I. General Background

The Internal Revenue code can provide significant tax consequences at the time of sale for both real property and personal property. Although the limit on the capital gains tax rate may serve to reduce the taxes due on one portion of the recognized gain, I.R.C. §§1245 and 1250 may apply and possibly result in taxes due at the higher marginal tax rate levels. Compounding this problem is the fact that many property owners have long since forgotten that they have reduced the basis of their property (through ACRS), and in many cases the original basis of the land is all that remains.

I.R.C. §1031 offers an interesting option to "sellers" facing these tax consequences. However, it should be noted that there are many non-tax reasons to consider an exchange. For example, an owner of a management-intensive apartment complex might desire to exchange for a commercial building under a triple net lease. As another example, an owner of a business may desire to exchange for a business in a better location. Whatever the reason, whether tax- or non-tax-related, I.R.C. §1031 could provide the solution.

Many individuals believe that an exchange is a totally tax-free event. I.R.C. §1031 provides a deferral of tax on any realized gain and not a tax-free treatment. Seldom is an exchange transaction totally tax deferred. Typically, the seller must acquire some amount of "unlike" property or "boot" to balance the equities, which results in a partially taxable transaction (exchange).

To better understand the material in this chapter, several terms need to be defined. First, I.R.C. §1031 and the word "exchange" are synonymous, and any reference to either means the same thing. Second, the property being sold is referred to as the "relinquished" property, and the property to be acquired is referred to as the "replacement" property.

Note: The word "exchange" leaves the impression that both parties to an exchange have something the other party wants. How often will this occur? The reality of an exchange is that the typical situation involves a simple sale of the "relinquished" property, followed by the purchase of the "replacement" property. What makes this "sale and repurchase" a qualified deferred exchange under I.R.C. §1031 is the fact that the statutory and regulatory requirements are strictly followed.

Caution. Readers should seek competent advisers in this subject area. Typically, such advisers include a
tax professional (to do the calculations), an attorney (to write the exchange agreements), a realtor (to provide the buyers, sellers, and purchase and sales contracts), and a qualified intermediary (to hold escrowed funds, maintain trust accounts, and perform title/closing services.)

Before we discuss the technical parts of an exchange, let's look at a typical three-cornered, nonsimultaneous exchange. This example demonstrates the most common type of exchange that occurs. Refer to the chart on page 662.

Example

1. Chris owns a property he wishes to exchange. He places the property on the market and enters into a sales contract with Anne on 5/1/97, with a closing date of 6/1/97. An extremely important factor to keep in mind is that Chris may have not been aware of I.R.C. §1031 at the time he placed the property on the market or at the time the sales contract is signed. It is still possible to treat this transaction as a deferred exchange.

2. Either before 5/1/97, if he originally planned to use I.R.C. §1031, or after 5/1/97 but before 6/1/97, if he decided later, Chris should hire the services of a qualified intermediary, such as a title company, a facilitator, or a specialist holding him- or herself out as a qualified intermediary. It is recommended that you use a bonded intermediary, as large monetary sums are often involved. Chris would enter into an exchange agreement with the qualified intermediary. In this agreement the key elements of I.R.C. §1031 are addressed. Chris would then assign the sales contract with Anne to the qualified intermediary.

3. On 6/1/97 Chris and Anne would close on the sale of Chris's property. The net sales proceeds would be retained by the qualified intermediary in a trust or escrow account, and title to Chris's property would be direct-deeded from Chris to Anne.

4. The closing date of 6/1/97 sets the I.R.C. §1031 exchange in motion. Chris must identify (covered later) the replacement property within 45 days, and receive (close on) the replacement property within 180 days of 6/1/97. Failure to meet either time limit will result in a taxable sale. No extensions of these time lines are permitted.

5. On 6/5/97, Chris signs a purchase contract with Kristen with a scheduled closing date of 9/5/97. Chris notifies the qualified intermediary via an identification document (or the purchase contract), and Chris and Kristen close on 9/5/97, within the 180-day "completed" period.

At closing, the qualified intermediary will disburse the escrowed funds to Kristen and will "direct-deed" the title to Chris.

While this seems to be nothing more than an outright sale followed by a repurchase, adherence to I.R.C. §1031 and related Treasury guidelines will result in a fully or partially tax-deferred transaction.
Chris Seller (Exchanger) 

Qualified intermediary 

Anne Buyer of Chris's property 

Direct deed 

Contract date 5/1/97 
Closing date 6/1/97 

Sales Proceeds 

Direct deed 

Qualified intermediary 

Purchase proceeds 

Contract date 6/5/97 
Closing date 9/5/97 

Kristen Seller of replacement property to Chris 

45-day "identification period" 
180-day "receipt period"
II. Statutory Authority

Exchange of Property Held for Productive Use or Investment

Sec 1031 (1986 Code). (a) Nonrecognition of Gain or Loss from Exchanges Solely in Kind—

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

The statute clearly indicates that "no gain or loss shall be recognized" resulting from a qualified exchange. This means that if the exchange process is properly followed, the seller (exchanger) has no choice but to not pay tax on the gain or to not deduct the loss, if applicable. The point to remember is that some sellers would not have a significant taxable event arising from a sale; therefore, they should take care not to follow the exchange process. Examples of sellers who would not wish to take advantage of an exchange could include:

1. A seller with significant NOL carryovers that would offset capital gains and/or ordinary income arising from the sale.
2. A seller with a significant loss from operations (C or F) or a significant current-year capital loss that would offset the gain arising from the sale.
3. A seller with minimal recognized gain from a sale. In this case, the legal, accounting, and qualified intermediary expenses should be weighed against the actual tax liability that would result from an outright sale.
4. A seller that requires a significant amount of cash from the sale of the relinquished property.

I.R.C. §1031(a)(1) uses the wording "on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment." The key words in the part of the statute are:

1. "trade or business for investment" and
2. "like kind"

III. Trade or Business
Neither I.R.C. §1031 nor the regulations thereunder define "property held for productive use in a trade or business or for investment." However, the IRS has applied the meaning given to the term "property used in a trade or business" under I.R.C. §1231(b) for purpose of the like-kind exchange rules.

I.R.C. §1231(b) reads:

(b) Definition of Property Used in the Trade or Business—For purposes of this section—

(1) General Rule—The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in §167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year which is not—

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year.

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,

(C) any literary, musical, or artistic composition; a letter or memorandum; or similar property, held by a taxpayer described in paragraph (3) of §1221, or

(D) a publication of the United States government (including the Congressional Record) which is received from the United States government, or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by a taxpayer described in paragraph (5) of §1221.

I.R.C. §1231(b) includes all of the following (assuming the property is held for more than one year):

1. A commercial building housing literally any type of business (e.g., bank buildings, restaurants, barns, accountants' office buildings).

2. Business equipment (e.g., automobiles, trucks, computers, desks, forklifts, tool and die equipment, tractors, combines).

3. Nondepreciable real estate used in a business (e.g., farm ground, the land beneath a parking lot adjacent to a commercial building).

• Clearly, vacant land held for a long period of time would qualify as property "held for investment." So would residential lots purchased by a nondealer and held for future sale. The principle behind I.R.C. §1031 is continuity of ownership, so the question of how long both the relinquished property and the replacement property have or will be held by the taxpayer is a key factor in determining the intent of the taxpayer.

• In terms of the holding period, "the longer the better" is a good rule of thumb in differentiating between "held for investment" and "held for sale."

• Specifically not included in the definition of "trade or business or for investment" is the inventory of the seller or property held primarily for sale, such as the developed lots of a subdivision developer or

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the seller or property held primarily for sale, such as the developed lots of a subdivision developer or speculative homes built for sale by a home builder.

**Exclusions from I.R.C. §1031**

- **Specifically excepted from the application of I.R.C. §1031 are:**
  - A. Stock in trade or other property held primarily for sale
  - B. Stocks, bonds, or notes
  - C. Other securities or evidences of indebtedness or interest
  - D. Interests in a partnership
  - E. Certificates of trust or beneficial interests
  - F. Choses in action

- For purposes of this Code section, an interest in a partnership that has in effect a valid election under I.R.C. §761(a) to be excluded from the application of all of Subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.

- While items A, B, and C are fairly obvious, items D, E, and F require explanation.

**Interests in a Partnership**

- An interest in a partnership is excluded from I.R.C. §1031 coverage. However, the statute provides that an interest in a partnership that has made the I.R.C. §761(a) election (to be excluded from partnership treatment) is eligible to use the §1031 exchange rules. These electing partners are treated as having an interest in each of the assets of the partnership instead of an interest in the partnership.

- The same is true for many owners of real estate that, although reporting their income and expenses on a partnership return, Form 1065, actually (or probably) own the real estate as tenants in common. In actuality, they individually own partial interest in the assets, not the partnership.

- **Rev. Rul. 73-476, 1973-2 C.B.** 300 provides the following example:

  Andy, Brandy, and Candy each owned an undivided interest in Blackacre, Whiteacre, and Greenacre, respectively. Each individual exchanged the undivided interest in three separate parcels for a sale interest in one parcel. The transaction qualifies as a like-kind exchange.

  **Practitioner Note.**

  Many practitioners do not consider an exchange when a client who owns a partial interest in a real estate property reports the business income and expenses on a Form 1065. The actual ownership of the property should be scrutinized, for, more often than not, the partnership does not own the real estate property. The same result is true for other business entities, such as a corporation.

**Certificates of Trust or Beneficial Interest**
Prior to 1992, land trust beneficial interests did not qualify for §1031 treatment. However, Rev. Rul. 92-105, 1992-2 C.B. 204 allows exchanges of interests in a land trust, as long as the land trust does not create a partnership. [A few states (including Illinois) have adopted a land trust arrangement. It is not usually a "trust" for income tax purposes.]

Example. Henry Smith owns a 100% beneficial interest in a land trust that owns a real estate property. Henry wishes to sell (exchange) this property and reinvest in a qualified real estate property. This transaction can qualify as an exchange under §1031.

Choses in Action

The U.S. Supreme Court has defined this term as the "infinite variety of contracts, covenants, and promises, which confer on one party a right to recover a personal chattel or sum of money from another" (Sheldon v. Sill, 49 Supreme Ct. 441).

It would appear that this exclusion might have relevance with respect to certain contracts that are included in the overall sale of a business or property, yet not specifically involved in the sale of the business or property itself.

IV. Like-Kind

- As used in I.R.C. §1031(a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. The fact that the real estate is improved or unimproved is immaterial. Unproductive real estate held by someone other than a dealer for future use or future realization of appreciation is held for investment and not primarily for sale.

- For purposes of determining if the like-kind requirements are met, properties can be divided into three basic types:
  1. Depreciable tangible personal property
  2. Real property
  3. Intangible personal property and nondepreciable personal property

- Depreciable tangible personal property
  This type of property meets the like-kind requirement if it is exchanged for property of "like kind" or "like class."

- "Like class" means that both the relinquished and replacement properties are either in the same general asset class or the same product class. The determination is made as of the date of the exchange.
Practitioner Note.

The Taxpayer Relief Act of 1997 amended I.R.C. §1031(h) to exclude from the definition of "like-kind" personal property used predominantly within the United States and personal property used predominantly outside the United States (generally effective for transfers after 6/8/97 in taxable years ending after that date).

**General Asset Classes (from ADR Tables) (Rev. Proc. 87-56) Asset Classes 00.11–00.28 and 00.4**

1. Office furniture, fixtures, and equipment (asset class 00.11)
2. Information systems (computers and peripheral equipment) (asset class 00.12)
3. Data handling equipment, except computers (asset class 00.13)
4. Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21)
5. Automobiles and taxis (asset class 00.22)
6. Buses (asset class 00.23)
7. Light general-purpose trucks (asset class 00.241)
8. Heavy general-purpose trucks (asset class 00.242)
9. Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25)
10. Tractor units for use over the road (asset class 00.26)
11. Trailers and trailer-mounted containers (asset class 00.27)
12. Vessels, barges, tugs, and similar water transportation equipment, except those used in marine construction (asset class 00.28)
13. Industrial steam and electric generation and/or distribution systems (asset class 00.4)

**Example.** ABR Corporation exchanged a light general-purpose truck (class 00.241) for a tractor unit for use over the road (class 00.26). These properties are not like-kind as they are in different asset classes.

Practitioner Note.

The 13 asset classes listed above are the only asset classes under the general asset like-kind definition. From both the farm and non-farm standpoint, it is obvious that many assets are not listed (manufacturing equipment, tractors, combines, drills, etc.).

**Product Classes**

- Product classes include all the four-digit product classes within division D of the Standard Industrial Classification codes, set forth in the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (1987) ("SIC Manual"). Any two assets that are
listed in the same four-digit product class (other than the miscellaneous classes) are like-kind property.

- Since the SIC Manual was written to classify industries rather than products, use of the product classes
to find like-kind property is somewhat confusing. **The assets being traded by a taxpayer are**
classified by the industry that manufactures the assets rather than by the taxpayer's industry.

- Consequently, farm personal property falls into product classes such as 3423 (hand and edge tools,
  except machine tools and handsaws), 3425 (saw blades and handsaws), 3429 (hardware, not elsewhere
classified), and 3523 (farm machinery and equipment).

**Practitioner Note.**

Product classes ending with a 9 are the miscellaneous classes. Therefore, assets in product class 3429
(hardware, not elsewhere classified) are **not** like-kind property relative to other property in that class.

- Since most personal property used in a farm business is included in product class 3523 (farm
  machinery and equipment), farmers will generally qualify for I.R.C. §1031 treatment when they
exchange farm equipment for farm equipment.

**Application of the Class Rules**

- One item of property may not be classified within more than one general asset class or more than one
  product class. Furthermore, if a property is classified with any general asset class, that property may
not be classified within a product class.

**Example.** Allen transfers a printer (asset class 00.12), an automobile (asset class 00.22), and a
sanding machine (SIC code 3553) to Ruth in exchange for a computer (assets class 00.12), a light truck
(asset class 00.241), and a lathe (SIC code 3553). The printer and the computer are of like class because
they are in the same general asset class. The sanding machine and the lathe are of like class because
neither property is within a general asset class, but they are in the same product class. The automobile
and the light truck are not of like kind because they are neither in the same general asset class nor within
the same product class.

- **For depreciable tangible personal property that fails the "like class" test** (general asset class or
  product class), the **property may still satisfy the "like kind" test.** In determining whether properties
are of like kind, no inference is to be drawn from the fact that the properties are not of like class. To
determine if property is of like kind, the regulations indicate that all the facts and circumstances must
be considered.

**Example.** Lannie Lobdell exchanged an old 1989 Bush Hog for a 1997 Bush Hog. This
transaction qualifies for nonrecognition of gain under I.R.C. §1031 because the property exchanged is of
like kind.

**Real Property**
Treas. Reg. 1.1031(a)-1(b) states:

As used in §1031(a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate is improved or unimproved is not material, for the fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

The regulations provide the following examples of "like-kind" property:

1. City real estate for a ranch or farm
2. Leasehold of a fee with 30 years or more to run for real estate
3. Improved real estate for unimproved real estate

The courts have held that virtually any parcel of real property is of a like kind with any parcel of real property.

Other examples of "like-kind" real estate and the source of the information follow:

2. Undeveloped ranch land for a commercial building (H. Rutland, 36 T.C.M. 40, T.C. Memo 1977-8)
3. A commercial building for commercial condominium offices (PLR 8938045, 6/28/89)
4. An apartment building for vacant land plus golf course improvements (PLR 9428007, 4/13/94)
5. An improved lot and a house that is not the taxpayer's residence (Biscayne Trust Co. 18 BTA 1015)

However, real property located in the United States and real property located outside the United States are not like-kind property.

Intangible Personal Property and Nondepreciable Personal Property

Treas. Reg. §1.1031(a)-2(c) provides that an exchange of intangible personal property or nondepreciable personal property qualifies for nonrecognition of gain or loss under §1031 only if the properties are of like kind. No like classes are provided for these properties. Whether intangible personal property is of a like kind to other intangible personal property generally depends on the nature or character of the rights involved (e.g., a patent or copyright) and also on the nature or character of the underlying property to which the intangible personal property relates.

The regulations provide these two examples:
1. Taxpayer K exchanges a copyright on a novel for a copyright on a different novel. The properties exchanged are of a like kind.

2. Taxpayer J exchanges a copyright on a novel for a copyright on a song. The properties exchanged are not of a like kind.

Practitioner Note.

The goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business. This results in the inability of many businesses to use I.R.C. §1031 in situations where the allocated fair market value of the goodwill or going concern value results in a significant tax liability.

Other examples of intangible personal property and nondepreciable personal property that have been successfully exchanged include:

1. Stamp collections
2. Gems
3. Antiques
4. Coins and bullion
5. Player contracts
6. Memberships
7. Livestock
8. Works of art
9. Collectibles

V. Timing Rules—Deferred Exchanges

While the best exchange would involve a simultaneous transfer of one property for another, rarely does this happen. The most common exchanges are completed on a "nonsimultaneous" basis (or deferred exchange); that is, the relinquished property is first transferred and then the replacement property is acquired. However, I.R.C. §1031 places time limits on the entire exchange process.

Note: In order to properly complete an exchange, strict adherence to the timing rules is a must. I.R.C. §1031(a)(3) states:

(3) Requirement that Property Be Identified and that Exchange Be Completed Not More than 180 Days after Transfer of Exchanged Property—For purposes of this subsection, any property received by the taxpayer shall
be treated as property which is not like-kind property if—

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

(B) such property is received after the earlier of—

(i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(ii) the due date (determined with regard to extension) for the transferor’s return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

The timing rules include specific time limits of two aspects of the exchange. The first rule is the identification rule, and the second is the completion rule. Failure to meet either of these rules will result in a taxable transaction as opposed to a tax-deferred exchange.

**Identification Rule**

I.R.C. §1031(a)(3)(A) requires that the replacement property be identified on or before the 45th day after the date on which the taxpayer transferred (closed on) the exchanged property.

*Treas. Reg. §1.1031(k)-1(b)(2)* states that the identification period begins on the date the taxpayer transfers (closes on) the relinquished property and ends at midnight on the 45th day thereafter. For example, if the closing date of the relinquished property was 6/1/97, the 45-day period begins on 6/1/97 and ends at midnight on 7/15/97. In fact, the actual identification of the replacement property can occur prior to the closing date of the relinquished property, e.g., through a purchase contract on the replacement property. The key rule to remember, however, is that in no case can identification be met after the 45th day.

**Manner of Identifying Replacement Property**

- Treas. Reg. 1.1031(k)-1(c)(2) provides that the replacement property is identified only if it is designated as replacement property in a written document signed by the taxpayer and hand-delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either:
  1. The person obligated to transfer the replacement property to the taxpayer, or
  2. Any person involved in the exchange other than the taxpayer or a disqualified person.

- The regulations provide examples of persons involved in the exchange as including any of the parties to the exchange, a qualified intermediary, an escrow agent, and a title company.

- An interesting point in this regard is that any replacement property purchased (closed) within the 45-day identification period is automatically considered identified.

- For the identification rule to be met, the replacement property must be unambiguously described in the written document or agreement.

- In describing real property, the regulations indicate that the legal description, or street address, or a
distinguishable name (e.g., the Mayfair Apartment Building) is appropriate. For personal property, a specific description of the particular type of property will suffice.

- The regulations provide specific rules regarding the number of replacement properties that may be identified.

- Regardless of the number of relinquished properties transferred by the taxpayers as part of the same deferred exchange, the maximum number of replacement properties that the taxpayer may identify is:
  1. **Three properties** without regard to the fair market values of the properties (the "three-property rule"). This is not three properties for each property sold.
  2. Any number of properties as long as their aggregate fair market value as of the end of the 45-day identification period does not exceed **200%** of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer (the "200 percent rule").
  3. Any number of replacement properties received (closed) by the taxpayer before the end of the 45-day identification period.
  4. Any number of replacement properties identified before the end of the 45-day identification period and received (closed) before the end of the 180-day exchange period, but only if the taxpayer receives (closes) before the end of the exchange period identified replacement property the fair market value of which is at least **95%** of the aggregate fair market value of all identified replacement properties (the "95 percent rule").

**Practitioner Note.**

The most common identification methods used are methods 1, 3, and 4 above.

**Revocation of Identification.** In order to make exchanges really work, the regulations provide that an identification of replacement properties can be revoked and new replacement properties identified.

The point to remember is that the properties actually received (closed) by the 180th day must have been listed on the identification document as of the 45th day, unless identification method 3 above was used.

**The Receipt Rule (Completed).** I.R.C. §1031(a)(3)(b)(I)d(ii) requires that the replacement property is received (closed) on or before:

1. The day that is 180 days after the date on which the taxpayer transfers (closes) the property relinquished in the exchange, or
2. The due date, including extensions, for the taxpayer's tax year in which the sale (closing) took place for the relinquished property.

Clearly, this rule establishes a time limit in which to acquire the replacement properties. Take note that the 45-day identification period is within the 180-day period, not in addition to it. Also note that the 180-day period requires closing (transfer of deed), not merely a purchase contract negotiated and agreed upon within the 180 days.
The second part of the 180-day receipt rule places an additional restriction on the timing issue. For closings (on the relinquished property) after October 15 of each year, consideration should be given to filing Form 4868 (Automatic Extension of Time to File) to preserve the 180-day receipt period.

**Example.** Sue Ann closed on the sale (exchange) of her property on 12/19/97. It is now April 10, 1998, and she has yet to close on the purchase of the qualified replacement property. Closing is scheduled for 5/10/98. If Form 4868 is not filed, and the return is prepared and filed by April 15, 1998, Sue Ann will have to pay the tax on the gain on the sale of the relinquished property, even if she closes on the purchase of the replacement property. In effect, she has lost the benefit of the full 180-day "receipt" period.

**VI. Safe Harbor Rules**

In addition to the other technical requirements of I.R.C. §1031, a major stumbling block with exchanges involves the taxpayer actually or constructively receiving money or other property during the exchange process. To provide guidance in this area, Treas. Reg. 1.1031(k)-1(g)(1) provides four safe harbors to prevent the taxpayer from having actual or constructive receipt of money or other property.

1. **Security or guarantee arrangements.** The fact that an obligation of the taxpayer's transferee (owner of the replacement property) to transfer the replacement property to the taxpayer is or may be secured or guaranteed by one or more of the following will not place the taxpayer in a position of having actual or constructive receipt of money or other property.
   a. A mortgage, deed of trust, or other security interest in property (other than cash or a cash equivalent),
   b. A standby letter of credit, or
   c. A guarantee of a third party
2. **Qualified escrow accounts and qualified trusts.** If cash or a cash equivalent secures the obligation of the taxpayer's transferee (owner of replacement property), the taxpayer will not be in actual or constructive receipt of the cash or a cash equivalent if the cash or cash equivalent is held in a qualified escrow account or in a qualified trust.
3. **Qualified intermediaries.** If the taxpayer hires a qualified intermediary to transact the exchange, the intermediary will not be treated as an agent of the taxpayer. As a result, the taxpayer will not be in actual or constructive receipt of cash or a cash equivalent held by the intermediary. **By definition, a qualified intermediary is a person (or entity) who:**
   a. Is not the taxpayer or a disqualified person (defined later)
   b. Enters into a written agreement with the taxpayer (the "exchange" agreement)
A person is defined by Treas. Reg. 1.1031(k)-1(k) as **disqualified** if:
   a. Such a person is the agent of the taxpayer
   b. Such a person acts as the taxpayer's attorney, account, broker, investment banker, or real estate
c. Such a person bears a relationship to the taxpayer described in I.R.C. §267(b) or §707(b) (with substitution of 10% for 50% wherever 50% appears).

This listing of excluded relationships under these sections is long, but in brief includes:

a. Members of a family, including only brothers and sisters (whether by whole or half blood), spouse, ancestors, and lineal descendants
b. An individual and a corporation for that 10% in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual
c. A grantor and a fiduciary of any trust
d. A fiduciary of a trust and a beneficiary of a trust
e. A partnership and a person owning, directly or indirectly, more than 10% of the capital interest, or the profits interest, in such partnership
f. Two partnerships in which the same persons own, directly or indirectly, more than 10% of the capital interests or profits interest

[Note: This list is not all-inclusive. Please consult I.R.C. §§267(b) and 707(b) for the complete listing of excluded relationships.]

4. Interest or growth factors. The taxpayer can earn interest or a growth factor on the escrowed funds held during the exchange. The interest or growth factor is separate from the exchange and is taxable to the taxpayer.

Finally, with reference to the safe harbors of (1) qualified escrow accounts and qualified trusts, (2) qualified intermediaries, and (3) interest and growth factors, the taxpayers must not have the right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period.

VII. Common Problem Areas in Exchanging

Debt Relief

Exchangers must be careful when considering how much debt to take on in financing the replacement property. The basic rule is that the debt on the replacement property must be equal to or greater than the debt on the relinquished property. Otherwise, the exchanger will be considered to have received "boot" to the extent of the debt reduction. The only exception to this rule is the situation where the additional cash paid on the acquisition of the replacement property equals or exceeds the debt reduction between the relinquished and replacement properties.

Example. Allen sold a property and purchased another qualifying property. All technical requirements of I.R.C. §1031 were met as to language, timing, nonaccessible funds, etc. Allen's debt on
his relinquished property was $100,000 and the debt on the replacement property was $80,000. However, Allen invested $28,000 of his own money in acquiring the replacement property. Since the cash paid out ($28,000) equals or exceeds the debt relief ($20,000), Allen has not received "boot."

**Example.** Rich owns an apartment building in Chicago worth $250,000, secured by a first mortgage of $100,000. Rich intends to sell the building, net approximately $150,000, and purchase three $50,000 rental condominiums in the Padre Islands. All three condominiums will then be free and clear of debt. **This will not work!** Rich will be deemed to have received "boot" (debt relief) of $100,000, which could result in a significant tax liability.

**Practitioner Note.**
The last example is perhaps the most common reason why an exchange will not work for some taxpayers. If the property owner simply wants to sell, then pay off the mortgage, and then reinvest the equity with no new debt, the problem of debt relief is a significant problem.

**The Myth of "Loan Assumption"**
In earlier days, many exchangers felt that I.R.C. §1031 would work only in situations where the debt on each property (if any) was assumed by the other parties to the exchange. In fact, the IRS attempted a court challenge on this point in *Wittig v. Commissioner* (1995 T.C.M. 1995-461). The IRS initially won the case, but after considerable public reaction, the Tax Court's order was withdrawn.

**Practitioner Note.**
Had the Tax Court’s decision in *Wittig* stood, it would have sounded the death knell for I.R.C. §1031 exchanging. With almost all lending institutions initiating "due on sale" clauses for loans placed in the past, say, 15 years, the use of assumable mortgages in an I.R.C. §1031 exchange is clearly the exception rather than the norm.

**Convincing a Seller to Enlist the Counsel of Professionals Familiar with Exchanges**
The courts are littered with I.R.C. §1031 casualties who felt they could handle this transaction without expert guidance. The most common situation where taxpayers have lost the issue involves lack of formality and conformity with respect to I.R.C. §1031. In most of these cases, the taxpayer simply sold the relinquished property and did not qualify for deferred exchange treatment.

**Constructed Replacement Property**
In many instances a taxpayer desires to sell his property through I.R.C. §1031 and construct the
replacement property. This leads to some quirks in deals with both the 45-day identification rule and the 180-day completion/receipt rule.

**Identification Rule (45-day)**

Treas. Reg. 1.1031(k)-1(e)(2) provides that the replacement property to be produced is properly identified if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable (for example, plans and specifications).

**Receipt Rule (180-day)**

Treas. Reg. 1.1031(k)-1(e)(3) provides that the replacement property to be produced will be considered to be received by the taxpayers within the receipt period if:

1. In the case of personal property (e.g., autos, equipment, tractors) to be produced, the production is completed on or before the date the personal property is received by the taxpayer.
2. In the case of real property to be produced, where production of the property is not completed on or before the date the taxpayer receives the property, **only the construction that is completed will be deemed to have met the receipt requirement.** Any construction occurring after the property is received by the taxpayer will **not be treated** as property of a like kind. Another point to remember is that for the construction that has been completed on or before the date that the property is received by the taxpayer, the "property under construction" must constitute real property under local law. Treas. Reg. 1.1031(k)-1(e)(5)(i) provides the following example of personal property and real property to be produced.

**Example:** (i) B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers improved real property X and personal property Y to C on May 17, 1991. On or before November 13, 1991 (the end of the exchange period), C is required to transfer to B real property M, on which C is constructing improvements, and personal property N, which C is producing. C is obligated to complete the improvements and production regardless of when properties M and N are transferred to B. Properties M and N are identified in a manner that satisfied paragraphs (c) (relating to identification of replacement property) and (e)(2) of this section. In addition, properties M and N are of a like kind, respectively, to real property X and personal property Y (determined without regard to §1031(a)(3) and this section). On November 13, 1991, when construction of the improvements to property M is 20% completed and the production of property N is 90% completed, C transfers to B property M and property N. If construction of the improvements had been completed, property M would have been considered to be substantially the same property as identified. Under local law, property M constitutes real property to the extent of the underlying land and the 20% of the construction that is completed.

(ii) Because property N is personal property to be produced and production of property N is not completed before the date the property is received by B, property N is not considered to be substantially the same property as identified and is treated as property which is not of a like kind to property Y.

(iii) Property M is considered to be substantially the same property as identified to the extent of the underlying
land and the 20% of the construction that is completed when property M is received by B. However, any additional construction performed by C with respect to property M after November 13, 1991, is not treated as the receipt of property of a like kind.

**Depreciation Recapture**

If the exchange results in the recognition of gain, then the depreciation recapture provisions of I.R.C. §1245 (personal property) and I.R.C. §1250 (real property) must be considered.

- Pursuant to I.R.C. §1245(b)(4), the amount of realized gain recaptured as ordinary income cannot exceed the sum of:
  1. The gain recognized under I.R.C. §1031, plus
  2. The fair market value of non-I.R.C. §1245 property received in the exchange that is not taken into account in (a) above.

- Pursuant to I.R.C. §1250(d)(4)(A), depreciation recapture may occur even if there is no boot if the fair market value of §1250 property acquired is less than the amount of §1250 recapture gain.

The following example illustrates these points.

**Example: I.R.C. §1245 Property.** JoAnne, who operates a small machine shop, trades a used drill press with a fair market value of $50,000 for a later model having a fair market value of $25,000. In the trade, JoAnne also receives cash of $10,000 and a real estate lot with a fair market value of $15,000. JoAnne's basis in the old drill press is $20,000.

*Computation:*

<table>
<thead>
<tr>
<th>Drill press</th>
<th>$25,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>10,000</td>
</tr>
<tr>
<td>Real estate</td>
<td>15,000</td>
</tr>
<tr>
<td>Amount realized</td>
<td>$50,000</td>
</tr>
<tr>
<td>Adjusted basis of old press</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

JoAnne's recognized gain is limited to $25,000 [the cash (boot) of $10,000 and the real estate lot (not like kind) of $15,000]. Since I.R.C. §1245 overrides I.R.C. §1031, the $25,000 will be ordinary income.

**VIII. Example of Real Property Exchange**
Mr. Mathis owns an apartment building that he wishes to dispose of. He has become aware that a retail shopping center (strip mall) is on the market. After analyzing the shopping center income, expense, and cost details, he has placed a contingent offer to purchase the center. The offer was accepted, and Mr. Mathis immediately placed his apartment building on the market.

The following information is relevant to this I.R.C. §1031 exchange.

### Apartment Building
- **Original price**: $720,000
- **Depreciation used**: 31.5 years, SL
- **Building allocation**: 80%
- **Land value**: 20%
- **Date purchased**: 1/1/92
- **Anticipated date of sale**: 9/1/97
- **Sales price**: $850,000
- **Remaining mortgage**: $583,235
- **Tax bracket**: 35% (federal and state)
- **Transaction costs**: $45,000
- **Adjusted basis**: $629,326

### Shopping Center
- **Purchase price**: $1,000,000
- **Building allocation**: 80%
- **Land value**: 20%
- **Mortgage proceeds**: $600,000
- **Transaction costs**: $4,000
- **Anticipated date of closing**: 12/5/97

### Worksheet for I.R.C. §1031 Exchange of Property: John Mathis Problem

<table>
<thead>
<tr>
<th>Equity Balancing</th>
<th>Relinquished Property</th>
<th>Replacement Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value</td>
<td>$850,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Less loan</td>
<td>(583,235)</td>
<td>(600,000)</td>
</tr>
<tr>
<td>Equity</td>
<td>$266,765</td>
<td>$400,000</td>
</tr>
<tr>
<td>Boot required to balance equities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>133,235(\dagger)</td>
<td></td>
</tr>
<tr>
<td>Paper</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balanced equities</td>
<td>$400,000</td>
<td>$400,000</td>
</tr>
</tbody>
</table>

\(\dagger\) Cash required to balance equities

**Gain Realized**
## Gain Realized

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value of property received</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Less new loan</td>
<td>(600,000)</td>
</tr>
<tr>
<td>Plus boot received</td>
<td>0</td>
</tr>
<tr>
<td>Plus old loan</td>
<td>583,235</td>
</tr>
<tr>
<td>Less adjusted basis of relinquished property</td>
<td>(629,326)</td>
</tr>
<tr>
<td>Less transaction cost</td>
<td>(49,000)</td>
</tr>
<tr>
<td>Less boot paid</td>
<td>(133,235)</td>
</tr>
<tr>
<td>Gain realized</td>
<td>$171,674</td>
</tr>
</tbody>
</table>

## Unlike Property Received

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Old loan</td>
<td>583,235</td>
</tr>
<tr>
<td>Less new loan</td>
<td>(600,000)</td>
</tr>
<tr>
<td>Net loan reduction (if negative, enter -0-)</td>
<td>-0-</td>
</tr>
<tr>
<td>Plus boot received or minus boot paid</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>(133,235)</td>
</tr>
<tr>
<td>Paper</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
</tr>
<tr>
<td>Net unlike property received (if negative, enter -0-)</td>
<td>-0-</td>
</tr>
</tbody>
</table>

## Gain Recognized

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Lesser of gain realized (above) or net unlike property received (above))</td>
<td>-0-</td>
</tr>
<tr>
<td>Transaction cost</td>
<td>(49,000)</td>
</tr>
<tr>
<td>Gain recognized (if negative, enter -0-)</td>
<td>-0-</td>
</tr>
</tbody>
</table>

## Basis of Replacement Property

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted basis of relinquished property</td>
<td>$629,326</td>
</tr>
<tr>
<td>Plus new loan</td>
<td>600,000</td>
</tr>
<tr>
<td>Plus boot paid</td>
<td>133,235</td>
</tr>
<tr>
<td>Less boot received</td>
<td>-0-</td>
</tr>
<tr>
<td>Less old loan</td>
<td>(583,235)</td>
</tr>
<tr>
<td>Plus gain recognized</td>
<td>-0-</td>
</tr>
<tr>
<td>Plus transaction costs</td>
<td>49,000</td>
</tr>
<tr>
<td>Basis in replacement property</td>
<td>$828,326</td>
</tr>
</tbody>
</table>

## Footnotes

1. John Mathis will need to invest $133,235 of his own money to acquire the shopping center.
2. The realized but deferred gain with the exchange is $171,674. Had John sold the apartment building outright, his realized and recognized gain would have been $175,674, calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales price</td>
<td>$850,000</td>
</tr>
<tr>
<td>Less transaction costs</td>
<td>(45,000)</td>
</tr>
<tr>
<td>(the other $4,000 was costs incurred to purchase the replacement property)</td>
<td></td>
</tr>
<tr>
<td>Less adjusted basis</td>
<td>(629,326)</td>
</tr>
<tr>
<td>Realized gain and recognized gain if sold</td>
<td>$175,674</td>
</tr>
</tbody>
</table>

3. Computing the new basis in another way:
<table>
<thead>
<tr>
<th>Basis of old property</th>
<th>$629,326</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plus transaction costs</td>
<td>49,000</td>
</tr>
<tr>
<td>Plus additional down payment</td>
<td>133,235</td>
</tr>
<tr>
<td>Plus additional loan</td>
<td>16,765</td>
</tr>
<tr>
<td>New basis</td>
<td>$828,326</td>
</tr>
</tbody>
</table>