do not destroy the integrity of the exchange:

- The Exchanger's revocable living trust or other grantor trust may acquire Replacement Property in the name of the Exchanger individually, as long as the trust entity is disregarded for Federal tax purposes. Rev. Rul. 2004-86.
- The Exchanger's estate may complete the exchange after the Exchanger dies following the close of the sale of Relinquished Property. Rev. Rul. 64-161.
- The Exchanger may sell Relinquished Property held individually and acquire Replacement Property titled in a single-member LLC or acquire multiple Replacement Properties in different single-member LLCs as long as the Exchanger is the sole member and the single member LLCs are treated as disregarded entities. PLR 200732012.
- A married couple may exchange Relinquished Property held individually as community property for Replacement Property titled in a two-member LLC in which the married couple's ownership is community property, but only in community property states and only if they treat the LLC as a disregarded entity. Rev. Proc. 2002-69 as amended by Rev. Rul. 2013-17.
- A corporation that merges out of existence in a tax-free reorganization after the disposition of the Relinquished Property may complete the exchange and acquire the Replacement Property as the new corporate entity. TAM 9252001, PLR 200151017.
- An Illinois land trust is a disregarded entity for IRC §1031 purposes, so an Illinois land trust beneficiary may exchange his beneficial interest in Relinquished Property held by the trust for Replacement Property vested in the beneficiary individually, or in a different Illinois land trust, as long as the Exchanger is the beneficiary. Rev. Rul. 92-105.

Adding a party to vesting, such as when the Relinquished Property is owned by one spouse and the Replacement Property will be acquired by both spouses, could result in partial recognition of gain by the spouse on title to the Relinquished Property. Divesting Relinquished Property held in one entity, such as a corporation, partnership, or multi-member LLC and acquiring the Replacement Property in a different corporation, partnership, or multi-member LLC, or in the shareholders, partners or members individually, will disqualify the exchange because the exchange is being completed by a different taxpayer than the one starting the exchange. However, conversion of a general partnership to an LP or an LLC during the Exchange Period will not disqualify the exchange. PLR 99935065.

To avoid disqualifying the exchange, the Exchanger should not make any changes in the vesting of the Relinquished or Replacement Properties prior to or during the exchange. Exchangers are cautioned to consult with their tax or legal advisors regarding how their vesting issues will impact the structure of their exchange before they transfer the Relinquished Property. Proper planning and negotiation can make the difference between a successful exchange and a taxable problem.

# Limitations On The Safe Harbors: The “(g)(6)” Restrictions

The 1991 Treasury Regulations for tax deferred exchanges under IRC §1031 established four “safe harbors,” the use of which allow a taxpayer (Exchanger) to avoid actual or constructive receipt of money or other property for purposes of completing a §1031 exchange. The four safe harbors include (1) qualified intermediaries, (2) interest and growth factors, (3) qualified escrow accounts and qualified trusts, and (4) security or guaranty arrangements. These safe harbors may be used singularly or in any combination as long as the terms and conditions of each can be separately satisfied.

The first three of the safe harbors require the Exchange Agreement between the Exchanger and the Qualified Intermediary to expressly limit the Exchanger’s right to “receive, pledge, borrow, or otherwise obtain the benefits of money or other property” before the end of the 180-day Exchange Period, except as permitted by Treasury Regulation §1.1031(k)-1(g)(6). The safe harbors are not satisfied if these “(g)(6)” restrictions are not placed upon the Exchanger, even if the Exchanger never actually receives the exchange funds. Treas. Reg. §1.1031(k)-1(g)(8), Example 2(ii). The Exchanger may have access to the exchange funds prior to the end of the Exchange Period only upon the following exchange terminating events:

- A. Immediately after the end of the 45-day Identification Period if the Exchanger has not identified any Replacement Property.** Example: The exchange begins on April 1 when Exchanger transfers the Relinquished Property to a buyer. If Exchanger does not identify any Replacement Property, then the exchange will terminate at midnight on May 16. The exchange funds may be returned to the Exchanger on May 17.
- B. Upon receipt of all of the identified Replacement Property to which the Exchanger is entitled under the exchange agreement, but only after the end of the Identification Period.** Example (i): Using the facts above, except that Exchanger identifies a single Replacement Property on or before May 16 (i.e., day 45) and acquires that Replacement Property on May 25. The exchange will terminate on May 25, and any remaining exchange funds may be returned to the Exchanger after the closing. Treas. Reg. §1.1031(k)-1(g)(6)(iii)(A). Example (ii) Same facts except that Exchanger acquires the Replacement Property on April 15. Exchanger must wait until the end of the Identification Period to receive the unused exchange funds, because the Exchanger still has 31 days remaining in which to identify additional Replacement Properties. Example (iii): Same facts except that Exchanger identifies three Replacement Properties, Blackacre, Whiteacre and Greenacre. Exchanger does not identify these properties as “alternate” properties, even though Exchanger only intends to acquire one property. On May 25, Exchanger acquires Greenacre, leaving a balance of \$30,000 of unspent exchange funds. Since Exchanger properly identified other properties, which could potentially be acquired, Exchanger has not actually acquired all of the Replacement Property to which Exchanger is entitled. Therefore, return of the remaining exchange funds prior to the expiration of the 180-day Exchange Period would violate the (g)(6) restrictions and cause the entire transaction to be taxable.
- C. Upon the occurrence after the end of the Identification Period of (1) a material and substantial contingency, (2) related to the exchange, (3) provided for in writing, and (4) beyond the control of the Exchanger and of any disqualified person other than the person obligated to transfer the Replacement Property to the Exchanger.** Treas. Reg. §1.1031(k)-1(g)(6)(iii)(B). Although the Treasury Regulations provide very few examples, zoning, inspection or loan issues to which the contract is contingent may rise to the level of this four-pronged test. The IRS views this exception very narrowly, noting in PLR200027028 that the failure of a taxpayer and seller to agree upon contract terms for acquisition of a Replacement Property was not beyond the control of the taxpayer. The IRS explained, “it is within the owner’s control to decide to meet the seller’s demands or walk away from an uneconomic business deal.” To avoid violation of the (g)(6) restrictions, resulting in denial of §1031 tax-deferral treatment, the Exchanger should always consult with a tax advisor as to whether the occurrence of a particular contingency is sufficient to qualify under this provision.

# Qualified “Like-Kind” Property

There is a two-pronged test for properties to qualify for IRC §1031 tax-deferral treatment.

1. Both the Relinquished and the Replacement Properties must be held by the Exchanger either for investment purposes or for productive use in a trade or business. The Exchanger’s purpose and intent in holding the property is the critical test. The use of the property by other parties to the exchange (Relinquished Property buyer or Replacement Property seller) is irrelevant.
2. The Relinquished and the Replacement Properties must also be “like-kind.” The term “like-kind” refers to the nature or character of the property, ignoring differences of grade or quality. For example, unimproved real property is considered like-kind to improved real property, because the lack of improvements is a distinction of grade or quality; the basic real estate nature of both parcels is the same. Treas. Reg. §1.1031(a)-1(b). In essence, all real property in the United States is “like-kind” to all other domestic real property.

IRC § 1031(a)(2) specifically provides that real property held primarily for sale does not qualify for tax deferral under section 1031.

Following are examples of qualifying properties that could be exchanged:

- Raw land or farmland for improved real estate
- Oil & gas royalties for a ranch
- Fee simple interest in real estate for a 30-year leasehold or a Tenant-in-Common interest in real estate
- Residential, Commercial, Industrial or Retail rental properties for any other real estate
- Rental ski condo for a three-unit apartment building
- Mitigation credits for restoring wetlands for other mitigation credits

Under IRC §1031, the following properties do not qualify for tax-deferred exchange treatment:

- Stock in trade or other property held primarily for sale (i.e. property held by a developer, “flipper” or other dealer)
- Securities or other evidences of indebtedness or interest
- Stocks, bonds, or notes
- Certificates of trust or beneficial interests
- Interests in a partnership
- Choses in action (rights to receive money or other property by judicial proceeding)
- Foreign real property for U.S. real property
- Goodwill of one business for goodwill of another business

# Do Vacation and Second Homes Qualify For IRC §1031 Treatment?

It has been established that vacation or second homes held by the Exchanger primarily for personal use do not qualify for tax deferred exchange treatment under IRC §1031. In *Moore v. Commissioner*, T.C. Memo 2007-134, the Tax Court held that properties held for personal use with the mere hope or expectation of gain did not establish investment intent for a vacation home used only for the personal enjoyment of the taxpayer and his family and friends.

Revenue Procedure 2008-16, provides safe harbors under which the IRS will not challenge whether a dwelling unit qualifies as property held for use in a trade or business or for investment purposes. A dwelling unit is defined as “real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including sleeping space, bathroom and cooking facilities.”

The safe harbor for a vacation or second home to qualify as **Relinquished** Property in a §1031 exchange requires the Exchanger to have owned it for twenty-four months immediately **before** the exchange, and within each of those two 12-month periods the Exchanger must have 1) rented the unit at fair market rental for fourteen or more days, and 2) restricted personal use to the **greater of** fourteen days or ten percent of the number of days that it was rented at fair market rental within that 12-month period.

The safe harbor for a vacation or second home to qualify as **Replacement** Property in a §1031 exchange requires the Exchanger to own the vacation home for twenty-four months immediately **after** the exchange, and for each of those two 12-month periods the Exchanger must 1) rent the unit at fair market rental for fourteen or more days, and 2) restrict personal use to the **greater of** fourteen days or ten percent of the number of days it was rented at fair market rental within that 12-month period.

“Personal use” includes use by the Exchanger’s friends and family members that do not pay fair market value rent, but would not include use as a related party’s primary residence if the related party pays rent at a fair market rate. *Adams v. C.I.R.*, T.C. M. 2013-7-7

## Converting a Principal Residence To Minimize Taxes By Combining IRC §1031 and §121

IRC §1031 permits the deferral of capital gains tax on investment or business use property that is exchanged for like-kind investment or business use property of equal or greater value. The taxpayer’s current principal residence, being personal use property, will not qualify for a §1031 exchange. However, a taxpayer selling a primary residence that has been converted into use as a rental property for a period of time prior to sale, or that has been used partially for business purposes, such as a home office or a duplex, half of which is rented, may be able to combine IRC §121 and §1031 to maximize deferral of capital gains tax.

When the Exchanger’s principal residence is used partially for business purposes, the Exchanger must allocate between the personal use and the business use. The portion allocated to business or investment purposes qualifies for an IRC §1031 exchange and the residence portion may qualify for the exclusion from capital gain for personal residences under IRC §121. Revenue Procedure 2005-14 provides guidance on the concurrent application of IRC §121 and §1031.

§121 permits an exclusion from realized capital gain of \$250,000 for a single person and \$500,000 for a married couple (filing jointly) on the sale of a home used as a primary residence for any two of the past five years, but there are some limitations. IRC §121(b) requires the maximum exclusion to be reduced, based upon the ratio of time that the primary residence had a non-qualified use (after 12/31/08) during the taxpayer’s ownership that either preceded the home’s use as a primary residence or occurred between periods of use as a primary residence. Additionally, §121(d)(10) requires that a residence acquired as a Replacement Property in a §1031 exchange must be held by the Exchanger for a total of five years before it will qualify for any §121 capital gain exclusion.



# Other Interests In Real Property and Mixed Use Exchanges

Certain interests in real property, such as natural gas pipelines, may be exchangeable for a fee interest in real property. The IRS has historically looked to State law as a relevant factor in determining whether the interest in the property is treated as real property or as personal property. *Aquilino v. United States*, 363 U.S. 509 (1960). However, the characterization of properties as real or personal property under State law is not determinative of whether the properties qualify as like-kind for IRC §1031 purposes. That ultimate determination relies upon an analysis of the nature and character of the property as well as the extent of the property interest (i.e. perpetual or limited). *Koch v. C.I.R.*, 71 T.C. 54, 65 (1978); *Peabody Natural Resources Co. v. C.I.R.*, 126 T.C. 261 (2006); ILM 201238037.

**Oil, Gas, and Mineral Rights:** Courts look to the underlying nature of the right. If the right is perpetual, such as an easement or a royalty interest, it is generally real property for §1031 purposes. An overriding royalty interest in minerals traded for a city lot constituted a like-kind exchange. *Commissioner v. Crichton*, 122 F2d 181 (5th Cir. 1941). If the right is merely a production payment or a “carved out” right, it is not a real property interest for §1031. The assignment of a carved-out oil payment right for a fee interest failed to qualify for exchange treatment even though State law characterized the oil payments as a real property interest. *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). “The main distinction between the two transactions is the duration of the interests—an overriding royalty interest continues until the mineral deposit is exhausted whereas a carved-out oil payment right terminates usually when a specified quantity of minerals has been produced or a stated amount of proceeds from the sale of minerals has been received.” *Koch v. C.I.R.*, 71 T.C. 54, 65 (1978). In an exchange of gold mines for coal mines, the coal mines were subject to supply contracts that were considered contracts for the sale of goods and, as such, personal property under State law. However, for §1031 purposes the court concluded that the supply contract payments also created equitable servitudes that were part of the bundle of rights incident to the ownership of the coal mines and, as such, were also real property interests under State law. Thus their inclusion in the exchange of the real property did not constitute boot. *Peabody Natural Resources Co. v. C.I.R.*, 126 T.C. 261 (2006).

**Water Rights:** In states that treat water rights as real property rights, perpetual water rights are like-kind to a fee interest and may be exchanged for other real estate. Rev. Rul. 55-749, 1955-2 CB 295. Water rights in perpetuity have been distinguished from a right to a specific amount of water for a limited period, with the distinction in nature and character based on an analogous mineral rights holding. *Fleming v. C.I.R.*, 241 F2d 78 (5th Cir. 1957); *Wiechens v. U.S.*, 228 F.Supp.2d 1080 (D.Ariz.2002); LTR 200404044.

**Easements and Conservation Easements:** An exchange was upheld where taxpayer granted a perpetual easement and right of way to a power company and acquired a fee interest. Rev. Rul. 72-549, 1972-2 C.B. 472. Agricultural conservation easements in perpetuity that are real property interests under State law are like-kind to a fee simple. PLR 9851039. A perpetual conservation easement and a perpetual scenic conservation easement each characterized as real property interest under State law have both been held like-kind to a fee simple interest. PLRs 9601046, 9621012. Perpetual stewardship easements granting land use development credits were exchanged for fee interests. PLRs 200651018, 200651025. Development rights were successfully acquired in exchange for the sale of a fee simple interest in the relinquished property. PLR 200805012.

**Cooperative Apartments:** An interest in a cooperative apartment may be exchanged for a fee interest in any other type of real estate. Although ownership in a cooperative apartment is evidenced by stock and a long term lease, the IRS has reasoned that the primary use of cooperatives is as real estate and that coops are treated as real estate under various state statutes. PLRs 200137032, 200631012. Private letter rulings held that an Exchanger’s interest as a shareholder in a California cooperative would not fall within the definition of §1031(a) excluding stocks. PLRs 8810034, 8445010.

# Other Interests In Real Property and Mixed Use Exchanges (CONT.)

**Options and Contracts:** Although two early cases have been interpreted to support that an option to sell or purchase real property is like-kind to a fee interest, many tax advisors are uncomfortable with that position since the contract right does not become a real estate interest until it is exercised. *Starker v. U.S.*, 602 F.2d 1341 (9th Cir. 1979); *Biggs v. C.I.R.*, 632 F.2d 1171 (5th Cir. 1980).

**Timber Rights:** In some states, standing timber is considered an interest in real property and can be exchanged for any other interest in real property, such as an apartment complex or a retail mall. *Anderson v. Moothart*, 198 Or. 354, 256 P.2d 257 (1953) and *Cary A. Everett, T.C.M.* 1978-53. If the timber is being sold subject to a cutting contract, however, which requires that the timber be removed from the land within a reasonable time, this may be considered a personal property interest under applicable State law and not be of like-kind to real property for purposes of an exchange.

**Leasehold Interests:** A lease with 30 years or more remaining to run, including renewal options, is considered to be like-kind to a fee interest in real estate, but a lease with a term of less than 30 years is not. *Century Electric Co. v. C.I.R.*, 192 F.2d 155 (8th Cir. 1951); *Treas. Reg. §1.1031(a)-1(c)* and *Rev. Rul. 78-72*, 1978-1 C.B. 258. A “carve out” of a lease interest does not qualify for exchange treatment. Therefore, a fee owner of real property cannot exchange a “carve out” 30-year lease in that property for a fee interest in a replacement real property. *Rev. Rul. 66-209*, 1966-2 C.B. 299. This is in contrast to an exchange of real property that is subject to a long-term lease, which is still treated as real property for purposes of qualifying for an exchange since this is equivalent to the lessor’s underlying interest. *Rev. Rul. 76-301*, 1976-2 C.B. 241.

**Undivided Interests:** Another issue arises when there is a partition of property between co-owners, or when co-owners of the same property desire to exchange their undivided interests in the whole property for an exclusive fee interest in a portion of the same property. These transactions have been allowed and accorded favorable exchange treatment. *Rev. Rul. 79-44*, 1979-1 C.B. 265; *Rev. Rul. 73-476*, 1973-2 C.B. 300. The IRS has issued guidance for structuring a co-tenancy (tenancy in common or fractional ownership) arrangement in a Replacement Property where there are a large number of co-tenants. *Rev. Proc. 2002-22*. The structuring risk is that the IRS could recharacterize the co-tenancy arrangement as a partnership, viewing the interest being exchanged as a partnership interest rather than a fractional interest in real estate. This would cause exchange treatment to be disallowed because an interest in a partnership is ineligible under §1031.

**Mixed Use and Mixed Asset Exchanges:** Exchangers hold properties for various reasons, such as for investment, personal use, primarily for sale, or use in their trade or business. In these situations, tax and legal advice is necessary to allocate sale and purchase prices to the appropriate qualified and non-qualified property portions of the exchange. In *Sayre v. U.S.*, 163 F. Supp. 495, (S.D. W. VA. 1958) the Court ruled that any reasonable allocation would be acceptable. There is no requirement that the property be surveyed or partitioned to achieve this dual tax purpose. An allocation could be determined, for example, by an appraisal based upon the number of units or the relative square footage of the units. The proceeds from the sale of the qualified exchange portion of the Relinquished Property must be used to purchase qualified Replacement Property and not be used toward purchase of non-like kind or personal use assets, otherwise the expenditure will create taxable boot. For example, an Exchanger relinquishes the family homestead and the surrounding ranch, a mix of personal use and business use assets. The Exchanger can take advantage of the principal residence capital gain tax exclusion under IRC §121 for the home, and pursuing an exchange of the ranch portion of the property under IRC §1031. Proceeds allocated to the ranchland may only be used to acquire more investment or business use real estate; they may not be used to acquire a more expensive primary residence.

# Partnership Issues

Since 1984, IRC §1031 has specifically excluded exchanges of partnership interests from non-recognition treatment. Thus, §1031 does not apply to an exchange of interests in a partnership regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or in different partnerships, even if both partnerships own the same kind of real property.

A partnership, however, may exchange real property under §1031, as long as the partnership meets the requirements that apply to all exchange transactions (i.e., same taxpayer starting and completing the exchange, both the Relinquished and Replacement Properties will be held for investment or business purposes, etc.).

An important issue when addressing exchanges involving partnerships is the individual investment objectives of the partners. When the entire partnership wants to structure a tax deferred exchange, it is clear that the transaction can qualify under §1031. Problems arise, however, when one or more of the individual partners have different investment objectives.

The most commonly asked question is “Can a valid exchange still be structured if one of the partners drops out of the partnership?” Often one or more of the partners desire to withdraw from the partnership and receive cash or other property in return for their partnership interest. Most partnership issues can be resolved with advanced planning. Partners that may want to separate in future investments or sell the existing asset for cash should consult with their tax advisors before structuring the transaction.

**Distributing an undivided interest:** Although there are many structures, many practitioners believe that there is less risk of an exchange being disallowed on audit if the partners desiring to receive cash on the sale of the Relinquished Property (cash-out partners) receive a distribution of their partnership interest in the form of an undivided interest in the Relinquished Property prior to the closing of the sale. Then, as long as there are at least two partners (one of which was a partner prior to the redemption), this leaves the partnership in existence to accomplish the §1031 exchange. At the closing, the surviving partnership and each of the former partners convey their respective interests in the Relinquished Property, with the former partners receiving cash, and the Qualified Intermediary receiving the net proceeds due the partnership to enable the partnership to complete the exchange when it locates Replacement Property. Completing the redemption of the cash-out partners as far in advance of the sale, and if possible, prior to the execution of the contract of sale for the Relinquished Property, is highly desirable.

**Liquidate partnership and distribute tenancy-in-common interests:** Another possible solution is to liquidate the partnership prior to the exchange and distribute to each partner a tenancy-in-common interest in the Relinquished Property. It is advisable to transfer ownership to the individual Exchangers as far in advance of the exchange as possible. If a distribution or dissolution occurs shortly prior to the exchange (or shortly after the exchange), the key issue is whether the Relinquished Property (or Replacement Property) was “held for productive use in a trade or business or for investment purposes.” This qualified use requirement must be met by the individual Exchanger (former partner) for the exchange to be valid, and is problematic when the distribution occurs within close proximity of the sale or purchase transaction. Conversely, the qualified use issue can generally be avoided through the strategy of distributing an undivided interest to the cash-out partners only (prior to sale), without liquidation, allowing the partnership to survive and complete the exchange.

**“Drop and Swap” and “Swap and Drop”:** “Drop and Swap” transactions are when a Partnership distributes the Relinquished Property to the partners shortly before the exchange and “Swap and Drop” transactions are when the Partnership distributes the Replacement Property to the partners shortly after the exchange. These transactions are considered aggressive since under these structures, the partnership’s prior holding period is not attributed to the individual Exchanger (the distributee of the property) that is completing the exchange. Hence, the Exchanger may be considered to be acting on behalf of the partnership, and the sale and gain recognition will be attributed to the partnership. Accordingly, “Drop and Swap” and “Swap and Drop” transactions should only be considered with the guidance of a tax advisor.

# Partnership Issues (CONT.)

If distributing an undivided interest of the partnership property or dissolving the partnership well in advance of the exchange is not possible, the partners who want to exchange may consider one of the following: purchase of the interest of a retiring partner; sale by the partnership of the Relinquished Property for cash and an installment note; or a partnership division.

**Purchase of the interest of a retiring partner:** This technique can be implemented before or after a §1031 exchange. If done before the exchange, the partners who want to exchange contribute additional equity which is used to buy out the retiring partner(s). The partnership (with fewer partners) then enters into an exchange. The partnership must acquire Replacement Property which has the same or greater value compared to the Relinquished Property to fully defer taxes. If the partner buy out occurs after the exchange, the partnership typically refinances the Replacement Property received in the exchange to generate the cash necessary to buy out the retiring partner(s).

**Sale of the Relinquished Property for cash and an installment note:** This method involves having the buyer of the Relinquished Property pay with cash and an installment note; the cash is used by the partnership in the exchange and the retiring partner receives the installment note in redemption of his or her partnership interest. If at least one true payment is paid in the following tax year, it should be considered a valid installment note and receive installment sale treatment under I.R.C. §453. Most tax advisors suggest that at least 5% of the total payments of the note be made in the next tax year.

**Partnership division:** This technique can be done before, after and possibly during an exchange. Using the partnership division rules of I.R.C. §708(b)(2), a partnership can divide into two or more partnerships. If a new partnership contains partners, who together, owned more than 50% of the original partnership, it is deemed to be a continuation of the original partnership. Although there may be more than one “continuing partnership”, only the continuing partnership which has the greatest fair market value (net of liabilities) will continue to use the Employer Identification Number (EIN) of the original partnership. All other partnerships resulting from the division will obtain a new EIN.

For example, let’s assume that a partnership is comprised of John and Jeff (each owns a 50% interest) who no longer want to be partners; John wants to do a §1031 exchange but Jeff wants to sell his interest and “cash out”. John-Jeff Partnership would divide into two partnerships; John-Jeff Partnership I (John owns a 99% interest and Jeff owns a 1% interest) and John-Jeff Partnership II (John owns a 1% interest and Jeff owns a 99% interest). John-Jeff Partnership would transfer the partnership property 51% to John-Jeff Partnership I and 49% to John-Jeff Partnership II, as tenants in common. Upon sale of the Relinquished Property, 51% of the sale proceeds would go to a Qualified Intermediary for John-Jeff Partnership I’s §1031 exchange and 49% of the proceeds would be distributed to the John-Jeff Partnership II for further distribution to the individual partners. As a result, John has a 99% interest in the partnership which owns the Replacement Property (and which continues to use the original partnership’s EIN) and Jeff has received 99% of the cash value of his interest in the original partnership. After one to two years, John could buy Jeff’s interest in John-Jeff Partnership I and complete the separation, provided their tax advisor was comfortable with that timing. Although partnership division may not be suitable for partners who want to immediately completely separate their holdings, it provides a way to achieve this over a period of time and still comply with the “held for” requirement of §1031.

**Purchase of multiple properties by partnership:** Although some authority exists to apply partnership division to situations where both partners want to exchange (but into separate properties); some advisors are not comfortable having their clients do so because only one of the resulting partnerships is permitted to continue to use the original partnership’s EIN. They prefer that the partnership purchase multiple replacement properties. Applying this to our example, John-Jeff Partnership would exchange into two Replacement Properties and amend the partnership agreement to disproportionately allocate the respective income and depreciation from the properties to John and Jeff. Most advisors believe that at least 10% should be allocated to the minority partner. Accordingly, the John-Jeff Partnership would buy Whiteacre and Blackacre. John would be allocated 90% of the income and depreciation of Whiteacre and Jeff would be allocated 10%. The reverse would be applied to the allocation of income and depreciation relating Blackacre. After a period of time determined by their tax advisor (and with no prearranged plan) John and Jeff could dissolve the partnership distributing Whiteacre to John and Blackacre to Jeff.

# LLC Issues

Because of advantageous tax treatment combined with liability protection, limited liability companies (LLCs) have become a preferred way to own real estate in the United States. By understanding their structure, they can also be used to provide flexibility in complying with the requirements of a §1031 exchange. All 50 states have enacted laws permitting the formation of LLCs, including single member LLCs. Although they are separate entities (from their owners and/or managers) for legal and liability purposes, they may be disregarded entities for federal tax purposes. That means that although the member of a single member LLC is insulated from liability from the LLC's activities, the sole member is considered to be the taxpayer for federal tax purposes. This creates planning opportunities for §1031 exchanges.

For federal tax purposes, an LLC is characterized as one of the following: a sole proprietorship (which reports income on a Schedule C, D, E or F to Form 1040); a partnership (which reports income on Form 1065); or a corporation (which reports income on Form 1120 or Form 1120-S). If the LLC makes no election with the IRS to be taxed as a corporation, by default, a single member LLC is considered to be a sole proprietorship and therefore is disregarded from its member for federal tax purposes.

Similarly, an LLC with two or more members that makes no election with the IRS (to be taxed as a corporation) is considered to be a partnership for federal tax purposes. An exception to this rule is provided by Rev. Proc. 2002-69, which holds that the IRS will consider an LLC owned solely by a husband and wife as community property to be a disregarded entity. This only applies in the nine "community property states" which are: Louisiana; Texas; New Mexico; Arizona; California; Nevada; Washington; Idaho; and Wisconsin. An LLC owned solely by husband and wife would be considered to be a partnership in the 41 non-community property (common law) states.

As stated above, an LLC (either single member or multi-member) can make an election with the IRS to be treated as a corporation for tax purposes. If desired, the LLC can make a further election to be treated as an S corporation instead of a C corporation. In summary, an LLC with only one owner will be classified as a disregarded entity or a corporation; whereas an LLC with two or more members will be classified as a partnership or a corporation (unless it is a husband and wife LLC in a community property state).

The use of disregarded entities can be helpful in resolving challenges which may be presented by the vesting requirements for a valid §1031 exchange; i.e., the Replacement Property must be acquired by the same taxpayer that disposed of the Relinquished Property. Although there are other disregarded entities such as Delaware Statutory Trusts (Revenue Ruling 2004-86), Delaware business trusts, Massachusetts nominee trusts, Illinois land trusts (Revenue Ruling 92-105), and grantor trusts; the use of single member LLCs is probably the most common in connection with §1031 exchanges.

Treasury regulation §301.7701-(3)(b)(1) provides that single member LLCs that acquire property are ignored for federal tax purposes and that the member is treated as the direct owner of the property. The IRS has issued Private Letter Rulings holding that the disposition of the Relinquished Property (or acquisition of the Replacement Property) by a disregarded entity of the taxpayer will be treated for purposes of §1031 as a direct disposition or acquisition of the asset by the taxpayer. PLR 9807013. The key to understanding the use of disregarded entities in a §1031 exchange context is the identification of the taxpayer. To have a valid §1031 exchange, the same taxpayer must sell the Relinquished Property and acquire the Replacement Property. For example, assume a taxpayer wants to exchange a Relinquished Property that he owns individually; but he wants to acquire the Replacement Property in a single member LLC to protect himself from liability. Because of the disregarded treatment of single member LLCs for tax purposes, this is not a problem.

Lenders frequently require that the Replacement Property be purchased in a "bankruptcy remote" entity. In addition, an Exchanger may be concerned about contingent liability relating to the selling entity and does not want take a chance that the Replacement Property might become subject to a future judgment related to the Relinquished Property or its nominal owner. In both of these situations, a disregarded single member LLC is very useful. A new single member LLC can be created to acquire the Replacement Property with the taxpayer that owned the Relinquished Property (individual, partnership, corporation, LLC, etc.) being the sole member of the new LLC.

Finally, it should be noted that the IRS has ruled on numerous occasions that the acquisition of the membership interest in a disregarded entity holding the Replacement Property is treated (for §1031 purposes) as the acquisition of the replacement property. PLR 200118023. This may avoid double transfer taxes in some states, particularly in reverse exchanges involving parking arrangements. For example, assume the Replacement Property is being held by an Exchange Accommodation Titleholder (EAT) in a disregarded single member LLC. Acquiring the Replacement Property through assignment of the membership interest of the LLC will satisfy the exchange and may not trigger transfer taxes in states in which transfer taxes are assessed upon recording of a deed, but not upon transfer of membership interest.



# Impact Of Depreciation Recapture On Exchanges

Depreciation is an integral part of calculating the adjusted basis of property, and thus is an important component of the non-recognition provisions of IRC §1031. Depreciation is a means of allowing the taxpayer a reasonable deduction for the exhaustion, wear, and tear of business use property. When business use property is sold or exchanged, the Code requires the depreciation previously taken by the taxpayer to be “recaptured.” Upon the disposition of the taxpayer’s property, depreciation recapture applies to that portion of tax gain attributable to sale proceeds received up to the amount of depreciation taken over the life of the asset. All business use property is subject to depreciation recapture. The recapture provisions, however, are different depending on whether the asset being sold or exchanged is real or personal property.

**IRC §1250 property** is generally defined as improved real property that is subject to a depreciation deduction on the taxpayer’s return. The recapture provisions applicable to §1250 property are fairly complex. An accelerated cost recovery (ACRS) method of depreciation was used for property placed in service on or before 12/31/1986. A modified accelerated cost recovery (MACRS) straight-line system of depreciation was used after 1986. For §1250 property, any depreciation taken under ACRS in excess of the depreciation that would be allowed under a MACRS straight-line cost recovery method is taxed as ordinary income and any gain attributable to unrecaptured depreciation under the MACRS schedule (unrecaptured §1250 gain) is currently taxed at 25%.

**IRC §1245 property** is generally depreciable personal property, although the Code does classify certain types of real property placed in service prior to 1987 as §1245 property. Currently, §1245 property is only personal property used in a trade or business. Dispositions of §1245 property that result in a gain are subject to depreciation recapture. Unlike §1250 property, however, recaptured depreciation on §1245 property is not entitled to a preferential lower tax rate. Under §1245, all depreciation that has been taken on the subject property must be recaptured and taxed as ordinary income, but only to the extent that gain is recognized on the sale or exchange transaction.

**Cost Segregation:** Some owners of large real estate properties utilize a “cost segregation” study as a means of maximizing the benefits of both real property straight-line depreciation and personal property accelerated depreciation. A cost segregation is a detailed engineering study that reallocates certain components of §1250 (real) property to §1245 (personal) property. The goal of cost segregation is to carve out fixtures, HVAC systems and other elements of personal property that have been incorporated into the building, and treat them as separate from the real estate so that the taxpayer may take advantage of the more generous accelerated depreciation schedules available for personal property. CCA 200648026. When a taxpayer exchanges improved real property for which cost segregation has been utilized, care must be taken to ensure that the Replacement Property will have sufficient §1245 property to offset §1245 recapture, in addition to having sufficient §1250 property to offset §1250 recapture, otherwise boot will be recognized. For example, if a cost segregated shopping center were exchanged for raw land, there would be no depreciable personal property in the Replacement Property to offset the §1245 depreciation taken over the life of the Relinquished Property shopping center, and recapture would be required.

**Step in the Shoes:** In 2004 the IRS revised the rules for “step in the shoes” depreciation to eliminate any tax advantage of acquiring Replacement Property with a longer recovery period or more favorable accelerated depreciation method than the Relinquished Property it replaced. Treasury Regulation §1.168(i)-6T requires that portion of basis in the new Replacement Property representing exchanged basis (not basis from additional cash) to be recovered over the remaining life of the Relinquished Property using the same method that was used for the Relinquished Property if the Replacement Property has the same or shorter recovery period or the same or more accelerated depreciation method. Alternatively, the regulation requires exchanged basis to be recovered over the remaining life of the Relinquished Property utilizing the depreciation method of the Replacement Property if it has a longer recovery period or a less accelerated depreciation method. In summary, the IRS wins both ways. Pre-existing basis of property acquired in an exchange must now be depreciated using the recovery period and method applicable to either the Relinquished or Replacement Property, whichever is least advantageous to the taxpayer.



# Refinancing Before and After Exchanges

Refinancing to pull equity out of a property prior to or after completing a tax deferred exchange can result in a taxable transaction under the “step transaction doctrine.” The IRS can argue that a “cash-back” refinancing, immediately before the exchange is completed, is just one step in many steps that results in not reinvesting all of the equity from the Relinquished Property. It follows that the refinance loan proceeds would be taxable as boot. This “step transaction” doctrine allows the IRS to re-characterize seemingly separate transactions into one transaction for tax purposes. The result is an unfortunate outcome for the Exchanger if the IRS believes that there was no independent business purpose for the refinance. In other words, the threshold question is, “was the purpose of the loan nothing more than the Exchanger’s desire to take cash out of the equity of either the Relinquished or Replacement Properties without paying tax?”

In *Fred L. Fredericks v. Commissioner*, TC Memo 1994-27, 67 TCM 2005 (1994), the Exchanger refinanced the Relinquished Property two weeks after executing a contract to sell the property and less than a month prior to the resulting exchange. Using the step transaction doctrine, the IRS argued that the refinance proceeds should be considered taxable boot. The Exchanger prevailed by showing that he had attempted to refinance the property over a two-year period. In this instance, the Court concluded that the refinance transaction: a) had an independent business purpose; b) was not entered into solely for the purpose of tax avoidance; and c) had its own economic substance which was not interdependent with the sale and exchange of the Relinquished Property.

Exchangers should discuss their plans to refinance with their tax advisors and carefully consider the following issues to help avoid the pitfalls of the “step transaction doctrine”:

- As a rule of thumb, the refinance transaction should be separate from the exchange sale or purchase transaction to support the position that they are not interconnected
- The refinance loan and sale or purchase in the exchange should be documented as separate transactions to avoid any “interdependence” of the transactions
- It is generally considered less risky to refinance the Replacement Property (rather than the Relinquished Property) through a separate post-closing transaction
- The Exchanger should be able to demonstrate an independent business purpose for a refinance loan on the Relinquished Property

# Seller Financing Combined with a Tax Deferred Exchange

Sometimes it is necessary or desirable for an Exchanger to accept payment from the Relinquished Property purchaser in the form of cash and a promissory note. Treas. Reg. §1.1031(k)-(1)(j)(2) provides guidance for coordinating the tax deferral benefits of IRC §1031 with the installment sale benefits of IRC §453.

There are three basic scenarios in which an Exchanger may combine the benefits of seller financing with a §1031 exchange. For each scenario below, assume that the Exchanger sells Relinquished Property for \$100. The Buyer wishes to pay \$20 cash and give a promissory note for the balance of \$80.

- 1. Exchanger has access to additional cash and desires an income stream.** Exchanger funds \$80 cash at closing of the Relinquished Property sale, representing Exchanger's loan to the buyer. (Exchanger may borrow the cash necessary to loan to Buyer.) Qualified Intermediary receives \$100 cash from sale of Relinquished Property. Exchanger receives the buyer's note (payable to Exchanger) and security instrument outside of the exchange. Exchanger's basis in the note is \$80; principal payments on the note are nontaxable as return of principal, interest payments are taxable as ordinary income, as received. Qualified Intermediary uses \$100 to buy Replacement Property, allowing for a completely tax-deferred exchange.
- 2. Exchanger does not have cash to fund the loan to the Buyer outside of the exchange.** Upon closing the sale of the Relinquished Property, Qualified Intermediary receives the \$20 cash and a promissory note (and security instrument, if any) from the buyer for \$80, payable to the Qualified Intermediary. When the Exchanger is ready to acquire Replacement Property, Exchanger can arrange for Qualified Intermediary to sell the note (1) to Exchanger for the remaining principal balance due on the note (Exchanger may borrow the cash necessary to purchase the note), OR (2) to a third party note buyer (but any discount will be treated as boot and will reduce the amount of gain deferred), OR (3) to the lender that will make the loan to the Exchanger for purchase of the Replacement Property. Qualified Intermediary then has \$100 cash with which to buy Replacement Property allowing the Exchanger to defer all of the gain. If the Exchanger has purchased the note, Exchanger will have an \$80 basis in the note. Principal payments on the note will be non-taxable as return of principal; interest payments will be taxable as ordinary income, as received. Alternatively, Exchanger can arrange for the Qualified Intermediary to assign the note to the Replacement Property seller as part of the purchase price, along with the \$20 cash, resulting in complete deferral of gain.
- 3. Exchanger does not have cash to fund the loan to the Buyer outside of the exchange and the exchange partially or completely fails.** The Qualified Intermediary is holding \$20 of Exchange Funds and the buyer's note, but the Exchanger is unable to fully complete the exchange and carries back (i.e. retains) the \$80 promissory note as a result. Qualified Intermediary uses \$20 cash to acquire Replacement Property, but the Exchanger is unable to identify and acquire any additional Replacement Properties. Upon termination of the exchange, the Qualified Intermediary assigns the note and security instrument to the Exchanger. Basis in the Relinquished Property will be allocated first to the Replacement Property, with any basis in excess of \$20 allocated to the note. To the extent that Exchanger's basis in the Relinquished Property was less than \$20, gain that was rolled into the Replacement Property will be deferred indefinitely. Recognition of the gain attributable to the note will be spread over the life of the note. Pursuant to the installment rules under IRC §453, the Exchanger will recognize and pay capital gains tax on the gain allocated to the note incrementally, and ordinary income tax on the interest, as the payments are received.

# Related Party Exchanges

Exchanges between related parties are allowed but the Exchanger must follow specific rules for the exchange to qualify for tax deferral. Related party exchanges must be disclosed on IRS Form 8824.

**Related Parties:** Related parties are defined in IRC §267(b) and §707(b)(1) as persons or entities bearing a relationship to the Exchanger, such as certain members of a family (brothers, sisters, spouse, ancestors and lineal descendants); a grantor and fiduciary of any trust; two corporations which are members of the same controlled group; and corporations and partnerships with more than 50% direct or indirect common ownership in the entities.

**Two-Year Holding Period:** Under IRC §1031(f) it is clear that two related parties, owning separate properties, may “swap” those properties with one another and defer the recognition of gain as long as both parties hold their Replacement Properties for two years following the exchange. This rule was imposed to prevent taxpayers from using exchanges to shift the tax basis between the properties to avoid paying taxes upon the subsequent sale of one of the properties. Exceptions to the two-year holding period are allowed only if the subsequent disposition of the property is due to 1) the death of the Exchanger or related person, 2) the compulsory or involuntary conversion of one of the properties under IRC §1033 (if the exchange occurred before the threat of conversion), or 3) the Exchanger can establish that neither the exchange nor the disposition of the property was designed to avoid the payment of Federal income tax as one of its principal purposes.

**Related Seller:** Exchanges in which the Replacement Property seller is the related party are not likely to qualify for tax deferral unless the related party seller also does an exchange. Under Revenue Ruling 2002-83, exchange treatment will be denied to an Exchanger who, through a Qualified Intermediary, acquires Replacement Property from a related party seller that receives cash or other non-like-kind property, regardless of whether the Exchanger holds the Replacement Property for the requisite two years. The IRS will generally view this transaction as yielding the same result as if the Exchanger swapped properties with a related party, and then the related party immediately sold the property acquired, violating the two-year holding requirement. The related party rules of §1031(f) cannot be avoided by interposing an unrelated Qualified Intermediary.

Following Rev. Rul. 2002-83, the IRS ruled that §1031(f) would not trigger gain recognition in a series of exchanges involving related partnerships that used an unrelated Qualified Intermediary since 1) neither related party was cashing out of their investment in real estate and 2) each related party represented that they would hold their Replacement Property for the required two years following their exchange. PLRs 200440002, 200616005. The IRS has issued several rulings permitting a “daisy chain” of exchanges in which Exchanger acquired Replacement Property from a related seller who also acquired Replacement Property from another related seller, as long as the last related seller acquired its Replacement Property from an unrelated seller, and all held their respective Replacement Properties for at least two years. The IRS has ruled that a small amount of boot (5% or less) received by any of the related Replacement Property sellers, will not destroy all of the other related exchanges. PLRs 201220012, 201216007, 201048025, 200820025, 200820017.

**Related Buyer:** The IRS has clarified that there is no basis shifting or tax avoidance when the taxpayer, through an unrelated Qualified Intermediary, transfers Relinquished Property to a related buyer, but acquires Replacement Property from an unrelated seller. The exchange likely will be respected even if the related buyer voluntarily disposes of the property it acquired from the taxpayer within two years of acquisition. The Service’s rationale was that only the taxpayer owned property before the exchange and the taxpayer continued to be invested in like-kind property following the exchange. Because the related buyer did not own property prior to the exchange, its subsequent disposal would not result in cashing out or basis-shifting by the taxpayer. PLRs 200709036, 200712013, 200728008, 201027036.

**Avoidance of Federal Income Tax:** Under IRC §1031(f)(2)(C) and (f)(4), a related party exchange will be disallowed if it is part of a transaction (or series of transactions) structured to avoid payment of Federal income tax or the purposes of the related party rules. In determining whether these sections apply, the IRS and the Tax Court tend to look at the overall tax result of the transactions to the related parties as a consolidated unit. Even if there is no basis shifting, an exchange in which Replacement Property is purchased from a related party seller (that does not also do an exchange) will be disallowed if the related seller ultimately pays less tax on the sale of the Replacement Property than the Exchanger would have paid on the sale its Relinquished Property, due to factors such as net operating losses or lower tax rate available to the related seller. *Ocmulgee Fields, Inc. v. CIR*, 132 T.C. No 6 aff’d 613 F.3d 1360 (11th Cir. 2010), *Teruya Brothers, Ltd. v. CIR*, 124 T.C. No. 4, aff’d 580 F.3d 1038 (9th Cir. 2009), PLR 201013038. Conversely, the IRS has upheld exchanges where it could be demonstrated that there was no basis shifting and that avoidance of Federal income tax was not a principal purpose of the transaction, notwithstanding that the taxpayer and related parties swapped properties, and then the related buyer voluntarily disposed of the property it had acquired from the taxpayer shortly after the exchange. PLRs 200706001 and 200730002.

# Disaster Relief Deadline Extensions

Revenue Procedure 2007-56 permits extension of IRC §1031 exchange deadlines upon issuance of an IRS Notice or other guidance permitting relief to taxpayers due to Federally declared disasters. Note that an IRS Notice of a Federally declared disaster is different from a FEMA disaster declaration, and the extensions of 1031 deadlines are not available until the IRS publishes its Notice granting relief.

For “affected taxpayers,” the deadlines for the 45-day Identification Period and the 180-day Exchange Period will be extended by the later of 120 days or the due date listed in the IRS Notice, but the extension may not go beyond the due date (including extensions) for filing the tax return for the year of the transfer. Affected taxpayers will be defined in the IRS Notice, but generally they include Exchangers whose primary residence or principal place of business is located within the disaster zone. Other taxpayers may be eligible for an extension if they will have difficulty meeting the 45-day and / or 180-day deadlines because of any of the following reasons:

- The Relinquished Property or the Replacement Property is located in the disaster zone
- The principal place of business of any party to the transaction is located in the disaster zone
- A party to the transaction is killed, injured or missing due to the disaster
- A necessary document relevant to the exchange or relevant land record is destroyed, damaged or lost due to the disaster
- A lender won't fund because of the disaster
- A title insurance policy cannot be issued due to the disaster

To be eligible for relief, the Exchanger must have sold the Relinquished Property before the date of the Federally declared disaster, or in the case of a reverse exchange, the Exchange Accommodation Titleholder (EAT) must have taken title to either the Relinquished or Replacement Property on or before the date of the Federally declared disaster. Only the deadlines that fall on or after the date of the Federally declared disaster will be extended.

The IRS publishes Disaster Relief Notices on its website. It frequently updates these notices in the weeks following the disaster to add counties to the disaster zone. Exchangers who wish to take advantage of these deadline extensions should check the IRS website frequently to determine if disaster relief is available.

**This disaster relief is optional. Exchangers that are “affected taxpayers” must advise their Qualified Intermediary that they are eligible for disaster relief, and that their exchange deadline(s) are extended, otherwise the original 45-day and 180-day deadlines will control.**

# FIRPTA Issues in §1031 Exchanges

The Foreign Investment in Real Property Transfer Act (IRC §1445 & Treasury Regulations §1.1445), more commonly known as “FIRPTA” is a federal law that requires withholding on dispositions of U.S. real estate by “foreign persons,” defined as a nonresident alien individual, a foreign corporation that does not have a valid election under section 897(i) to be treated as a domestic corporation, a foreign partnership, a foreign trust, or a foreign estate. The law imposes an obligation upon a transferee (buyer) of any interest in the real estate to withhold 15% of the sale price (10% if a personal residence with a sale price of \$1 Million or less).

However, if the sales price is under \$300,000 and the transferee intends to reside in the property no withholding is required. There is a separate 30% withholding of income paid to Foreign Persons, which affects interest earnings on the exchange funds, (but any interest withholding is generally done by the bank). The buyer (or designated withholding agent) is obligated to withhold 15% of the sale price of the real estate (10% if a personal residence with a sale price of \$1 Million or less) and send it to the IRS within 20 days after the date of the transfer.

**Withholding Certificate.** Withholding can be delayed, reduced or eliminated if the Exchanger applies for and receives a Withholding Certificate (IRS Form 8288-B). The application for a Withholding Certificate must be submitted to the IRS on or before the Relinquished Property closing, along with a copy of the Replacement Property contract. The Exchanger must give a copy of the application to the withholding agent. Withholding is still required at 15% of the sale price of the real estate (10% if a personal residence with a sale price of \$1 Million or less), but the filed application permits the withholding agent to hold the withheld amount until the IRS makes a final determination. The IRS must act upon an application within 90 days. If the IRS declines to grant the exemption, payment of the withholding must be sent to the IRS within 20 days after receipt of the IRS’ notice of determination.

If the Withholding Certificate is not received prior to the purchase of the Replacement Property, the Exchanger will not have use of the withheld funds. Unintentional boot caused by withholding can be avoided if the Exchanger contributes sufficient additional cash into the escrow or exchange account to cover the applicable withholding amount so that the full 100% of the sale proceeds will be available to buy Replacement Property. It is possible to use all of the exchange funds and have a full deferral without adding cash, but advance planning is necessary to allow sufficient time to receive the Withholding Certificate.

**Simultaneous Exchange with NO Boot.** If the Exchanger does a simultaneous exchange and there is absolutely no boot (including no debt relief), withholding is not required, but the Exchanger must provide the Buyer with a signed FIRPTA Notice of Non-Recognition Transfer prior to the closing. The IRS does not require a particular form, but the Notice must include certain information. The buyer may rely upon the Notice unless they have actual knowledge that the facts stated are untrue (for example, if the closing statements indicate that there will be some form of boot). The buyer must send the Notice of Non-Recognition Transfer to the IRS not later than 20 days after the date of transfer. The Exchanger should provide a copy of the Notice of Non-Recognition Transfer to the QI.

**Other Required Documents.** The foreign Exchanger must provide the QI with an IRS Form W8-BEN (in lieu of a Form W-9) that discloses the Exchanger’s Individual Tax Identification Number (ITIN). An ITIN can be applied for on IRS Form W-7. IPX1031 will not disburse any funds (regardless of withholding) on behalf of a Foreign Person Exchanger who does not have an ITIN.

# Estimating the §1031 Tax Deferral on the Sale of Investment Property

An Exchanger should always consult with competent independent legal and/or tax advisors to determine the applicability of any IRC §1031 tax deferred exchange benefits. The gain, not the profit or equity, from the transfer of investment property is subject to the combination of federal and state capital gain taxes and federal taxes on the gain due to the depreciation taken on the property. Remember, it is possible to have little or no equity in the investment property being transferred and still owe taxes!

**This formula is a guide to estimate the potential capital gain tax owed on the transfer of property:**

## 1. First, calculate the Adjusted Basis:

	Original Purchase Price		\$ _____
Plus	Non-expensed Improvements	+	\$ _____
Equals		=	\$ _____
Minus	Depreciation Taken	-	\$ _____
Equals	Adjusted Basis	=	\$ _____

## 2. Second, use the Adjusted Basis to determine the Capital Gain Tax:

	<b>Sales Price</b>		\$ _____
Minus	Adjusted Basis	-	\$ _____
Equals	Adjusted Sales Price	=	\$ _____
Minus	Transaction Costs	-	\$ _____
Equals	<b>Total Gain on Sale</b>	=	\$ _____
Times	State Capital Gain Tax Rate	x	\$ _____ %
Equals	<b>State Capital Gain Tax</b>	=	\$ _____ (A)
	Gain Due to Appreciation	=	\$ _____
Times	Federal Capital Gain Tax Rate on		
	Gain Due to Appreciation	x	\$ _____ %
Equals	<b>Tax on Gain Due to Appreciation</b>	=	\$ _____ (B)
	Gain Due to Depreciation Taken	=	\$ _____
Times	Federal 25% Tax Rate on		
	Gain Due to Depreciation Taken	x	25%
Equals	<b>Tax on Depreciation Taken</b>	=	\$ _____ (C)

**Total of Taxes (A) + (B) + (C) = \$ \_\_\_\_\_**  
**equals the approximate amount of tax that is deferred by doing an IRC §1031 tax deferred exchange.**

NOTE: Neither the federal deduction for state taxes nor the additional 3.8% tax on net investment income is included in this calculation.



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