Chapter 10: Like-Kind Exchanges

Corrections were made to this workbook through January of 2006. No subsequent modifications were made.

GENERAL BACKGROUND

If a client anticipates selling property which will create a large gain and acquiring similar property a short time later, he might want to consider a like-kind exchange. Properly executed, the gain the taxpayer realizes on the sale is not currently recognized. Instead, he has a reduced basis in his replacement property. If the exchange is executed improperly, the transaction can result in recognition of gain which may have considerable adverse tax consequences. The provisions of IRC §1031 are very strict, and the taxpayer's advisor must have a thorough understanding of them in order to ensure nonrecognition of gain. Tax professionals must not confuse the provisions of §1031 with §1033. While §1031 includes a sale followed by the investment in other property, IRC §1033 only applies to transactions which are the result of an involuntary conversion such as a casualty, theft, or threat of eminent domain.

In addition to tax considerations, there may be non-tax reasons to consider an exchange. For example, the owner of a labor-intensive apartment complex might want to exchange for a commercial building that uses triple net leases. Likewise, the owner of a commercial building may want to exchange for a building in a different location. While these are both valid reasons for wanting to exchange properties, without the provisions of §1031, owners may not be able to make the exchange due to cash erosion caused by heavy income taxes on disposition.

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Under current tax law and regulations, it is possible for a person to sell property and buy replacement property without the current payment of federal income tax on the sale. This can be done without the buyer of the property or the seller of the replacement property getting directly involved in the exchange, other than to acknowledge that an exchange is taking place.

RELEVANCE OF IRC §1031 EXCHANGE IN TODAY'S MARKETPLACE

The §1031 exchange is in use in almost every real estate marketplace. Common examples include the sale of agricultural land to both farm-related and non-farm-related investors, the use of tenant-in-common investment properties, and the purchase of resort properties. In the non-real estate market, exchanges are commonly used to affect trade-ins on one item of machinery for another. It is imperative that the tax and accounting professions both understand the intricacies of the §1031 exchange, as well as the tax reporting of the transaction.

Observation. Like-kind exchange property need not be held long term (more than one year) to qualify for like-kind exchange treatment.

TAX CONSEQUENCES OF SELLING WITHOUT AN EXCHANGE

For both real and personal property, there can be significant tax consequences at the time of sale. While reduced capital gain tax rates lessen the impact, §§1245 and 1250 may apply. The recapture of depreciation under §1245 adds substantial unforeseen income, which can be taxed at higher marginal tax rates. With the use of ACRS and MACRS depreciation, basis in assets can decrease very rapidly. In some cases, the only basis remaining is in land.

For taxpayers whose top tax bracket exceeds 15%, the unrecaptured §1250 gain is taxed at 25%, rather than the normal 15% capital gain rate.

Example 1. Sherry is single. She purchased an apartment building on July 1, 1987. She sold it on July 1, 2004. The facts and figures regarding the sale of this rental real estate property follow:

Purchase price	$145,000
Amount allocated to land	(20,000)
Depreciable cost of building	$125,000

MACRS (27.5-year life) method of depreciation was used.

Sales price	$245,000
Expense of sale	(15,000)
Cost of property	(145,000)
Total MACRS depreciation	77,266
Gain on sale	$162,266

Other Facts about Sherry. Her 2004 taxable income on Form 1040 is $237,100. Included in this figure is a $7,000 capital gain distribution from mutual funds, and a $14,000 long-term stock sale gain.

Sherry's 2004 tax liability, including AMT, is $48,626. If she disposes of the building in a like-kind exchange her tax liability is $12,371 and there is no AMT. **This results in a savings of $35,895.**

Note. These calculations do not take into account state income tax ramifications, if applicable.

ADVANTAGES AND DISADVANTAGES OF LIKE-KIND EXCHANGES

ADVANTAGES

- A **property may be more marketable** if the seller is willing to take another property in exchange as part of the sale. Since "boot" can be used as a part of the exchange, a seller can receive cash for a part of the sale and property as another part. Property can then be sold at a later date. This may be preferable to an installment sale if the seller is concerned about the financial capacity of the buyer.

Note. The cash received constitutes taxable boot.

- An exchange can facilitate a seller's **change in investment strategy**.
- Since less cash is required with an exchange, the buyer may find it **easier to obtain financing** for the purchase.
- An exchange can allow for a **consolidation of investments**.

Example 2. Mary owns 200 acres of land 20 miles from her main farming enterprise. Because of the death of her neighbor, 175 acres adjoining the home farm becomes available for sale. By participating in an exchange, Mary is able to sell her 200 acres and purchase new property without the need for additional financing.

- Without the tax burden of a sale, an investor is able to build an asset base more rapidly. This can provide for a **larger asset base**.

DISADVANTAGES

- The **property must be like-kind** for the exchange to qualify for §1031 treatment. A description of what constitutes like-kind is found later in this chapter.
- While "boot" can be used in an exchange, "relinquished" property and "replacement" property **should have similar values.** Both buyer and seller must be willing to participate in the exchange.
- Because the exchange results in a transfer of basis, the replacement property can have a **low depreciable basis** if it is later sold.
- **Strict time requirements** apply.
- Exchanger should have **competent advisors.**
- **Tax rates, both marginal and capital gains,** have not been as favorable in many years as they are today. Some consideration should be given to the pay now or pay later question, taking into account potential estate tax considerations.

STATUTORY AUTHORITY — IRC §1031

The authority for nonrecognition of gain in like-kind exchanges is IRC §1031.

TAX TREATMENT

In a like-kind exchange, no gain or loss is recognized if a taxpayer exchanges:

- Property held for productive use in his trade or business, together with cash, for other property of like-kind for the same use. For example, a used passenger automobile for a new passenger automobile to be used for a like purpose;
- Urban for rural real estate (only if the taxpayer is not a real estate dealer);
- Real property, of which he is the lessee, and the lease has an unexpired term **of at least 30 years** for a fee simple interest in real property;
- Improved real estate for unimproved real estate; or
- Investment property and cash for investment property of a like-kind.[1]

§1031(a) states:

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.

[1] Treas. Reg. §1.1031(a)-1(c)

The key words in this part of the statute are:

- **Trade or business or for investment,** and
- **Like kind.**

TRADE, BUSINESS, OR INVESTMENT

Although §1031 and its related regulations fail to define "property held for productive use in a trade or business or for investment," the IRS applies the §1231(b) definition of this term to like-kind exchanges.

IRC §1231(b) states:

(b) Definition of Property Used in the Trade or Business

> *(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 includable 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) a copyright; a literary, musical, or artistic composition; a letter or memorandum; or similar property, held by a taxpayer described in paragraph (3) of §1221(a), 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(a).*

IRC §1231(b) includes all of the following types of property, assuming they are held for more than one year:

1. A commercial building housing **any type of business,** such as bank buildings, restaurants, barns, accountants' office buildings, and the like.
2. **Business equipment** such as automobiles, trucks, computers, desks, forklifts, tool and die equipment, tractors, combines, and the like.
3. **Nondepreciable real estate used in a business**, such as farm ground, the land beneath a parking lot adjacent to a commercial building, and the like.

PROPERTY HELD FOR INVESTMENT

> **Note.** The issue of vacation home property held for investment is discussed later in this chapter.

Vacant land held for several years qualifies as property held for investment. However, §1031 does not specify a specific holding period minimum for either the relinquished property or the replacement property. Residential lots purchased by a non-dealer and held for future sale also qualify. The principle behind §1031 is continuity of ownership. A key factor in determining the intent of the taxpayer is how long both the relinquished property and the replacement property are or will be held by the taxpayer. A good rule of thumb in differentiating between "held for investment" and "held for sale" is "the longer it is held, the better."

Specifically not included in the definition of "trade or business or for investment" is inventory of the seller, or property held primarily for sale. Examples are the developed lots of a subdivision developer or speculative homes built for sale by a home builder.

LIKE-KIND

The words "like kind," as used in §1031, have reference to the nature or character of property and not to its grade or quality. One kind or class of property may not be exchanged for property of a different kind or class. However, the terms "nature or character," "grade or quality," and "kind or class" are of little help in determining if properties will be considered of like-kind. Real property is not like-kind to personal property, and whether property is considered real property or personal property is generally determined by state law.

Different and much more complex rules apply in determining if personal property is like-kind to other personal property. Those rules are covered later in this chapter.

Exclusions from §1031

There are specific exclusions for property under §1031. The following items are excluded from the application of §1031:

1. Stock in trade or other property held primarily for sale;
2. Stocks, bonds, or notes;
3. Other securities or evidences of indebtedness or interest;
4. Interests in a partnership;
5. Certificates of trust or beneficial interests (see later discussion); and
6. Chose in action.

Items 1, 2, and 3 are fairly straightforward and easy to understand. Items 4, 5, and 6 require more information to explain their meaning.

Interests in a Partnership. An interest in a partnership is not eligible for §1031 treatment.

> **Example 3.** JoAnn owns a 25% partnership interest in Tabatha Partnership. She may not exchange her 25% partnership interest in Tabatha Partnership for a 25% interest in Bewitched Partnership.

If the partnership owns property, and all partners wish to exchange the partnership property, there is no problem since any entity can use the provisions of §1031. **The problem arises when all of the partners are not in agreement with using §1031,** and some want to sell and others want to exchange.

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In this instance, there is a need to distribute the property, or otherwise dissolve the partnership. The individual owners, as tenants in common, could decide for themselves whether to do a like-kind exchange or to sell outright.

> **Caution.** When the real property is held as tenants-in-common (TIC) by the partners, and **Form 1065 has been used to report the income and expense of the real estate property, the IRS may construe the property as partnership owned.**

However, §1031(a) provides that co-tenants that make the **§761(a) election** (to be excluded from partnership treatment) are not treated as a partnership. Instead, they are treated as TIC ownership and any co-tenant may use a like-kind exchange for his interest in the property. These electing co-tenants are treated as having an interest in each of the assets of the partnership instead of an interest in the partnership. In order to ensure that the TIC property previously reported on Form 1065 qualifies for the exchange, the partnership should file a partnership return marked FINAL RETURN with the appropriate box checked. The final return of a partnership is due on the 15th day of the fourth month following the dissolution. In this case, since the title to the property was never held in the partnership name, presumably the dissolving event is the reporting of the transfer of the property to the tenants in common.

> **Note.** This is obviously only a paper transaction since the property is already titled in the names of the co-tenants.

Consideration should also be given to the preparation of a TIC agreement, not a partnership agreement. These steps should be taken as early a possible before the exchange.

> **Caution.** The distribution of assets by a partnership to its partners is generally a nontaxable event, unless cash is distributed to a partner in excess of that partner's basis in his partnership interest.

Example 4. Peggy, Peter, and Jacob each own an undivided interest in Rolling Hills, Flat Lands, and Maple Acres, respectively. This activity **has not been reported on Form 1065**. Any of these three co-tenants can exchange their undivided interest in the three separate parcels. The transaction qualifies as a like-kind exchange. If the rental activity **has been reported on Form 1065,** and not all co-tenants wish to participate in an exchange, a final return should be filed and the steps outlined above followed.

> **Note.** For the reasons stated above, **practitioners should use caution when considering the use of Form 1065 to report income and expense from co-owned TIC property.**

Certificates of Trust or Beneficial Interest. Prior to 1992, land trust beneficial interests did not qualify for §1031 treatment. Beginning in 1992, exchanges of interests in a land trust are allowed, provided the land trust does not create a partnership. A few states (including Illinois) have adopted a land trust arrangement. It is usually not considered a trust for income tax purposes.

Example 5. Henry owns a 100% beneficial interest in a land trust that owns 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.

Chose in Action. Black's Law Dictionary defines "chose in action" as "a right to personal things of which the owner has not the possession, but merely a right of action for their possession." The U.S. Supreme Court 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."[2] It appears that this exclusion might have relevance for certain contracts that are included in the overall sale of a business or property, but are not specifically involved in the sale of the business or property itself.

KEY ISSUES OF §1031

From the tax professional's point of view, there are three important issues to understand when assisting a client with a §1031 exchange:

1. **Logistical Issue.** This focuses on the framework and timing requirements of an exchange. The vast majority of exchanges follow a basic framework.
2. **Like-Kind Issue.** It is important to have a thorough understanding of the term "like-kind."
3. **Quantitative Issue.** This focuses on the numbers (sales prices, mortgages, and equities) of the properties involved in the exchange.

A properly executed §1031 exchange is nothing more than a carefully orchestrated sale of property(s) followed by a carefully orchestrated purchase of replacement property(s). Technically, the exchanger does not need a team of specialists to properly complete an exchange. However, it is strongly advised. The accountant should advise a client to use a team of specialists when making an exchange.

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2. *Sheldon v. Sill,* 49 Supreme Ct. 441, January Term 1850

- The accountant's role is to make the calculations and prepare the income tax reporting forms.
- The attorney's role is to write exchange agreements.
- The realtor's role is to provide buyers, sellers, and sales contracts.
- The intermediary's role is to hold escrowed funds, maintain escrow accounts and possibly perform title and closing services. While there is no legal requirement to use a qualified intermediary, their use is strongly recommended to insure proper attention to §1031 details.

An exchange requires careful adherence to the details. The tax consequences of the IRS ruling that an exchange does not qualify for §1031 treatment are severe. It is the details that differentiate a normal sale (resulting in recognition of tax liability), from an exchange (with a potential 100% tax deferral of the tax liability).

EXCHANGE LOGISTICS

The most straightforward exchange involves a simultaneous transfer of one property for another, although this rarely occurs. The most common exchanges are deferred exchanges. These are completed on a "nonsimultaneous" basis. In a deferred exchange, the closing for the transfer of the relinquished property may take place prior to locating or acquiring the replacement property. Several requirements must be met for a deferred exchange to qualify as a like-kind exchange.

Timing Requirements

IRC §1031 places time limits on the entire exchange process. A properly executed exchange strictly adheres to the timing rules.

IRC §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*
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> *(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 for two aspects of the exchange. The first addresses the identification of property, and the second addresses the completion rule. Failure to meet either of these requirements results in a taxable transaction as opposed to a tax-deferred exchange.*

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Caution. For sales of relinquished properties after October 15, a problem arises if the replacement properties are not purchased before April 15 (March 15 for corporations) of the following year. This assumes the taxpayer uses a calendar year. **The problem** is that the 180-day replacement period is cut short by the April 15 (March 15) due date, so that any properties acquired after April 15 (March 15 for corporations), but within the 180 day period, **will not qualify as like-kind property** to the property sold.

A simple remedy to protect the taxpayer is to file for an extension of time to file the return. This provides for the entire original 180-day reinvestment period. For individual taxpayers, filing Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return,* accomplishes the desired result. Form 7004, *Application for Automatic Extension of Time to File Corporation Income Tax Return* is completed if the taxpayer is a corporation.

Exchanges between Related Parties. If a taxpayer exchanges property with a related taxpayer, special rules apply pertaining to time periods after the exchange. There is no §1031 treatment if the related party disposes of the exchanged property within **two years** of the last transferred property, or if the taxpayer disposes of the replacement property.

Example 6. Terri is involved in a §1031 exchange. She sold her property to an unrelated person. However, the property she is acquiring is owned by her brother, Gary. Since Terri and Gary are related,[3] Terri must retain ownership of the property purchased from Gary for a minimum of two years, unless specific exceptions to this rule apply.

Note. If Terri does not retain ownership of the replacement property for two years after the date of exchange, she must amend the tax return for the year of the original exchange.

Recognition of the gain is not triggered if the disposition occurs as a result of the taxpayer's or related party's death, as a result of a compulsory or involuntary conversion, or if the disposition is established to the satisfaction of the Secretary that neither the exchange nor the disposition has as one of its principal purposes the avoidance of federal income tax.

For purposes of like-kind exchanges, a related party is defined as any person bearing a relationship to the taxpayer described in IRC §§267(b) or 707(b)(1). These include:

- Members of a family (siblings, spouse, ancestors, and lineal descendants);
- An individual and a corporation of which more than 50% in value of the outstanding stock is owned, directly or indirectly, by or for such individual;
- Two corporations part of the same control group;
- A grantor and a fiduciary of the same trust;
- A fiduciary and a beneficiary of the same trust;
- A fiduciary of a trust and a fiduciary or beneficiary of another trust where the same person is a grantor of both trusts;
- A fiduciary of a trust and a corporation of which more than 50% in value of the outstanding stock is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
- A person and an organization to which §501 applies, and which is controlled directly or indirectly by the person or by members of his family;
- A corporation and a partnership if the same person owns more than 50% in value of the outstanding stock and more than 50% of the capital interest or the profits interest in the partnership;
- An S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation;
- A partnership and a person owning, directly or indirectly, more than 50% of the capital or profits interest in the partnership;
- Two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interests;[4] or
- An executor or an estate and a beneficiary of the estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.[5]

3. IRC §§1031(f)(3) and 267(b)
4. IRC §707(b)(1)
5. IRC §267(b)

Caution. Tax preparers must be aware of related party transactions. The Code states:

IRC §1031(f)(4) Treatment of certain transactions — this section (related party exchanges) shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection.

See page 554 in Chapter 13, "Rulings and Cases," for a court case involving a like-kind exchange between related parties.

In 2002, the IRS fired a warning shot for §1031 exchanges between related parties. Consistent with prior rulings, in Rev. Rul. 2002-83, the IRS took the position that if one of the related parties receives cash or unlike-kind property, then the exchange does not qualify for §1031 nonrecognition. This ruling, for many observers, changes the thinking about related party exchanges. Prior to this, a related party exchange was thought to simply require a two-year holding period, wherein the more important issue is the type of property (like-kind or unlike-kind and money) received by the related parties.

Holding Period Change for §121 Property Acquired in Like-Kind Exchange

IRC §121 provides the $250,000/$500,000 gain exclusion attributable to the sale of a principal residence. This is perhaps one of the most significant tax saving provisions of the last 10 years. However, when coupled with the benefits of the exchange, the potential exists for the elimination of most tax due on the sale of a previously utilized business or investment property.

IRC §121(d)(10) was added by the American Jobs Creation Act of 2004. The purpose of this law change was to restrict the use of the §1031 exchange, followed by converting the acquired property into a principal residence. The new §121(d)(10) reads:

Property acquired in like-kind exchange.

If a taxpayer acquired property in an exchange to which section §1031 applied, subsection (a) shall not apply to the sale or exchange of such property if it occurs during the ***5-year period*** *beginning with the date of the acquisition of such property.*

This new provision is effective for sales after October 22, 2004, and does not take into account the date of acquisition. As a result, principal residence owners **who acquired the residence in a §1031 exchange** have to meet a five-year look-back period before the residence qualifies for the benefits of the §121 exclusion.

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Example 7. Kyle and Amy sell a single-family rental property with a value of $350,000, an adjusted basis of $110,000, and a realized gain of $240,000. Kyle and Amy claim $4,000 depreciation on the property after May 6, 1997. They properly deferred all gain by purchasing a rental condominium in Ft. Myers, FL. The Florida property is actively rented during the prime seasonal rental period. After renting the property for a little over two years, they decide to move into the property and convert it to their principal residence.

If they use the property as their principal residence for at least two years, and retain title to the property for a minimum period of five years, the original gain on the sale of the rental ($240,000) is eliminated. The only gain that is taxed is attributable to the depreciation claimed after May 6, 1997 ($4,000), and will be taxed at a rate no higher than 25%. On the other hand, if they do not own the Florida property for at least five years, none of the gain on the sale is excludable under §121.

Simultaneous Exchange

Example 8. Rose and Joe are siblings. When their parents died, Rose inherited commercial property located in Illinois and Joe inherited commercial property located in Florida. The FMV of each property is currently $550,000. Rose is the oldest sibling and she plans to retire to Florida. Joe was offered a great job in Chicago and he plans to move to Illinois.

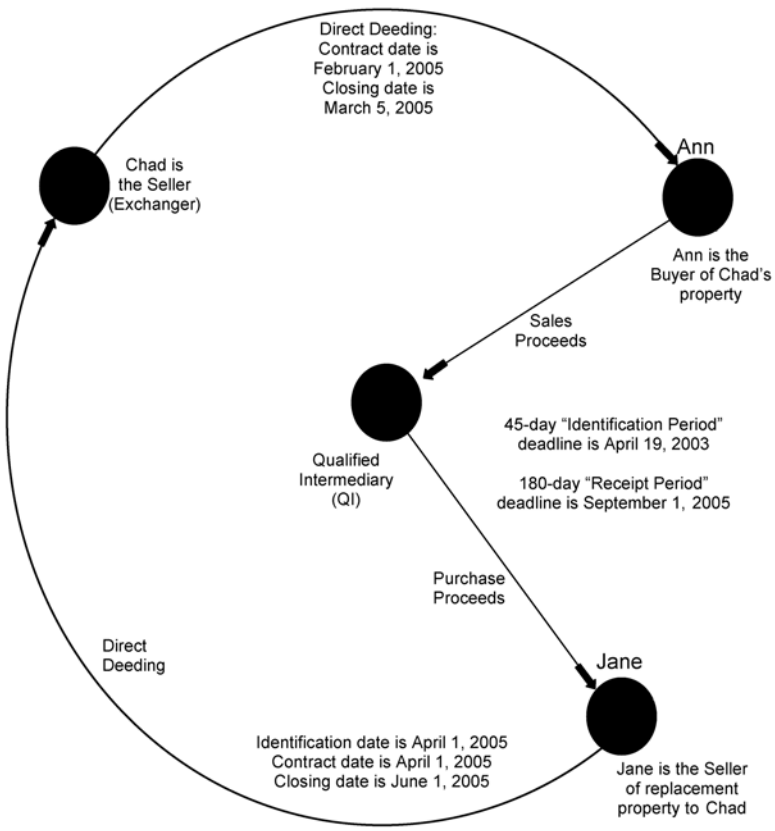
Rose and Joe want to exchange properties so they can each be closer to the property they own. Their simultaneous exchange (closings basically at the same time) qualifies for §1031 treatment. Since Rose and Joe are related, they must own the exchanged property for the two-year period in order to protect the §1031 treatment of their exchange.

Deferred Exchange

Example 9. Chad is 55 years old. He owns a commercial building in Cleveland that he wants to sell. He wants to avoid current federal income tax on this property. His Cleveland property is fully depreciated, and his only basis is in the land. Chad wants to exchange his property for another commercial property in sunny Arizona where he plans to retire. Chad found a buyer (Ann) for his property in Cleveland, and he located property in Arizona that is for sale (by Jane).

Chad closed on his sale to Ann on March 5. He did not identify an Arizona property (replacement) until April 1. In order to avoid taxation on the gain of the sold (relinquished) property, he must use a qualified intermediary (QI) to hold the proceeds from the sale. The QI accepted Ann's payment and held it until Chad closed on the Arizona property. Since this was not a simultaneous exchange, Chad was required to identify his replacement property by April 19, and close on that property by September 1. He met those timing requirements and consequently his transaction is allowed §1031 treatment. The following flowchart represents the exchange logistics.

Like-Kind Exchange Flowchart



Note. The fact that a contract was negotiated for the purchase of the replacement property prior to the sale of the relinquished property does not preclude a tax-deferred exchange result. A seller who enters into a contract to sell the relinquished property may still enter into an exchange of the property, if an exchange agreement is signed **prior** to closing. On the other side of the exchange, the seller of the relinquished property may enter into a contract to purchase the replacement property prior to closing on the sale of the relinquished property.

Reverse Exchange

There are times when a property unexpectedly comes up for sale. The taxpayer wants to purchase the property, but needs to sell an existing property to be able to finance the new purchase. If he must pay tax on the property he is selling, he may not be able to afford the purchase. This taxpayer has the reverse situation of a normal exchanger. In this case, he wants to purchase the replacement property first and then sell the relinquished property.

IRC §1031 rules do not specifically address this situation. However, the IRS issued guidelines for this type of transaction.[6] This is called a reverse exchange.

The most significant difference between a regular and reverse exchange is that an exchange accommodation titleholder (EAT) must take title to the replacement property in a reverse exchange. An EAT is defined as:

A person who is not the taxpayer or a disqualified person and is subject to federal income tax or, if such person is treated as a partnership or S corporation for federal income tax purposes, more than 90% of its interests or stock are owned by partners or shareholders who are subject to federal income tax.[7]

One of the difficulties of a reverse exchange is paying for the replacement property. Since the relinquished property has not been sold, the taxpayer must find a way to pay for the replacement property. The EAT temporarily holds the replacement property for the taxpayer, but is not typically willing to finance the property. If the transaction should fall through because the taxpayer cannot find a buyer for the property the taxpayer needs to sell, the taxpayer will end up owning a property he may not want to own. This is due to the fact that the EAT will eventually want the taxpayer to take title to the property that the EAT purchased for the taxpayer.

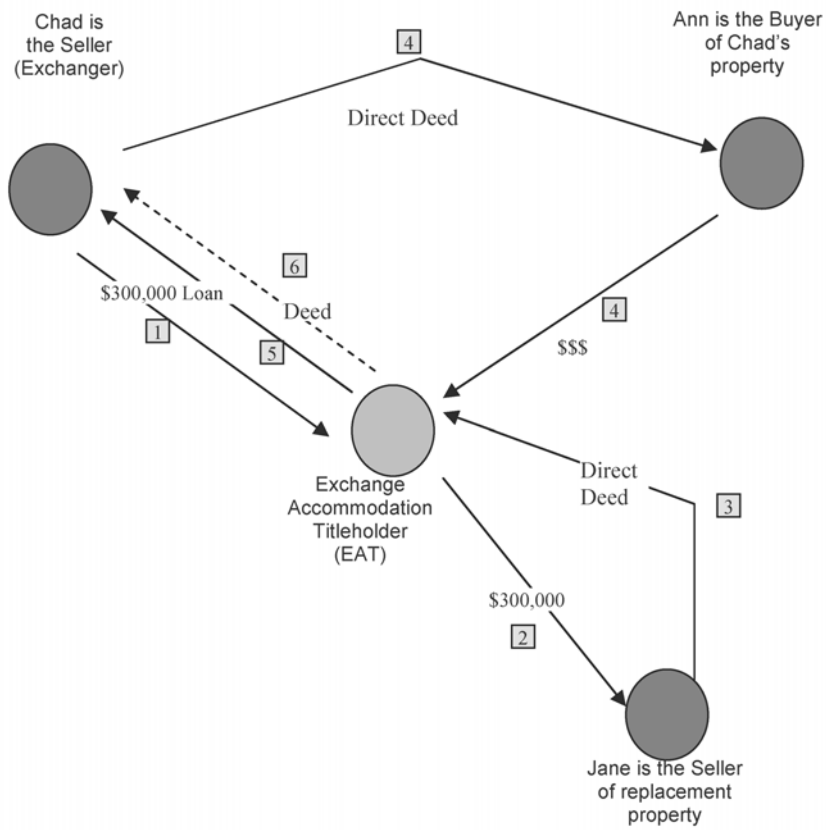
Consequently, the taxpayer normally loans the EAT money to purchase the replacement property. However, if the taxpayer has good credit, his bank may be willing to loan the money, knowing it holds the replacement property as security and will be repaid when the relinquished property is sold.

6. Rev. Proc. 2000-37, September 15, 2000

7. Ibid

Example 10. Use the same facts as **Example 9,** except Chad purchases Jane's property before he sells to Ann. Chad must utilize an EAT. He loans $300,000 to the EAT. The EAT pays for Jane's property and the property deed is transferred to the EAT. Ann pays the EAT for Chad's property and the EAT transfers the cash to Chad.

Reverse Like-Kind Exchange Flowchart



1. Chad loans $300,000 to his EAT.
2. The EAT conveys purchase price proceeds to Jane.
3. Jane conveys title to replacement property to the EAT. (The EAT is now in title.)
4. At closing with Ann, title to Chad's relinquished property is conveyed to Ann.
5. At closing with Ann, Ann's purchase proceeds are conveyed to the EAT.
6. Chad's loan is repaid by the EAT to Chad out of Ann's purchase proceeds.
7. Title to the replacement property is conveyed by the EAT to Chad.

METHODS OF IDENTIFYING REPLACEMENT PROPERTY

According to the Code, replacement property is required to be identified on or before the 45th day after the date on which the taxpayer transferred (closed on) the exchanged property.[8] According to the regulations, the identification period begins on the date the taxpayer transfers (closes on) the relinquished property and ends at midnight on the 45th day thereafter.[9] **The term "days" refers to calendar days, not business days.**

8. IRC §1031(a)(3)(A)
9. Treas. Reg. §1.1031(k)-1(b)(2)

Example 11. Bakers, Inc. files its federal income tax return on a calendar-year basis. Bakers, Inc. enters into a sales contract with Fryers, Inc. for the sale of a warehouse property. The closing on this sale to Fryers, Inc. occurs on November 16, 2004.

The identification period ends at midnight on December 31, 2004, the day which is 45 days after the date of transfer of the warehouse. The exchange period ends at midnight on March 15, 2005, the due date for Bakers' federal income tax return for the taxable year in which Bakers transferred the warehouse. However, if Bakers, Inc. is allowed the automatic six-month extension for filing its tax return, the exchange period ends at midnight on May 15, 2005, the day which is 180 days after the date of transfer of the warehouse.

RULES FOR IDENTIFYING REPLACEMENT PROPERTIES

Manner of Identifying Replacement Property

1. Replacement property is identified only if it is designated as replacement property in a signed written document. This document must be hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to a person (other than the exchanger or a related party) involved in the exchange.
2. An identification of replacement property made in a written agreement for the exchange of properties signed by all parties thereto before the end of the identification period is treated as satisfying the requirements. It is not necessary for the agreement to be "sent" to a person involved in the exchange.

Description of Replacement Property

Replacement property is identified only if it is unambiguously described in the written document or agreement. Real estate generally is unambiguously described by a legal description or street address.

Alternative and Multiple Properties

Regardless of the number of relinquished properties transferred as part of the same deferred exchange, there are limitations on how many replacement properties may be identified. The exchanger may identify more than one property as replacement property subject to one of four rules:

1. Any replacement property received by the exchanger before the end of the identification period will in all events be treated as identified before the end of the identification period.
2. **The Three-Property Rule.** The maximum number of replacement properties the exchanger may identify is three properties without regard to the FMVs of the properties.
3. **The 200% Rule.** The exchanger may identify any number of properties as long their aggregate FMV is not more than 200% of the aggregate FMV of all the relinquished properties.
4. **The 95% Rule.** The exchanger may identify any number of properties as long as the exchanger closes on 95% of the FMV of those identified by the 180th day.

Observation. The IRS ruled in Letter Ruling 200513010 that undivided fractional interests (UFIs) in realty would **not** be considered "interests in a business entity" under Treas. Reg. §301.7701-2(a). Consequently, the UFIs qualified as "qualified replacement property" under IRC §1031 like-kind exchange rules.

This is only the second ruling the IRS issued under Rev. Proc. 2002-22 which specifies the conditions under which it rules on the UFI-business entity issue. More importantly, this ruling provides a fairly detailed blueprint for real estate entrepreneurs to follow in structuring undivided fractional interest ownership arrangements that adhere to IRS guidelines.

See discussion regarding tenant-in-common exchanges later in this chapter.

LIKE-KIND REQUIREMENT

As used in §1031(a), the words "like kind" refer 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

Depreciable tangible personal 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. A single property may not be classified within more than one asset class or within more than one product class. In addition, property classified within any asset class may not also be classified within a product class. Class determination is made as of the date of the exchange.

The definition of "like-kind" does not include personal property used predominantly within the United States for personal property used predominantly outside the United States. This change came as a result of an amendment to §1031(h) under the Taxpayer Relief Act of 1997. This change is generally effective for transfers after June 8, 1997, in taxable years ending after that date.

General Asset Classes (from ADR Tables).[10] Property within a general asset class consists of property described in one of the asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87-56, 1987-2 C.B. 674. These classes describe types of depreciable tangible personal property frequently used in businesses.[11] Following is a description of asset classes 00.11–00.28 and 00.4.

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10. Rev. Proc. 87-56, October 19,1987
11. Treas. Reg. §1.1031(a)-2(b)(2)

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

Example 12. ABR Corporation exchanges 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 since they are in different asset classes.

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

Example 13. Tom's Speedy Delivery Service traded its 2004 Ford Ranger pick-up truck for a 2005 Volkswagen Jetta when gas prices reached $2.45 per gallon. Both vehicles are used 100% for business. The trade does not qualify as a like-kind exchange since the pick-up truck is in asset class 00.241 and the car is in asset class 00.22. This is true even though they are used for exactly the same purpose.

Treasury Decision 9202. The regulations relating to the classification of property[12] as like-kind were released May 18, 2005. These amendments to the regulations replaced the Standard Industrial Classification (SIC) system with the North American Industry Classification System (NAICS) for determining what properties are of a like class for purposes of §1031.

These final regulations apply to transfers of property made by taxpayers on or after August 12, 2004. However, taxpayers may apply the regulations to transfers of property made by taxpayers on or after January 1, 1997, in taxable years for which the period of limitation for filing a claim for refund or credit under §6511 has not expired.

12. Treas. Reg. §§1.1031(a)-2 and 1.1031(j)-1

Additionally, taxpayers may treat properties within the same product classes under a four-digit SIC code as properties of like-class for transfers of property made by taxpayers on or before May 19, 2005.

Product Classes. A product class consists of depreciable tangible property that is described in a six-digit product class within Sectors 31, 32, and 33 (pertaining to manufacturing industries) of the NAICS.[13] The NAICS codes may be found on the internet at **www.census.gov/epcd/www/naics.html**.

> **Note.** Product classes ending in nine are 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 NAICS code 333111 (farm machinery and equipment), farmers generally qualify for §1031 treatment when they exchange farm equipment for farm equipment.

General asset classes and product classes are modified or updated from time to time. Exchanges occurring after a modification or update use the modified or updated classes.[14]

The following examples (names added) are contained in the regulations:

Example 14. Amanda transfers a personal computer (asset class 00.12) to Betty in exchange for a printer (asset class 00.12). For Amanda, the properties exchanged are within the same general asset class and, therefore, are of a like-class.

Example 15. Charlie transfers an airplane (asset class 00.21) to Dave in exchange for a heavy general-purpose truck (asset class 00.242). The properties exchanged are not of a like-class because they are within different general asset classes. Because each of the properties is within a general asset class, the properties may not be classified within a product class. The airplane and heavy general-purpose truck are also not of a like-kind. Therefore, the exchange does not qualify for nonrecognition of gain or loss under §1031.

Example 16. Earl transfers a grader to Frank in exchange for a scraper. Neither property is within any of the General Asset Classes, and both properties are within the same Product Class (NAICS code 333120). The grader and scraper are of like-class and deemed to be of like-kind for purposes of §1031.

Example 17. Gertie transfers a personal computer (asset class 00.12), an airplane (asset class 00.21), and a sanding machine (NAICS code 333210) to Hank in exchange for a printer (asset class 00.12), a heavy general-purpose truck (asset class 00.242), and a lathe (NAICS code 333210). The personal computer and the printer are of like-class because they are within the same general asset class; the sanding machine and the lathe are of like-class because they are within the same product class (although neither property is within any of the general assert classes). The airplane and the heavy general-purpose truck are neither within the same general asset class nor within the same product class, and are not like-kind.

Real Property

Like-Kind Property Examples. The regulations provide the following examples of "like-kind" property:

- Urban real estate for rural real estate (only if the taxpayer is not a real estate dealer); [15]
- Real property, of which he is the lessee, and the lease has an unexpired term of at least 30 years, for a fee simple interest in real property;[16]

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13. Treasury Decision 9202, May 18, 2005
14. Treas. Reg. §1.1031(a)-2(b)(4)
15. Treas. Reg. §1.1031(a)-1(c)
16. Rev. Rul. 78-72, January 1, 1978

- Improved real estate for unimproved real estate;
- Timberland for bare land; [17]
- Undeveloped ranch land for a commercial building;[18]
- A commercial building for commercial condominium offices;[19]
- An apartment building for vacant land plus golf course improvements;[20] and
- An improved lot and a house that is not the taxpayer's residence.[21]

In many situations, the courts held that virtually any parcel of real property is of a like-kind with any other parcel of real property. However, **real property located in the United States and real property located outside the United States are not like-kind properties.**

Example 18. Sally owns an apartment building valued at $1,000,000 in Springfield, Missouri. This building was a gift from her uncle in 1980 as part of his estate plan. Her uncle paid $160,000 for the property in 1960. The only remaining basis is $20,000 for land.

Sally plans to move to Savannah, Georgia. She wants to sell the property in Springfield and purchase a commercial building in Savannah for $1 million. The property in Savannah will provide her a steady income in retirement and will take little effort to manage. The transaction costs for the sale and repurchase are $80,000.

Sally learns from her accountant that she will owe in excess of $150,000 in state and federal taxes if she sells the property in Missouri. If Sally used the provisions of §1031, she can sell the property in Missouri and purchase the Georgia property through an §1031 exchange. The basis in the new property is $100,000 ($20,000 + $80,000). An exchange defers the gain that would be recognized from the Missouri property until a later date when the Georgia property is sold.

Example 19. Mitchell owns property that includes a small shoe repair shop. The FMV of the property, including the equipment in the shop is $110,000. The original cost of the equipment was $50,000 but it is now fully depreciated with a basis on $0. The cost of the building and land was $70,000 and it has a current basis of $40,000. Based on a recent appraisal, the value of the land and building is $100,000 and the value of the equipment is $10,000. Mitchell exchanges this property for unimproved land with a FMV of $110,000.

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FMV of unimproved land	$110,000
Basis of relinquished property	(40,000)
Gain realized	$ 70,000

Since the replacement property does not include any IRC §1245 property, Mitchell recognizes gain not to exceed the $10,000 FMV of the equipment, the non like-kind property. Mitchell has a basis on $30,000 in the unimproved land and the remaining $30,000 of gain is deferred until the unimproved land is sold.

Note. If the relinquished property contains any §1245 depreciation, it must be recaptured if the replacement property is not eligible for at least an equal amount of §1245 depreciation. More discussion on this topic can be found in Chapter 9, "Small Business Issues," on pages 342–345.

17. Rev. Rul. 78-163, January 1, 1978
18. *H. Rutland,* 36 TCM 40, TC Memo 1977-8, January 17, 1977
19. Letter Ruling 8938045, June 28, 1989
20. Letter Ruling 9428007, April 13, 1994
21. *Biscayne Trust Co.* 18 BTA 1015, February 5, 1930

Intangible or Nondepreciable Personal Property

An exchange of intangible personal property or nondepreciable personal property qualifies for nonrecognition of gain or loss under §1031 if the properties are of like-kind.[22] Intangible personal property is property that has no physical value, but is merely the representative or evidence of value. The property is intrinsically capable of being sold, transferred, or pledged.

Examples of intangible personal property and nondepreciable personal property that are 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

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.

> **Example 20.** Linda exchanges a copyright on a novel for a copyright on a different novel. The properties are considered of a like-kind.

> **Example 21.** Samuel exchanges a copyright on a novel for a copyright on a song. The properties are not considered of a like-kind.

Goodwill or Going Concern. 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 §1031 in situations where the allocated FMV of the goodwill or going concern value results in a significant tax liability.[23]

QUANTITATIVE ISSUE

One of the most commonly misunderstood parts of an exchange is the quantitative part. What dollar values must be met in order to achieve the highest amount of tax deferral? In addition to the requirements of timing and like-kind property, the exchanger must be careful to purchase the right amount of replacement property, to carry the right amount of debt, and to have the right amount of equity in the replacement property.

Boot

A common term used in §1031 exchanges is "boot." Boot refers to the receipt of cash or personal property not considered like-kind. Receiving boot in a like-kind exchange does not defeat the exchange. The receipt of boot results in a taxable event to the exchanger. However, in many cases it does not result in the entire exchange transaction becoming taxable. The gain is limited to the amount of money and unlike property the exchanger receives.

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22. Treas. Reg. §1.1031(a)-2(c)

23. Treas. Reg. §1.1031(a)-2(c)(2)

Boot is calculated by adding the amount of cash received to the FMV of the unlike property received. Boot typically consists of cash, notes, and personal property.

Receipt of Boot. Receipt of boot is **taxable**. If a taxpayer receives other property or money in an exchange, any gain is recognized in an amount not to exceed the sum of money and FMV of the other property. However, if there is any loss to the taxpayer, it is not recognized to any extent.[24]

Example 22. Larry purchased real estate in 1985 for $40,000. He exchanges it for real estate with an FMV of $100,000 and $5,000 in cash. The recognized gain is limited to the cash received, which is $5,000.

Payment of Boot. Payment of boot is **not taxable.** If a taxpayer gives money or other property in a tax-free exchange, the money or FMV of property given increases the basis of property received.

Example 23. Larry in **Example 22** receives real estate which has an FMV of $30,000, a mower which has an FMV of $3,000, and $12,000 in cash. Larry realizes a gain of $5,000, all of which is recognized.

Real estate FMV	$30,000
Mower	3,000
Cash	12,000
FMV of replacement property	$45,000
Basis of relinquished property	(40,000)
Gain realized	$ 5,000

The basis of the property received in the exchange is the basis of the real estate, decreased by the amount of money received, and increased by the amount of gain that is recognized.

Basis of relinquished real estate	$40,000
Cash received	(12,000)
Gain recognized	5,000
Basis of replacement property	$33,000

The basis of the replacement property is allocated between the mower (non like-kind property) and the real estate. The basis of the mower is its FMV at date of the exchange. The basis of the replacement real estate is the remaining $30,000.

10

Net Mortgage Relief: One Form of Boot. Exchange transactions become more complicated when both properties are mortgaged. When calculating the relief, the mortgages are netted.

If the mortgage on the replacement property is **less** than the mortgage on the relinquished property, the difference is considered boot received. This amount is referred to as mortgage relief.

Mortgages on property given up by the exchanger are counted as boot received. However, the exchanger is permitted to offset mortgages on the replacement property against this boot. This is called "netting the liabilities."

Example 24. Grady exchanges relinquished property which has an outstanding mortgage balance of $25,000. Grady obtains a mortgage of $12,000 on the replacement property. The difference between the mortgage on the replacement property ($12,000) and the relinquished property ($25,000) is mortgage relief ($13,000). The $13,000 net mortgage relief is considered boot received by Grady, and is therefore taxable.

If the mortgage on the replacement property is **more** than the mortgage on the relinquished property, the difference is considered boot paid.

Example 25. Fred exchanges property with Grady. Using the facts given in **Example 24,** Fred treats the additional $13,000 mortgage assumed as boot and increases the basis in the property he receives.

24. Treas. Reg. 1.1031(b)-1(a)

Calculating net mortgage relief becomes more complicated when the mortgage on the replacement property is more than the mortgage on the relinquished property. The excess is treated as boot paid but is subject to the offset rule. Mortgage boot paid offsets mortgage boot received but does not offset cash or unlike property boot received.[25]

Assumption of Liabilities. Although this does not commonly occur, taxpayer liabilities, assumed with the relinquished property as a part of the exchange, or liabilities included with the replacement property are treated as money received by the taxpayer at the time of the exchange. This is the case whether or not the exchange results in recognition of gain or loss to the taxpayer.

Example 26. William owns an apartment building which has an adjusted basis of $700,000 and is subject to a $200,000 mortgage. He transfers the property to Lauren in exchange for $70,000 in cash and another apartment building with a FMV of $800,000. The transfer to Lauren is subject to the $200,000 mortgage. William realizes a gain of $370,000 on the exchange computed as follows:

Value of replacement property	$ 800,000
Cash	70,000
Liabilities transferred with relinquished property	200,000
Total consideration received	$1,070,000
Less: adjusted basis of relinquished property	(700,000)
Gain realized	$ 370,000

Under §1031(b), William recognizes $270,000 of the gain ($70,000 cash + $200,000 assumed mortgage). The basis of the apartment building acquired by William is $700,000 computed as follows:

Adjusted basis of relinquished property		$700,000
Less money received: cash	$ 70,000	
Liabilities transferred with relinquished property	200,000	
Total	$270,000	(270,000)
Difference		$430,000
Plus: amount of gain recognized upon the exchange		270,000
Basis of property acquired upon the exchange		$700,000

Treatment of Paid Selling Expenses. Selling expenses paid in connection with a §1031 exchange are treated as cash boot paid. This offsets boot received, if any. Selling expenses include brokerage commissions and other closing costs such as title policy fees, escrow fees, and recording fees.

Example 27. Patty owns property with an adjusted basis of $30,000 and exchanges it for like-kind property with an FMV of $100,000 and $35,000 cash. Patty pays a $9,000 commission to a real estate broker. The taxable gain is limited to the $26,000 net boot received ($35,000 – $9,000).

If no cash or property boot is received in the exchange but mortgage relief exists, the exchanger may offset sales expenses paid against the net mortgage relief. If the offset creates a "loss," the Code prohibits any deduction. However, these expenses would be added to the basis of the replacement property.[26]

The tax-free provisions of §1031 do not apply to unlike-kind property transferred in the exchange. If the exchanger invests cash into the exchange, no gain is recognized to the exchanger. However, if the exchanger gives boot in the form of property other than money, a gain or loss is recognized. The transaction is treated as a sale of the unlike property and regular gain and loss tax rules apply. The gain or loss is the difference between the exchanger's adjusted basis in the property and the FMV at the time of the exchange.[27]

25. Treas. Reg. §1.1031(d)-2

26. IRC §1031(a)(1)

27. IRC §1031(b)

Value-Debt-Equity Rules

Three basic quantitative rules are followed in order to achieve the highest amount of tax deferral:

1. The **value** of the replacement property(s) must be equal to or greater than the value of the relinquished property(s). The value is determined by comparing the sale price of the relinquished property to the replacement property's purchase price – HUD-1.[28]
2. The **debt** on the replacement property(s) must be equal to or greater than the debt on the relinquished property(s). This value is determined by comparing the mortgage payoff amount on the sale of the relinquished property to the mortgage taken out on the purchase of the replacement property – HUD-1.
3. The **equity** in the replacement property(s) must be equal to or greater than the equity in the relinquished property(s). The exchanger should receive no cash in the transaction – HUD-1.

There is one exception to rule #2. If the debt on the replacement property(s) is less than the debt on the relinquished property(s), this debt relief is not taxable to the extent that the exchanger invested additional funds to purchase the replacement property.

Value, Debt and Equity Computations. Each one of these examples represents a sale of relinquished property (old) and the purchase of replacement property (new). This exercise is intended to provide the tax professional with a quick look at whether a client is moving in the right direction with the "numbers" part of a §1031 exchange.

1.

	Old	New
Value	$100,000	$120,000
Debt	20,000	40,000
Equity	80,000	80,000

Does this work? **YES**, due to the fact that the value and debt on the new property equaled or exceeded those respective amounts on the old property.

2.

	Old	New
Value	$600,000	$500,000
Debt	340,000	340,000
Equity	260,000	160,000

Does this work? **NO**, due to the fact that the purchase price of the new was less than the sales price of the old. In addition, the equity reduction in the new property is indicative of money taken (boot) by the exchanger.

3.

	Old	New
Value	$760,000	$810,000
Debt	250,000	250,000
Equity	510,000	560,000

Does this work? **YES**, due to the fact that the purchase price of the new was more than the sales price of the old. The debt remained the same and the increase in equity in the new property is indicative of additional money invested by the exchanger.

28. HUD-1 is the typical closing statement used in real estate transactions

REPORTING OF LIKE-KIND EXCHANGES

IRC §1031 exchanges are reported for tax purposes in the tax year in which the sale of the relinquished property(s) occurs. This rule may not seem to make sense in light of the fact that the replacement property may not be purchased until the following tax year. Consider the three following examples:

1. Relinquished property sold on May 3, 2005, replacement property purchased on July 7, 2005. The 2005 Form 8824 reflects the §1031 exchange.
2. Relinquished property sold September 6, 2004, replacement property purchased February 2, 2005. The 2004 Form 8824 reflects the §1031 exchange. No extension of time to file is needed since the 180-day completion period expires prior to April 15, 2005.
3. Relinquished property sold on December 19, 2004, replacement property purchased on May 2, 2005. The 2004 Form 8824 reflects the §1031 exchange, but an extension of time to file (Form 4868) must be filed on a timely basis to provide the exchanger additional time (April 15–May 2, 2005) to complete the purchase of the replacement property.

The Form 8824 is a fairly straightforward tax form to complete. The form is divided into four parts:

Part I. Information on the Like-Kind Exchange

Part II. Related Party Exchange Information

Part III. Realized Gain or Loss, Recognized Gain, and Basis of Like-Kind Property Received

Part IV. Deferral of Gain from Section 1043 Conflict of Interest Sales

Completion of **Part III** of Form 8824 can be one of the most confusing parts of the §1031 process. Without the HUD-1 closing documents for the sale of the relinquished property(s) and the purchase of the replacement property(s), the tax professional cannot start the calculation of the realized gain, recognized gain, and the adjusted basis of the replacement property(s).

Part IV of Form 8824 is used only by officers or employees of the executive branch of the federal government for reporting the nonrecognition of gain under §1043 on the sale to comply with the conflict-of-interest requirements.

Example 28. On April 14, 2005, Robert exchanges property which he originally acquired on January 1, 2001. On May 1, 2005, he identifies the qualified replacement property and actually acquires it on July 25, 2005.

Relinquished property information:	
Original cost	$ 85,000
Improvements	5,500
Accumulated depreciation (SL)	44,000
Adjusted basis	46,500
FMV	134,000
Sales expenses	9,357
Mortgage principal payoff	64,418
Replacement property information:	
Purchase price	$245,000
Transaction costs	1,596
Mortgage taken	125,000

Equity Balancing Worksheet[29]
(For Use in Determining Cash Given or Received)

1. FMV of like-kind property given up 134,000
2. FMV of unlike property/services given up (Part III, line 9) 0
3. Total FMV of like and unlike property given up (line 1 + line 2) 134,000
4. Liabilities given up with property (Part III, line 7)....................64,418
5. Equity in like/unlike property given up (line 3 – line 4) 69,582

6. FMV of like-kind property received (Part IV, line 1) 245,000
7. FMV of unlike property/services received (Part III, line 12 + line 13) 0
8. Total FMV of like and unlike property received (line 6 + line 7)....................245,000
9. Liabilities received/assumed with property (Part III, line 8) 125,000
10. Equity in like/unlike property received (line 8 – line 9)....................120,000
11. Cash given (received) (line 10 – line 5) 50,418

(Negative amount is cash received, and should equal amount on line 1 of Part III)
(Positive amount is cash given, and should equal amount on line 2 of Part III)

Tax Deferred Exchange Worksheet[30]

PART I — Adjusted Basis of Property Given Up: <u>Like-Kind</u>

Description of property given up: Single Family Rental

1. Original cost of other basis 85,000
2. Improvements.................... 5,500
3. Total (line 1 + line 2) 90,500
4. Depreciation/ACRS/MACRS allowed or allowable 44,000
5. Casualty losses deducted ....
6. Investment/energy credits claimed....................
7. Deferred gain....................
8. Total (sum of lines 4 through 7) 44,000
9. Adjusted Basis (line 3 – line 8) 46,500

PART II — Adjusted Basis of Property Given Up: <u>Unlike-Kind</u>

Description of property given up:

1. Original cost of other basis....................
2. Improvements....................
3. Total (line 1 + 2)....................
4. Depreciation/ACRS/MACRS allowed or allowable ....
5. Casualty losses deducted ....
6. Investment/energy credits claimed....................
7. Deferred gain....................
8. Total (sum of lines 4 through 7) ....
9. Adjusted Basis (line 3 – line 8) ....

Not Applicable

29. Reproduced from CFS Tax Tool Software®. Used with permission.

30. Reproduced from CFS Tax Tool Software®. Used with permission.

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PART III — Boot Received

1. Cash received 0
2. Cash paid 50,418
3. Expenses incurred for exchange (9,357 + 1,596) 10,953
4. Total (line 2 + line 3) 61,371
5. Net cash received (line 1 – line 4) or 0
6. Net cash paid (line 4 – line 1) 61,371
7. Liabilities given up 64,418
8. Liabilities received 125,000
9. FMV of unlike property/services given 0
10. Total (line 6 + line 8 + line 9) 186,371
11. Net liabilities (line 7 – line 10, but not < zero) 0
12. FMV of unlike property received 0
13. FMV of services received 0
14. Total boot received (sum of lines 5, 11, 12, and 13) 0

PART IV — Realized Gain or Loss

1. FMV of like-kind property received 245,000
2. FMV of unlike property received 0
3. FMV of services received 0
4. Cash received 0
5. Liabilities given up 64,418
6. Exchange price (sum of lines 1 through 5) 309,418
7. Adjusted basis of like-kind property given up 46,500
8. Adjusted basis of unlike property given up 0
9. Cash paid 50,418
10. Expenses incurred for exchange 10,953
11. Liabilities received 125,000
12. Basis of property given up (sum of lines 7 through 11) 232,871
13. Realized gain or loss (line 6 – line 12) 76,547

PART V — Recognized Gain or Loss

Recognized gain or loss on unlike property given up:

1. FMV of unlike property/services given up 0
2. Adjusted basis of unlike property given up 0
3. Recognized gain/loss on unlike property (line 1 – line 2) 0

Recognized gain on the exchange of like-kind property:

4. Total boot received (Part III, line 14) 0
5. Realized gain/loss (Part IV, line 13) 76,547
6. Gain/loss (Part V, line 3) 0
   (Gain entered as negative, loss entered as positive)
7. Total of line 5 and line 6 76,547
8. Recognized gain on like-kind property (lesser of line 4 or 7) 0

PART VI — Basis of Property Received

1. Adjusted basis of like-kind property given up 46,500
2. Adjusted basis of unlike property given up 0

3. Cash paid 50,418
4. Expenses incurred for exchange 10,953
5. Liabilities received 125,000
6. Gain recognized on exchange 0
7. Total (sum of lines 1 through 6) 232,871
8. Cash received 0
9. Liabilities given up 64,418
10. Loss recognized on exchange 0
11. Total (sum of lines 8 through 10) 64,418
12. Basis of all property acquired (line 7 – line 11) 168,453
13. FMV of unlike property received 0
14. FMV of services received 0
15. Total (line 13 + line 14) 0
16. Basis of like-kind property received (line 12 – line 15) 168,453

For Example 28

Form **8824**

Department of the Treasury
Internal Revenue Service

Like-Kind Exchanges

(and section 1043 conflict-of-interest sales)

▶ Attach to your tax return.

OMB No. 1545-1190

2005

Attachment Sequence No. 109

Name(s) shown on tax return: Robert Exchange

Identifying number: 001-22-3333

Part I **Information on the Like-Kind Exchange**

Note: *If the property described on line 1 or line 2 is real or personal property located outside the United States, indicate the country.*

1 Description of like-kind property given up ▶ Single Family Rental

2 Description of like-kind property received ▶ Single Family Rental

3	Date like-kind property given up was originally acquired (month, day, year)	3	1 / 1 / 2001
4	Date you actually transferred your property to other party (month, day, year)	4	4 / 14 / 2005
5	Date like-kind property you received was identified by written notice to another party (month, day, year). See instructions for 45-day written notice requirement	5	5 / 1 / 2005
6	Date you actually received the like-kind property from other party (month, day, year). See instructions	6	7 / 25 / 2005

7 Was the exchange of the property given up or received made with a related party, either directly or indirectly (such as through an intermediary)? See instructions. If "Yes," complete Part II. If "No," go to Part III ☐ Yes ☒ No

Part II **Related Party Exchange Information**

8 Name of related party | Relationship to you | Related party's identifying number

Address (no., street, and apt., room, or suite no., city or town, state, and ZIP code)

9 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did the related party directly or indirectly (such as through an intermediary) sell or dispose of any part of the like-kind property received from you in the exchange? ☐ Yes ☐ No

10 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did you sell or dispose of any part of the like-kind property you received? ☐ Yes ☐ No

*If both lines 9 and 10 are "No" and this is the year of the exchange, go to Part III. If both lines 9 and 10 are "No" and this is **not** the year of the exchange, stop here. If either line 9 or line 10 is "Yes," complete Part III and report on this year's tax return the deferred gain or (loss) from line 24 **unless** one of the exceptions on line 11 applies.*

11 If one of the exceptions below applies to the disposition, check the applicable box:

a ☐ The disposition was after the death of either of the related parties.

b ☐ The disposition was an involuntary conversion, and the threat of conversion occurred after the exchange.

c ☐ You can establish to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as its principal purpose. If this box is checked, attach an explanation (see instructions).

For Paperwork Reduction Act Notice, see page 4. Cat. No. 12311A Form **8824** (2005)

For Example 28

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Name(s) shown on tax return. Do not enter name and social security number if shown on other side.
Robert Exchange

Your social security number: **001 : 22 : 3333**

Part III **Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received**

Caution: *If you transferred* ***and*** *received* ***(a)*** *more than one group of like-kind properties or* ***(b)*** *cash or other (not like-kind) property, see* ***Reporting of multi-asset exchanges*** *in the instructions.*

Note: *Complete lines 12 through 14* ***only*** *if you gave up property that was not like-kind. Otherwise, go to line 15.*

12	Fair market value (FMV) of other property given up	12			
13	Adjusted basis of other property given up	13			
14	Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale			14	
	Caution: *If the property given up was used previously or partly as a home, see* ***Property used as home*** *in the instructions.*				
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred (see instructions)			15	
16	FMV of like-kind property you received			16	245,000
17	Add lines 15 and 16			17	245,000
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses **not** used on line 15 (see instructions)			18	168,453
19	**Realized gain or (loss).** Subtract line 18 from line 17			19	76,547
20	Enter the smaller of line 15 or line 19, but not less than zero			20	
21	Ordinary income under recapture rules. Enter here and on Form 4797, line 16 (see instructions)			21	
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies (see instructions)			22	
23	**Recognized gain.** Add lines 21 and 22			23	
24	Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions			24	76,547
25	**Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23			25	168,453

Part IV **Deferral of Gain From Section 1043 Conflict-of-Interest Sales**

Note: *This part is to be used* ***only*** *by officers or employees of the executive branch of the Federal Government for reporting nonrecognition of gain under section 1043 on the sale of property to comply with the conflict-of-interest requirements. This part can be used* ***only*** *if the cost of the replacement property is more than the basis of the divested property.*

26 Enter the number from the upper right corner of your certificate of divestiture. (**Do not** attach a copy of your certificate. Keep the certificate with your records.) ▶ __________ – __________

27 Description of divested property ▶ ....

28 Description of replacement property ▶ ....

29	Date divested property was sold (month, day, year)			29	/ /
30	Sales price of divested property (see instructions)	30			
31	Basis of divested property	31			
32	**Realized gain.** Subtract line 31 from line 30			32	
33	Cost of replacement property purchased within 60 days after date of sale	33			
34	Subtract line 33 from line 30. If zero or less, enter -0-			34	
35	Ordinary income under recapture rules. Enter here and on Form 4797, line 10 (see instructions)			35	
36	Subtract line 35 from line 34. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797 (see instructions)			36	
37	**Deferred gain.** Subtract the sum of lines 35 and 36 from line 32			37	
38	**Basis of replacement property.** Subtract line 37 from line 33			38	

Form **8824** (2005)

DEPRECIATION OF PROPERTY ACQUIRED IN A LIKE-KIND EXCHANGE

BACKGROUND

The IRS became aware of inconsistent depreciation treatment by taxpayers of property that had a basis determined under §1031(d) or §1033(b) (replacement property). Some taxpayers were depreciating the replacement property using the same depreciation method, recovery period, and convention as the exchanged or involuntarily converted property (relinquished property) while other taxpayers were depreciating the replacement property as if it were newly placed in service.

In response, the IRS and Treasury issued Notice 2000-4 (2000-1 C.B. 313), published January 18, 2000. Notice 2000-4 instructed taxpayers how to depreciate MACRS property that has a basis determined under §1031(d) or §1033(b) (replacement MACRS property), provided that the exchanged or involuntarily converted property was also MACRS property (relinquished MACRS property). **The notice stated that replacement MACRS property placed in service after January 3, 2000, is depreciated over the remaining recovery period of, and using the same depreciation method and convention as, the relinquished MACRS property. Any excess of the basis in the replacement MACRS property over the adjusted basis in the relinquished MACRS property is treated as newly purchased MACRS property**. Notice 2000-4 also stated that the IRS and Treasury intended to issue regulations to address these transactions. Public comments on the nature and scope of these temporary regulations were requested. Because of the added complexity of the depreciation schedule, Notice 2000-4 was not very popular in the tax professional community.

TREASURY DECISION 9115

On February 27, 2004, the IRS issued **Treasury Decision 9115**, effective on March 1, 2004. This document replaced Notice 2000-4 and contained regulations relating to the depreciation of property subject to MACRS depreciation. Specifically, these regulations provided guidance on how to depreciate MACRS property acquired in a §1031 exchange or as a result of a §1033 involuntary conversion when both the replacement property acquired and the relinquished property disposed of are subject to MACRS depreciation (cost recovery) in the hands of the acquiring taxpayer. The following excerpts and examples from these regulations provide guidance on the calculation of depreciation deductions following a §§1031 or 1033 transaction.

General Rule

Exchanged Basis. The temporary regulations provide rules for determining the applicable recovery period, depreciation method, and convention used to determine the depreciation allowances for the replacement MACRS property for the taxpayer's basis[31] in the replacement MACRS property as does not exceed the taxpayer's adjusted depreciable basis in the relinquished MACRS property (exchanged basis). In general, the exchanged basis is depreciated over the remaining recovery period of, and using the depreciation method and convention of the relinquished MACRS property (general rule).

This general rule applies if the replacement MACRS property has the **same or a shorter recovery period or the same or a more accelerated depreciation method** than the relinquished MACRS property. Under certain circumstances, this rule could adversely affect taxpayers engaging in like-kind exchanges or involuntary conversions. For example, a taxpayer must depreciate replacement MACRS property with a shorter recovery period over the longer recovery period of the relinquished MACRS property even if the taxpayer could depreciate the replacement MACRS property over a shorter recovery period by treating the property as newly acquired MACRS property. The temporary regulations provide an election not to apply the temporary regulations and to treat the replacement MACRS property as MACRS property placed in service by the acquiring taxpayer at the time of replacement. Taxpayers may use this election to ameliorate the possible adverse effects of applying the general rule to this type of transaction.

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31. As determined under §1031(d) and the regulations under §1031(d) or §1033(b) and the regulations under §1033(b)

The general rule does not apply if the replacement MACRS property has a **longer recovery period or less accelerated depreciation method** than the relinquished property:

- The recovery period of the replacement MACRS property is longer than that of the relinquished MACRS property. The exchanged basis in the relinquished MACRS property is depreciated, beginning in the year of replacement, over the remainder of the recovery period that would have applied to the replacement MACRS property. It is treated as if the replacement MACRS property had originally been placed in service when the relinquished MACRS property was placed in service by the acquiring taxpayer.
- The depreciation method of the replacement MACRS property is less accelerated than that of the relinquished MACRS property. The taxpayer's exchanged basis in the relinquished MACRS property is depreciated, beginning in the year of replacement, using the less accelerated depreciation method of the replacement MACRS property. This is the method that would have applied to the replacement MACRS property if the replacement MACRS property had originally been placed in service when the relinquished MACRS property was placed in service by the acquiring taxpayer.

For taxpayers who wish to use the optional depreciation tables to determine the depreciation allowances for the replacement MACRS property instead of the formulas (for example, see section 6 of Rev. Proc. 87-57 (1987-2 C.B. 687, 692)), the temporary regulations provide guidance on choosing the applicable optional table as well as how to modify the calculation for computing the depreciation allowances for the replacement MACRS property.

Excess Basis. Excess basis is defined as the excess of the MACRS basis of the replacement property minus the MACRS basis of the relinquished property. The excess basis is treated as if it were a separate property from the relinquished property. Therefore, the basis of the replacement property is composed of two parts. One is the excess basis and the other is the remaining basis of the relinquished property. For depreciation, the excess basis is treated as if it is placed into service at the time the newly acquired property is placed into service. If the replacement property is acquired prior to the disposition of the relinquished property it is treated as acquired on the disposition date of the relinquished property.

The depreciation allowance for the excess basis is determined using the applicable recovery period, depreciation method, and convention prescribed under §168 for the MACRS replacement property at the time of replacement.

Election Not to Apply Temporary Regulations

Commentators suggested that implementing the general rule for all depreciable property was burdensome because taxpayers would have onerous computational and administrative difficulties due to the possibility of having to track different depreciation components of one asset. Responding to these comments, the temporary regulations include a provision by which taxpayers may elect not to apply these temporary regulations. If a taxpayer elects not to apply the temporary regulations, the taxpayer must treat the entire basis (i.e., both the exchanged and excess basis) of the replacement MACRS property as being placed in service by the acquiring taxpayer at the time of replacement. Consistent with this treatment, the taxpayer treats the relinquished MACRS property as disposed of at the time of the disposition of the relinquished MACRS property. The election must be made by typing or legibly printing at the top of Form 4562, *Depreciation and Amortization,* "ELECTION MADE UNDER SECTION 1.168(i)-6T(i)," or in the manner provided for on Form 4562 and its instructions: DEPRECIATION OF PROPERTY ACQUIRED IN A LIKE KIND EXCHANGE.

Note. Consideration for electing out of the two separate depreciation line items should be made when trading an asset with a remaining adjusted basis at greater cost recovery period under MACRS than the newly acquired asset. This could be the case in a like kind exchange of a warehouse with a 39-year MACRS recovery period for an apartment complex that has a shorter 27-year recovery. However, when this situation is reversed with a trade of residential property for commercial property, it is well worth the taxpayer's time to maintain two separate line items for depreciation of the same asset, as greater depreciation deductions will result in the early years following the trade of real estate.

Example 29. Jack Downey received an offer of $1.4 million for an apartment building that he has owned for the past 10 years. Mr. Downey acquired this residential rental property on January 1, 1995, for a cost of $990,000. After reviewing the tax implications of paying the tax on the gain with his tax advisor, or reinvesting in like-kind property, Mr. Downey decided to do a §1031 exchange. He located a mini-warehouse selling for $2 million that offered excellent cash flow. The trade was made effective July 1, 2005.

Mr. Downey's adjusted basis in his apartment building as of July 1, 2005, was $650,182, which was computed as follows:

Original cost of apartment building	$990,000
Less: amount allocated to land costs	(100,000)
Depreciable basis 27.5-years MACRS	$890,000
Depreciation claimed thru July 1, 2005	(339,818)
Adjusted basis of depreciable building cost	$550,182
Add back land costs	100,000
Adjusted basis of relinquished property	$650,182

To complete the like-kind exchange for the warehouse property, Mr. Downey must add the cash difference of $600,000, the cost of the mini-warehouse ($2 million) minus the selling price of his apartment building ($1.4 million). His new basis in the mini-warehouse facility is $1,250,182, which represents the cash boot of $600,000 plus the adjusted basis of the property given up ($650,182).

If Mr. Downey elected not to follow Treasury Decision 9115 (Temp. Regs.) and not start the depreciation process on the entire cost over MACRS 39 years, his annual depreciation expense available (assuming $100,000 land costs) is $31,047 in the year of the exchange and $29,492 thereafter. His tax practitioner decides to maintain two separate computations for this asset in order to achieve greater "up front" depreciation deductions. At the end of the recovery period, the same amount of depreciation will be realized from this transaction. Being able to "front load" this depreciation deduction in the early years, Mr. Downey receives the benefit of the time value of money and current tax savings. An illustration of the additional depreciation benefits is as follows:

	2005	2006	2007	2008	2009
Using dual depreciation	$33,429	$34,690	$34,690	$34,690	$34,690
Electing to have one asset	31,047	29,492	29,492	29,492	29,492
Difference	$ 2,382	$ 5,198	$ 5,198	$ 5,198	$ 5,198

Note. The $890,000 basis will be fully depreciated in 29 years. However, the $600,000 basis will be depreciated 39 years.

Automobiles

When trading one business auto for another business auto, claiming the proper amount of depreciation can be a challenge. The overriding principle is that the maximum allowable depreciation combined for both autos cannot exceed the luxury auto dollar cap limits under §280F. The luxury caps vary depending on the placed-in-service year and the recovery year. Generally, the combined depreciation allowance for a relinquished auto and a replacement auto is limited to the replacement auto's §280F limit for the year.

Note. These caps are shown in Chapter 14, "Tax Rates and Useful Tables," of this workbook.

Example 30. Johnny Johnson bought a used BMW in 2002 for $40,000. In March 2005, Mr. Johnson traded in his used BMW for a new 2005 Acura TL and paid the cash difference of $16,000. Both vehicles are used 100% in his business of installing satellite dishes in residential homes. The vehicles are depreciated under five-year MACRS using the half-year convention. No §179 deduction was claimed on either auto, and the used BMW was not qualified for bonus depreciation.

Under the guidance of IRS Notice 2000-04, the replacement's property's basis is treated as if it were two separate properties for depreciation purposes. The maximum available depreciation for a luxury car placed in service for the year 2005 is $2,960. To determine the overall depreciation available for the replacement auto, the taxpayer must compute the depreciation in the following order:

1. Compute the depreciation deduction for the relinquished auto exchanged. However, it cannot exceed the overall limitations of §280F. Since this is the fourth year of the BMW's depreciation, the amount allowable is $1,775.
2. Compute the bonus depreciation remaining, if any, on the auto being traded. In this case, the bonus depreciation is not a factor.
3. Compute the depreciation deduction on the remaining exchanged basis to the extent that the replacement auto's §280F limit or the relinquished auto's §280F limit (whichever is smaller) exceeds the sum of items 1 and 2. In this case, the limit is again $1,775, so no additional depreciation is available.
4. Compute the bonus depreciation on the remaining excess basis of the replacement auto, if any. In this case, the used BMW does not qualify for bonus depreciation.
5. Compute the depreciation deduction for the excess basis of the replacement auto to the extent that the replacement auto's §280F limit exceeds the sum of items 1, 2, 3, and 4. In this example, the maximum allowable depreciation for the replacement auto is $2,960, which is the maximum depreciation which may be claimed for both cars.

Note. Taxpayers can avoid these calculations by electing out of the temporary regulation, and treating the cost of the replacement vehicle as one purchase (adjusted basis of the trade-in plus the cash difference). In the absence of bonus depreciation, this may be the best solution for most taxpayers.

TENANT-IN-COMMON EXCHANGES

Rev. Proc. 2002-22 allows investors who sell relinquished property(s) to purchase tenant-in-common (TIC) ownership interests in replacement property(s). Since §1031 specifically forbids "partnership interest," there was reluctance on the part of QIs, attorneys, and accountants prior to the release of Rev. Proc. 2002-22 to provide advice on what seemed to be the purchase of a "partnership interest."

TIC ownership allows several investors to own an undivided, deeded interest in a single property. This form of ownership is a fairly recent innovation that enables the small investor to participate in the ownership of large, premium commercial and investment properties. This form of ownership is not a joint venture, partnership, or limited partnership. In a TIC, each investor owns an undivided, or fractional interest in the property. The owners are bound together under a management or operating agreement.

The provisions of Rev. Proc. 2002-22 do not state any minimum or maximum investment amount for a TIC investment. In practice, it appears that the minimum investment per TIC interest is approximately $250,000 and the average is in the $500,000 range. However, the IRS issued Letter Ruling 200513010 which outlines an overall ownership restriction cap of 35 persons, along with numerous other prerequisites for an "undivided fractional interest," or tenants-in-common interest.

All other provisions of §1031 apply to TIC exchanges. The only difference is the type of ownership interest, which prior to Rev. Proc. 2002-22 would have "stretched" the like-kind definition. For investors who want to maintain an investment in real estate, but do not want the responsibility of day-to-day property management, a tenant-in-common (TIC) exchange may be the right choice.

PROBLEM AREAS OF §1031

THE IMPROVEMENT EXCHANGE

In many instances, the exchanger's goal is to use an exchange to sell a given real estate property and to construct the replacement property. In other situations, the exchanger may wish to make improvements to the replacement property as part of the exchange. Treasury regulations specifically address these issues and provide special rules for identification and the receipt of the replacement property to be produced.[32]

Improvement (construction) exchanges are typically more complex than regular exchanges. In addition, the fees charged by most qualified intermediaries are usually higher for this type of exchange.

It is well established that an exchanger cannot build the replacement property on land that the exchanger already owns.[33] However, under §1033 (involuntary conversion) individuals are allowed to build on land they already own.

Improvements must be identified within the 45-day identification period, and the improvements must be done before the exchanger closes on the purchase of the replacement property. That is not to say that all the improvements must be completed prior to the closing, it simply means that if total tax deferral through §1031 is the goal, then sufficient value in the replacement property and improvements completed before the closing must exist to meet the value-for-value rule discussed earlier in this chapter.

Example 31. The 180-day replacement period expires one week from today. The replacement property consists of land purchased as part of the exchange for $300,000 and a building to be constructed at a cost of $800,000. The building is 40% complete at this time. The sales price of the relinquished property is $900,000. Taking into account the $300,000 that the exchanger has paid for the land and the $320,000 (40% × $800,000) value of the completed part of the building, the exchanger sells for $900,000 and purchases for $620,000. This results in a partially taxable exchange since the property acquired after the exchanger closed on the property, $480,000 (60% × $800,000), does not qualify as like-kind property.

Caution. While it is obvious that the replacement property to be constructed does not have to be finished prior to the exchanger closing on the purchase, it is clear that only the portion completed prior to the closing qualifies as like-kind. The taxpayer must time the sale of the relinquished property and the start of the construction of the replacement property to ensure sure that the value-to-value numbers are satisfied to achieve maximum tax deferral under §1031.

VACATION PROPERTIES

This area of §1031 theory causes a lot of confusion and disagreement among exchange consultants. IRC §1031(a)(1) specifically requires that a property be held "for trade or business" or "for investment" before that property can be considered for exchange treatment. Given the current high real estate appreciation rates in many areas and the surge in second home, resort, and vacation property purchases, the question often surfaces as to whether these properties qualify for exchange treatment. In other words, were these properties purchased for "investment" or were they purchased for the personal use of the owners?

While it may seem difficult to determine the real reasons for the purchase of these types of properties, Some commentators use the §280A rules of second home and vacation property. However, the IRS never officially ruled on taking this position nor does the Code or Regulations of §1031 make mention of this position. These rules are based on the number of days the property is used for rental and the number of days used for personal purposes.

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32. Treas. Reg.§1.1031(k)-1(e)1-4

33. *Bloomington Coca-Cola Bottling Co. v. Commr.,* 189 F.2d (CA7 1951), May 28, 1951

Under the vacation property rules, net losses are deductible if there is no personal use (rented only) or if the personal usage is kept to a minimum (14 day or 10% rule). Presumably, these properties qualify for §1031 treatment. On the other hand, §280A(d) provides that a taxpayer may not deduct losses for a dwelling unit used as a residence by the taxpayer during the year. §280A(d) provides that a taxpayer uses a dwelling unit as a residence if the taxpayer uses the unit for personal purposes for a number of days which exceeds the greater of 14 days, or 10% of the number of days during the year the dwelling unit is rented for market value. Presumably, these properties do not qualify for §1031 treatment.

Observation. It would be very difficult to argue that property is "held for investment" if the taxpayer has consistently deducted investment property mortgage interest on Schedule A as a qualified second residence instead of reporting the interest on Form 4952, *Investment Interest Expense Deduction.*

Note. Considering the high appreciation rates in many of the resort areas, two planning options exist. The first is to convert the second home or vacation property to a principal residence and eventually use the §121 gain exclusion. (Remember the new five-year holding period, if the property were acquired in an exchange.) The second is to eliminate all personal usage, or keep personal usage within the 14 day or 10% rule, so as to qualify the property for §1031 treatment.

DEALER OR FIXER-UPPER PROPERTIES

Many tax practitioners face this issue every filing season. Is the client a dealer or an investor? Without reviewing the taxes resulting from the two classifications, every practitioner knows that so-called "dealer" status carries a tax cost far in excess of that of an investor. One of those tax costs is the loss of §1031 treatment for property "held primarily for sale."[34]

Who is a dealer? There are no guaranteed situations or safe harbors that a taxpayer can rely on. However, over the years a list of criteria has been developed to assist in making the determination of dealer or investor:[35]

- The purpose for which the property was initially acquired
- The purpose for which the property was subsequently held
- The extent to which improvements, if any, were made to the property by the taxpayer
- The frequency, number, and continuity of sales by the taxpayer
- The extent and nature of the transactions involved
- The ordinary business of the taxpayer
- The extent of advertising, promotion, or other active efforts used in soliciting buyers for the sale of the property
- The listing of the property with brokers
- The purpose for which the property was held at the time of sale

As can be seen by the list of factors, the distinction between who is a dealer as opposed to an investor is clearly a subjective one and depends on the particular facts of each situation.

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34. IRC §1031(a)(2)(A)

35. *Klarkowski v. C.I.R.,* TC Memo 1965-328, March 30, 1965

The following two examples illustrate two possible scenarios.

Example 32. Karl is an architect who designs hospitals and other medical facilities on a full-time basis. He wants to acquire one or two properties each year to "fix up" and sell once necessary repairs are finished. Karl intends to use four workers from his brother's construction company to make the renovations. If Karl finds that this activity is successful, he hopes to start buying and renovating between six to eight properties each year. He asks his tax professional whether he will be allowed to defer the realized gain from the disposition of these initial properties by using the provisions of §1031.

Results. There is a good chance Karl would be considered a "dealer" who is selling "inventory." Therefore, the like-kind exchange rules of §1031 would not be available to defer any gain realized upon disposition.

Example 33. Bob and Sue are married. They want to buy a small seashore cottage, which is in need of extensive repairs. They plan to hold the property for investment, and may rent it periodically to others. They finish the repairs. Before they are able to rent the property, they are approached by a buyer who offers them twice what they originally paid for it. They ask their tax professional whether they can defer the gain realized on the property's disposition by using the provision of §1031.

Results. Bob and Sue could likely take advantage of the §1031 deferral provisions if all requirements are met.

COURT CASES

The following cases involve like-kind exchanges and may offer guidance in specific situations a tax professional may encounter.

☺ Held for Investment

Joseph R. Bolker v. Commissioner, 9th Circuit Court of Appeals, 85-1 USTC ¶9400, May 17, 1985

☹ Like-Kind and Timing Requirements

Florida Industries Investment Corporation and Subsidiaries, Petitioners-Appellants v. Commissioner, Respondent-Appellee, Like-kind exchanges: Recognition of gain or loss: Nonrecognition: Escrow agreements, US-CT-APP-11, 2001-1 USTC ¶50,334, (March 23, 2001)

☹ Disposition of Partnership Interest; Liquidation versus Sale

Emory K. Crenshaw, as Executor of the Estate of Francie Wood Wilson, Deceased v. United States of America, 5th Circuit Court of Appeals, 71-2 USTC ¶9698, October 22, 1971

☹ Timing Requirements

Terry D. Smith v. Internal Revenue, 4th Circuit Court of Appeals, 97-2 USTC ¶50,928, November 19, 1997

☹ Constructive Receipt

Keith K. Klein v. Commissioner, TC Memo 1993-491, 66 TCM 1115, October 26, 1993

☹ Sale versus Exchange

Emsy H. and Annie Swaim v. United States of America, U.S. District Court, Texas, Dallas Division, 79-2 USTC ¶9462, June 11, 1979

☹ Partnership Interest Sold of Exchanged

Estate of Rollin E. Meyer, Sr., Deceased; Rollin E. Meyer, Jr., Executor; and Henrietta G. Meyer, Surviving Wife v. Commissioner, 9th Circuit Court of Appeals, 74-2 USTC ¶9676, August 29, 1974

☹ Failure to Qualify

C. Bean Lumber Transport, Inc. v. United States of America, U.S. District Court, Arkansas, Hot Springs Division, 99-1 USTC ¶50474, March 1, 1999

☹ Constructed Property

Donald DeCleene and Doris DeCleene v. Commissioner, 115 TC —, No. 34, 115 TC 457, November 17, 2000