Chapter 4: Like-Kind Exchanges

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Corrections were made to this workbook through January of 2008. No subsequent modifications were made.

OVERVIEW

Under IRC §1031(a), **no gain or loss is recognized on the exchange of property held for productive use in a trade or business, or held for investment, if such property is exchanged solely for property of like-kind that is held either for productive use in a trade or business or for investment.** The primary benefit of the provision is that it allows taxpayers to sell their investment or business property and replace it with investment or business property without having to pay income and/or capital gains tax on the transaction. A tax-deferred exchange results in the postponement of gain or loss until disposal of the property acquired in the exchange.

Note. For sales after December 31, 2007, and before January 1, 2011, for property held more than one year, the capital gain tax rate is 0% for individuals in the 15% and lower tax brackets, and 15% for individuals in higher marginal brackets.[1]

Tax-deferred exchange treatment is available for real and personal property as well as intangible property, although the rules differ depending on the type of property involved.

1. Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)

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Example 1. This example compares two identical sales of investment property, side by side. On the left, the sale is conducted normally with capital gains tax triggered. On the right, the sale is structured as a like-kind exchange with the sale proceeds used to buy qualified replacement property.

Selling Investment Property without a 1031 Exchange			Selling Investment Property as a 1031 Exchange		
Selling price	$500,000	$500,000	Selling price	$500,000	$500,000
Less indebtedness		(350,000)	Less indebtedness		(350,000)
Balance		$150,000	Balance		$150,000
Original purchase price	(300,000)		Original purchase price	(300,000)	
Taxable gain	$200,000		Taxable gain	$200,000	
Combined federal and state capital gains tax rate	× 20%		Combined federal and state capital gains tax rate for qualified §1031 transaction	× 0%	
Capital gains tax due	$ 40,000	(40,000)	Capital gains tax due	$ 0	(0)
Net cash left for investment		$110,000	Net cash left for investment		$150,000
			Current tax savings		$ 40,000

Note. The above example does not include depreciation recapture or any potential AMT in the computation for the nonqualified transaction.

LOCATION OF REPLACEMENT PROPERTY

For exchanges involving real estate, the transferred property and the replacement property must be located in the United States and can be any type (commercial, residential, industrial, vacant land, agricultural, etc.) as long as the property meets the "held for" requirement. The code specifies that foreign real estate is not like-kind to domestic real estate, and the IRS ruled that property in the U.S. Virgin Islands is property within the United States.[2]

Example 2. Mary owns a rental home in Illinois and exchanges it for a parcel of vacant land in Kentucky. Later, Mary exchanges the land for a warehouse in Florida. Still later, Mary exchanges the warehouse for an undivided partial interest in an office tower in Chicago. Mary then exchanges her partial ownership of the office tower for total ownership of a local office building, which will be occupied in part by Mary's sole proprietorship, with Mary leasing the balance of the building for income. All of these transactions can be structured as qualified like-kind exchanges under IRC §1031.

When contemplating whether to sell an asset or to defer the tax using a like-kind exchange, consideration should be given to the impact of AMT on the taxpayer's total tax liability due to the recognition of capital gain on a sale. A large capital gain for ordinary income tax purposes may increase AMTI to the point that the AMT exemption is substantially reduced or eliminated.

2. Letter Ruling 9038030 (June 25, 1990)

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HANDLING ADJUSTED BASIS

From an overall tax and financial planning perspective, before entering into a tax-deferred exchange, the adjusted basis of the replacement property should be determined. **Like-kind exchanges result in tax-deferral, not tax elimination.** To preserve the deferred gain, the basis of the replacement property equals the basis of the property transferred, reduced by any cash received and any loss realized, and increased by any gain recognized (such as cash boot received).[3] Thus, when a tax-deferred exchange is used to defer gain from a sale, the gain is ultimately passed along to the replacement property. Gain is recognized when the taxpayer eventually sells and "cashes out." The basis of the replacement property is its purchase price less the gain previously deferred, less any further depreciation.[4]

Example 3. Ten years ago, Seth Poole bought an item of depreciable tangible personal property for use in his business. He paid $50,000 for the item and depreciated it at $1,666 per year for the last 10 years. Seth's current basis in the property is presently $33,334 ($50,000 – $16,666). Seth sells the property for $85,000 and exchanges into a property valued at $100,000. The substituted basis on the replacement property is $48,334 ($100,000 – ($85,000 –$33,334)). This is the replacement property price less the deferred gain.

If Seth later sells the property for cash, the amount of capital gain is determined by subtracting the costs of the sale and the substituted basis from the selling price. The balance is capital gain. If the sale price is $150,000, and qualified costs to Seth are $12,000, the capital gain in this example is $89,666 (($150,000 – $12,000) – $48,334).

CAPITAL GAIN VERSUS EQUITY

It is important not to confuse capital gain with equity. Equity is the amount of money that remains after selling the property and paying all related liabilities and mortgages.

Example 4. Five years ago, Maxwell bought a property for $200,000. It presently has a mortgage balance of $130,000, and a basis of $166,667. If Max sells the property for $400,000, paying $30,000 in closing costs and commissions, he has equity of $240,000 (($400,000 – $130,000) – $30,000). This is the amount of cash he receives at closing. However, Maxwell's capital gain on the property is the difference between basis and the adjusted selling price or $203,333 (($400,000 – $166,667) – $30,000). Unless this transaction is a tax-deferred exchange, capital gains tax is owed on the entire gain. A combined federal and state capital gain rate of 20% triggers a tax of $40,667, plus any potential AMT.

Note. Practitioners must be careful if the client refinanced the property after the original purchase. The client may wish to consider an exchange unless he has additional funds to pay the taxes.

Example 5. Grady buys a property for $100,000 with a mortgage of $70,000. Later, the property value increases to $210,000 and he refinances with a new mortgage of $140,000. If Grady sells this property for $210,000 and does not structure the transaction as a tax-deferred exchange, the $110,000 gain will require the federal tax payment of $16,500 (($210,000 – $100,000) × 15%). The larger the transaction and the more money and leveraging involved, the less after-tax cash is available to the taxpayer.

Observation. This is often the case with taxpayers in financial distress. They are forced to sell property to repay debt. Unfortunately, there is no money left to pay the tax on the gain resulting from the sale.

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3. IRC §1031(d)

4. The taxpayer's holding period for the replacement property includes the period during which the taxpayer held the relinquished property. In other words, the holding periods are tacked together.

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BASIS ALLOCATION

When a single property is exchanged for multiple like-kind properties in a tax-deferred exchange, the basis of the exchanged property is allocated to the properties received in proportion to the respective FMVs on the date of the exchange. If boot is involved in the transaction, the basis for the total property is computed and allocated to the individual assets received in the exchange. If a loss is involved, the loss is not recognized, but basis is allocated to the properties received in the exchange.[5]

Example 6. Adam Baum traded a bulldozer with a basis of $10,000 for another bulldozer worth $8,000 and received $1,000 cash. The $1,000 loss is not recognized, and the basis of the acquired bulldozer is $9,000 ($10,000 less cash received).

> **Note.** If property that is not depreciable personal property is received in an exchange, basis is first allocated to that property to the extent of its FMV, with any remaining basis then allocated to the depreciable personal property received in the exchange.

If both depreciable real property and other property are acquired in an exchange, the basis is allocated between each class of property in proportion to their respective FMVs. The FMV of depreciable real property for purposes of the allocation is reduced by the amount of the recapture income that is not recognized in the exchange. If multiple items of depreciable real property are acquired in the exchange, the basis is allocated between or among those properties in proportion to their relative FMVs. If recapture income is not recognized in an exchange of depreciable real property, the amount of unrecognized gain is treated as additional depreciation for the acquired property. The additional depreciation is allocated to the depreciable real properties in proportion to their adjusted basis if more than one item of depreciable real property is acquired in the exchange.

THE QUALIFIED INTERMEDIARY

DEFINITION

A qualified intermediary (QI) is an independent third party that helps facilitate a tax-deferred exchange. The QI enters into a written agreement, known as an exchange agreement, with the taxpayer. As required by an exchange agreement, the QI acquires the property rights of the taxpayer and transfers it to the buyer, then acquires the replacement property from the seller and transfers it to the taxpayer.[6]

RESTRICTED PARTIES

Generally, the following cannot be a QI:

- A person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within a 2-year period;
- Persons that have a direct lineal relationship with the taxpayer (i.e. taxpayer's parent, child, sibling, etc.); and
- Certain other parties, such as the owner of the relinquished property.

As such, it is common that the QI is an independent company that specializes in handling tax-deferred exchange transactions. Also, a disqualified person cannot own 10% of any QI used by his clients without also becoming disqualified. For example, if even so much as 10% ownership of a QI is held by a CPA or real estate agent, then that QI is considered a disqualified person for every client who has used that CPA or real estate agent in the last two years.

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5. Treas. Reg. §1.1031(c)(1)

6. The QI does not actually have to receive and transfer title when direct deeding is used.

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ROLE OF THE QUALIFIED INTERMEDIARY

The QI is the catalyst which transforms the ordinary purchase and sale of property into an exchange. The QI's duties typically include preparation of exchange documentation, holding of relinquished property in trust, and ensuring that the transaction complies with the safe harbor guidelines of the regulations.

Note. When two parties engage in a simultaneous exchange and the transaction is structured properly using a single escrow, a QI is not required.

ASSIGNMENT TO THE QUALIFIED INTERMEDIARY

In order for a 1031 exchange to qualify under the safe harbors, there must be a written agreement between the taxpayer and the intermediary. The agreement must state the taxpayer's intent to exchange and expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money or property held by the intermediary. With respect to the property, the intermediary can act as the agent of any party to the transaction. The intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to the agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. This provision allows a taxpayer to enter into an agreement for the transfer of the relinquished property (i.e., a contract of sale on the property), and thereafter to assign the taxpayer's rights in that agreement to the intermediary. Provided that **all** parties to the agreement are notified in writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as having entered into the agreement. Upon completion of the transfer, the intermediary is treated as having acquired and transferred the relinquished property.

Observation. In some states, purchase agreements prohibit assignment. In these states, the purchase agreement must contain an addendum that will allow assignment to a QI.

FUNCTION OF THE QUALIFIED INTERMEDIARY

The QI **does not** provide legal counsel or offer specific tax advice to the exchanger but usually performs the following services:

- Coordinate with the exchangers and their advisors in order to structure a successful exchange,
- Prepare the documentation for the relinquished property and the replacement property,
- Furnish escrow with instructions and documents to effect the exchange,
- Secure the funds in an insured bank account until the exchange is completed,
- Provide documents to transfer replacement property to the exchanger and disburse exchange proceeds at the closing,
- Hold the document of identification of replacement properties sent by the taxpayer,
- Submit a full accounting of the exchange for the taxpayer's records, and
- Submit a Form 1099 to the taxpayer and the IRS for any growth proceeds/interest earned by exchange funds and paid to the taxpayer.

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REPORTING THE TRANSACTION

Upon completion of a like-kind exchange, the transaction must be reported to the IRS utilizing Form 8824, *Like-Kind Exchanges,* whether or not the transaction triggers gain recognition or a loss. If no gain is recognized, Form 8824 indicates that the transaction is without tax consequences, and what the taxpayer's basis is in the relinquished property. Form 8824 must accompany the return for the tax year in which the relinquished property is sold, and must be filed with either Schedule D or Form 4797. For exchanges with related parties, Form 8824 must be filed for the two tax years immediately after the year of the exchange.

GENERAL PLANNING POINTS

From a planning perspective, clients can utilize a tax-deferred exchange in numerous contexts. Practitioners should consider the following possibilities for utilizing a tax-deferred exchange:

1. Property that has reached a plateau in value can be exchanged for a property that is improving in value.
2. Unproductive land can be exchanged for income-producing property.
3. Management-intensive properties can be exchanged for property requiring less involvement.
4. Distant properties can be exchanged for those located closer to the taxpayer's home.
5. A taxpayer can diversify or consolidate real estate holdings geographically or otherwise, which may help to reduce managerial burdens, lower maintenance expenses and/or provide greater opportunity for appreciation.
6. A run-down property can be exchanged for a newer property.
7. A property that has been fully depreciated can be exchanged for other property that can be depreciated.
8. A property can be exchanged for land which will be developed during the exchange period with exchange funds.
9. If the exchanged property is held until death, the decedent's heirs will receive a stepped-up basis.
10. An exchange can provide an opportunity to leverage the investment and obtain appreciation on a lender's funds (a tax-deferred exchange allowing ordinarily charged capital gains amounts to be applied to the purchase price of the replacement property).

Realistically, taxpayers should never have to pay taxes on their sale of trade or business property or property held for investment when they intend to reinvest the proceeds in like-kind property. To avoid all taxable gain, the following must apply:

1. The replacement property's fair market value must be equal to or greater than the fair market value of the relinquished property.
2. All the exchange proceeds from the sale of relinquished property must be used to acquire replacement property. As such, the equity in the replacement property must be equal to or greater than the equity in the relinquished property.
3. The replacement property debt must be equal to or greater than the relinquished property debt so as to avoid taxable gain due to debt relief.

If a taxpayer wants to take equity or cash from a property without paying tax, the taxpayer can encumber the relinquished property before an exchange or the replacement property after an exchange. But the IRS opposes equity being taken from relinquished property **in anticipation of** an exchange or from replacement property immediately following the exchange. While the IRS does not disapprove of pre-exchange financing, it must occur in advance of a taxpayer's contemplation of an exchange, rather than in anticipation of it. This is especially true if the refinancing has an independent economic significance from the exchange.

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BASIC REQUIREMENTS

There are four requirements for a tax-deferred exchange:

1. There must be an "exchange."
2. The property must be of a type that qualifies under IRC §1031.
3. The replacement property must be of a like-kind to the relinquished property.
4. Both the relinquished property and the replacement property must be held for productive use in a trade or business, or for investment.

EXCHANGE REQUIREMENT

Transaction Must Be an Exchange and Not a Sale

A tax-deferred exchange involves a reciprocal transfer of property for property by the same taxpayer. If the relinquished property is held by husband and wife as tenants by the entirety or as community property, the replacement property should also be held in the name of both spouses in equal shares. Also, if a taxpayer dies during the exchange period, the taxpayer's estate or trustee may complete the exchange.[7] The relinquished or replacement property can also be held in a revocable trust. However, care should be taken to avoid terminating grantor trust status during or immediately before or after an exchange because the termination results in a transfer to a new taxpayer. A sale of property followed by the purchase of qualifying replacement property is not a tax-deferred exchange. Selling property and subsequently buying replacement property does not qualify.

> **Note.** The taxpayer's intent to exchange does not mean an exchange actually occurred. The exchange must be structured properly. The courts consider the taxpayer's intent if the activities of the parties do not compel the conclusion that a sale occurred.[8] While there may be no practical difference between the substance of a sale and a reinvestment and the substance of an exchange of the properties, the tax treatment is obviously different. Under the regulations, a sale of relinquished property and the acquisition of replacement property can be converted into an exchange through an intermediary acting under the terms of an exchange agreement and within the provisions of a safe harbor.

Use of Exchange Funds

The code requires a written exchange agreement between the taxpayer and an intermediary. The agreement serves to protect the taxpayer from having constructive receipt of exchange funds during the exchange period. It expressly limits the taxpayer's rights to receive, borrow, pledge or otherwise receive the benefits of the money or property held by the intermediary during the period of the exchange. The funds can be used immediately towards completion of the exchange, but not for any other purpose during the exchange period.

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7. Rev. Rul. 64-161, 1964-1, C.B. 298

8. *Biggs v. Commissioner,* 632 F.2d 1171 (5th Cir. 1980); *Alderson v. Commissioner,* 317 F.2d 790 (9th Cir. 1963); *Barker v. Commissioner,* 74 TC 555 (1980).

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The taxpayer cannot receive funds held by the QI until **one of three events occurs:**

1. The 45-day identification period expires, and no identification was made (or property identification was revoked before the 45th day).
2. The taxpayer identifies property within the 45 days and closes on all identified properties.
3. The 180-day exchange period expires.

If the taxpayer receives funds from the QI before one of the three events occurs, the exchange **does not** qualify for tax-deferred treatment.

Safe Harbors

There are numerous ways to structure a tax-deferred exchange. Various treasury regulations establish safe-harbor procedures which include the use of a QI, direct deeding, the use of qualified escrow accounts for temporary holding of exchange funds, and other procedures. Therefore, it is desirable to structure exchanges so they are in harmony with the regulations. As a result, exchanges commonly employ the use of direct deeding and the services of a QI. Exchanges also occur without the services of a QI when parties to an exchange are willing to exchange deeds, or if they are willing to enter into an exchange agreement. However, 2-party exchanges are relatively uncommon since, in the typical exchange transaction, the seller of the replacement property is not the buyer of the taxpayer's exchange property.

QUALIFIED PROPERTY REQUIREMENT

Both the relinquished and replacement property must be property held for investment purposes or used in the taxpayer's trade or business. For real estate, it is immaterial whether the property is improved or unimproved, but it must meet the "held for" requirement.

Some property does not qualify to be part of a 1031 exchange, including:

- The taxpayer's personal residence, except perhaps that portion which is rented out or is the taxpayer's home office;
- Property purchased or held for resale;
- Land which is under development;
- Inventory property;
- Construction property held for resale;
- Securities or evidences of indebtedness;
- Certificates of trust or beneficial interests;
- A beneficial interest in a partnership;[9] and
- Stocks, bonds, or notes.

LIKE-KIND REQUIREMENT

Only like-kind property can be traded in a tax-deferred exchange. Property is considered like-kind if it is of the same nature or character, although not necessarily of the same grade or quality. Real property can be exchanged for real property, and personal property can be exchanged for personal property.[10] The like-kind standard is interpreted more narrowly when personal property is involved than when real property is being exchanged.

9. It is possible, however, to transfer an interest in a partnership to a second partnership as a contribution to capital with the taxpayer receiving an interest in the second partnership as a capital interest. See Rev. Rul. 84-115, 1984-2 C.B. 118.

10. Whether property is real or personal is generally determined by state law. See Tech. Adv. Memo. 200424001 (December 8, 2003).

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Rules for Personal Property and Intangibles

Under the regulations, depreciable tangible personal property held for productive use in a trade or business is considered exchanged for like-kind property if it is exchanged for property that is either like-kind or like-class.[11] In determining whether property meets the test of being like-kind, all facts and circumstances are considered.[12] Classes of depreciable personal property are provided for in the regulations.[13] Property is like-class to other depreciable tangible personal property if the exchanged properties are within the same general asset class or the same product class.[14] Under the regulations, a single property cannot be classified within more than one product class (or asset class), and the property's product class is determined as of the date of the exchange. The regulations also specify that other personal property (OPP), including intangible and nondepreciable personal property, can be exchanged only for OPP of a like kind.[15]

In defining depreciable tangible personal property of a like class, the regulations refer to 13 general asset classes of Rev. Proc. 87-56 and the 6-digit product classes listed in Sectors 31 through 33 (pertaining to manufacturing industries) of the North American Industrial Classification System (NAICS).[16] If a product is listed in more than one product class, the property is treated as listed in any one of those product classes.

The 13 general asset classes of Rev. Proc. 87-56 are:

- Office furniture, fixtures and equipment (.11);
- Information systems including computers and peripherals (.12);
- Data handling equipment except computers (.13);
- Airplanes, except those used in commercial or contract carrying of passengers or freight, and all helicopters (.21);
- Automobiles and taxis (.22);
- Buses (.23);
- Light, general-purpose trucks (.241);
- Heavy general-purpose trucks (.242);
- Railroad cars and locomotives, except those owned by railroad transportation companies (.25);
- Tractor units for use over-the-road (.26);
- Trailers and trailer-mounted containers (.27);
- Vessels, barges, tugs and similar water transportation equipment, except those used in marine construction (.28); and
- Industrial steam and electric generation and distribution systems (.4).

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11. Treas. Reg. §1.1031(a)-2(b)(1). Livestock of different sexes are not like-kind. *Rutherford v. Commissioner,* TC Memo 1978-505, December 21, 1978. Livestock of the same sex must be held for trade or business purposes or for investment (e.g., breeding purposes) and not primarily for sale. Poultry is not livestock.
12. The regulations do not define "depreciable tangible personal property." In addition, it is not clear to what extent state law governs the meaning of the term.
13. Treas. Reg. §1.1031(a)-2(c)
14. Treas. Reg. §1.1031(a)-2(b)
15. Ibid.
16. Treas. Reg. §1.1031 (a)-2(b)(2), effective August 12, 2004. The NAICS is published by the Office of Management and Budget and is available at www.census.gov/naics.

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Depreciable tangible personal property that does not fit within any of the classes listed above is classified into 4- or 6-digit product classes. These product classes were previously determined using the 4-digit codes contained in the Standard Industrial Classification (SIC) Manual. Transitional rules provide that properties within the same product classes based on the SIC Manual will be treated as property of a like class for transfers of property made by taxpayers on or before May 19, 2005. The NAICS codes are used to determine product classes for property transfers made on or after August 12, 2004, but taxpayers may apply the NAICS codes to transfers of property made by taxpayers on or after January 1, 1997, in tax years for which the period of limitation for filing a claim for refund or credit under IRC §6511 has not expired.

No like classes are provided for intangible personal property or nondepreciable personal property and an exchange of these properties qualifies for nonrecognition of gain or loss under IRC §1031 only if the properties are of a like kind.[17] 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, and also on the nature or character of the underlying property to which the intangible personal property relates.[18]

Rules for Real Property

For real property exchanges, the like-kind standard is extremely broad, and it is not necessary for exchange property to be income-producing.

> **Example 7.** April Schauer purchased unimproved residential lots and bare farmland near Oblong, Illinois. April derives no present income from the properties but anticipates that the lots and farmland will appreciate in value. April can exchange the properties for other like-kind property. For property held for investment, the longer the property is held the better the argument that the property qualifies for a tax-deferred exchange.

IRC §1031 requires a comparison of the exchanged properties to determine whether the nature and character of the transferred rights in and to the respective properties are substantially alike. Factors for consideration include the respective interests in the physical properties, the nature of the title conveyed, rights of the parties, and the duration of the interests.[19] While the definition of real property is generally determined by state law, there are exceptions. For example, a lease of 30 years or more is real property for tax-deferred exchange purposes, regardless of its characterization under state law.[20]

Oil, Gas, and Other Minerals

For exchanges of real property involving oil, gas, and mineral interests, the production payment part of the interest is usually considered personal property that is not like-kind to a real property interest. However, the royalty part of the interest is typically considered a real property interest that is like-kind to any other real property interest. The primary distinction between the two types of interests is their duration. A royalty interest continues until the mineral deposit is exhausted, but a carved-out oil production payment right usually terminates when a specified quantity of minerals has been produced, or a stated amount of proceeds from the sale of minerals has been received.

Timberland

An exchange of timberland for bare land is a like-kind exchange, but the right to remove standing timber for a limited period is not like-kind to timberland or other real property. The IRS ruled that two timberland tracts are like-kind even though they differ in quantity, quality, kind, age, and timber species.[21] However, an exchange of timber that was removed from the land shortly after the exchange for timber and land is not a like-kind exchange.[22]

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17. Treas. Reg. §1.1031(a)-2(c)(1)

18. For example, the IRS ruled that an FCC radio license is like-kind to an FCC television license. See Tech. Adv. Memo. 200035005, (May 11, 2000).

19. *Koch v. Comm'r,* 71 TC 54 (1978)

20. A 25-year lease with 3- to 10-year renewal options exercisable by the taxpayer is also like-kind to a fee. Rev. Rul. 78-72, 1978-1 C.B. 258.

21. Rev. Rul. 72-515, 1972-2 C.B. 466

22. Letter Ruling 9525002, (February 23, 1995)

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Water Rights

Perpetual water rights are like-kind to a fee interest in real estate.[23] If the rights are limited in duration or amount under state water law, they are not like-kind to a fee interest in real estate.[24] Water rights that are limited in quantity to a specific amount per year rather than limited in quantity to a specific percentage of the overall supply of water and are otherwise perpetual rights are like-kind to a fee interest.[25]

Unharvested Crops

For purposes of IRC §1031, unharvested crops are generally considered trade or business property rather than inventory.[26] Provided an unharvested crop is considered real property under state law, an exchange of farmland for other real property should occur **before** harvest to allow the taxpayer to exchange the unharvested crop, and avoid its potential classification as inventory taxed at ordinary income rates.

Land Sold on Contract

Contracts for real estate are considered real property for IRC §1031 purposes. Both the seller and the buyer may exchange land sold on contract for other real property at the time the land contract is executed, but not after it is paid off and the deed is recorded. The party holding an interest in real property for purposes of the tax-deferred exchange rules has the economic bundle of rights, but this is not necessarily the party that holds legal title. Because the buyer under an installment land contract is entitled to possession and beneficial ownership, the benefits and burdens of ownership under the contract have shifted to the buyer.

Partial Interests

For partial interests in real estate, a remainder interest is like-kind with another remainder interest and is also like-kind with a fee interest. A fee interest is like-kind with a life estate lasting at least 30 years. However, the granting of a life estate in exchange for a remainder interest is treated the same as the grant of a leasehold, and the remainder interest received is advance rent income, not like-kind property. Nevertheless, when the lease is for less than 30 years, but is renewable and contains below market rent, the IRS may view the lease as longer than a 30-year lease that is like-kind to a fee simple interest.[27]

Partitioned Interests

Under the regulations, gain or loss on the exchange of property is not recognized if property is exchanged for property that is the same in kind or extent.[28] Therefore, a partition is a tax-deferred exchange, unless a debt security is received or boot (unlike property) is involved.

IRC §1031 applies to the partition of undivided interests in **multiple** properties by tenants-in-common. However, a partition of a **single** parcel constitutes a severance of a joint tenancy rather than an exchange. For example, heirs can rearrange ownership interests to equalize tract values among themselves, or redraw boundary lines in a tax-deferred manner.

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23. Rev. Rul. 55-749, 1955-2 C.B. 295

24. *Wiechens v. United States,* 228 F. Supp. 2d 1080 (D. Ariz. 2002)

25. Letter Ruling 200404044 (October 23, 2003)

26. See IRC §1231(b)(4). Thus, the parenthetical exclusion of IRC §1031(a) for stock in trade or other property held primarily for sale does not apply.

27. See Letter Ruling 9126007 (March 27, 1991). See also Rev. Rul. 57-244, 1957-1 C.B. 247 (lease with initial five-year term and ten optional renewal periods of five years each was like-kind to a fee).

28. Treas. Reg. §1.1001-1(a)

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Example 8. Siblings Barb, Bill, and Betty each inherit a 1/3 undivided interest in three properties of equal value. In a partition, Barb, Bill, and Betty each exchange their 1/3 interest in each property for a 100% interest in one of the three properties. The transaction qualifies as a tax-deferred exchange and can be structured using a QI, or as a multiparty exchange, or a circular exchange.

Tenancy-In-Common (TIC) Arrangements

With TIC arrangements, the biggest concern is whether the IRS will treat the TIC arrangement received as replacement property, as an interest in real estate, or as a partnership. The guidelines in Rev. Proc. 2000-22 have become a safe harbor for structuring TIC interests that can be acquired as replacement property in a like-kind exchange. From those guidelines, the following are the essential elements in ensuring that a TIC arrangement is not a partnership:

- Each of the co-owners must hold title to the property as a tenant in common under local law. This means only a disregarded entity, such as a grantor trust,[29] may hold title. Title should not be held by a partnership even if it elects out of partnership status.
- Avoid the appearance that a joint venture or partnership exists by not filing a partnership return; conducting business under a common name; or executing an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity.
- Owners of the TIC interests must retain approval rights over the most important issues that impact their property (i.e., hiring of a manager, sale or other disposition of the property, any lease of the property, creation of liens, etc.).
- The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

Note. If the property is sold, any debt secured by a blanket lien must be satisfied, and the remaining sales proceeds must be distributed to the co-owners. Any retention of profit or debt by one of the co-owners would indicate the existence of a partnership.

As a consequence of these key elements, TIC arrangements are commonly structured either as a long-term triple-net lease of the property to a tenant, or as an arrangement whereby rent is paid by the tenants to the co-owners, and a property manager is hired to operate the property. Under the triple-net lease approach, the master lessee subleases the property to the tenants who are actually using the property. The rent paid to the co-owners is either a flat rent or is based on gross receipts, and the master lessee profits from the spread between the rent paid to the co-owners and the rent received from the actual tenants in the property. Under the property manager approach, a master lease is not utilized and the property management agreement must be renewed periodically (at least annually).

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29. The IRS ruled that a Delaware statutory trust is an investment rather than a business trust. Rev. Rul. 2004-86, 2004-2 C.B. 204. A Delaware statutory trust is an unincorporated association that is recognized as an entity separate from its owners against which creditors may not assert claims directly. The trust may sue or be sued in its own name and the trust property is subject to attachment or execution just as if the trust were a corporation. As such, the IRS ruled that beneficiaries of such a trust are considered to hold an undivided fractional interest in the property held by the trust. Thus, an exchange of real property through a QI is an exchange of real property for real property and not the exchange of real property for a certificate of trust.

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Easements

The IRS ruled on several occasions that a perpetual conservation or agricultural easement is an interest in real estate that is like-kind to a fee interest in real estate.[30] The key is how state law views easements. In many states, an easement is synonymous with a restrictive covenant and is an interest in real estate. On a similar note, an interest in an Illinois land trust is treated as personal property under state law, but the trust holds title to the land in the trust. Typically, the trustee can only deal with title to the land, and the trust usually reserves the exclusive use of the land to the grantor. As such, the IRS ruled that an interest in such a trust can be exchanged for real estate because the IRS views the taxpayer as trading the underlying land and not the interest in the trust.[31]

Conservation easements are universally classified as real estate, and the IRS ruled that an exchange of conservation easements for a fee interest is a like-kind exchange. In one situation, the taxpayer used a lawyer as an intermediary because one of the parties was the government, who cannot enter into a like-kind exchange.[32]

Dealer Properties

While the general rule is that all real property is like-kind to any other type of real property as long as it is held for investment or use in a trade or business, the rule does not apply for real estate that is held for sale or as inventory. This is an important distinction for "dealer properties."

> **Note.** Persons, who in their ordinary course of business, develop land for resale, or construct buildings or homes for resale, cannot utilize IRC §1031. For a developer or contractor, lots and buildings are considered inventory. While developers and contractors are not entirely barred from utilizing IRC §1031, the properties they exchange must be segregated from their development or contracting business.

Taxpayers that purchase apartment complexes with the intent of selling them to current occupants as condominiums also cannot utilize IRC §1031. The IRS views the acquisition of the apartment complex as being for resale. Likewise, the IRS takes a dim view of the so-called "fix and flip" transactions in which the taxpayer buys homes with the intention of improving them and immediately lists them for resale at a profit. These transactions do not qualify for tax-deferred exchange treatment because they are held for resale and not for investment purposes. Although if the properties are rented for a certain amount of time (or held for appreciation), they would qualify for tax-deferred exchange treatment.

Options

An option is generally considered a contract right that is an interest in real property. Some states have statutes that specify a contract right is an interest in real property. If no such state statute exists, the treatment of options under federal law controls for purposes of IRC §1031. In *Starker*,[33] the court acknowledged that an option is personal property but also stated that a contractual right should not be treated as a different ownership interest than the real property itself. In Rev. Rul. 84-121, the IRS also indicated that they deem options in real estate to be real property.

Condemnation

If real estate is sold to a governmental entity under threat of condemnation, consider whether the sale qualifies for IRC §1033 treatment instead of IRC §1031. Section 1033 allows for relaxed treatment for exchanges out of properties that are to be condemned.

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30. Letter Rulings 200201007 (October 2, 2001), 200203033 (October 18, 2001), 200203042 (October 18, 2001), 9621012 (February 16, 1996)

31. Rev. Rul. 92-105, 1992-2 C.B. 204 (taxpayer, as beneficiary, retained exclusive control of the management, operation, renting, and selling of the property and was required to file all tax returns, pay all taxes, and satisfy all other liabilities with respect to the real property although legal title was held by the trustee)

32. Letter Ruling 9232030 (May 12, 1992)

33. *Starker v. United States,* 602 F.2d 1341 (9th Cir. 1979).

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CONVERSION OF REAL ESTATE INVESTMENT PROPERTY TO PERSONAL USE

A qualifying investment property that is acquired in a tax-deferred exchange can be converted to personal use. While there is no specific holding period requirement, the conversion from investment to personal use should not occur until an extended period of time (probably at least two years) has passed between the conclusion of the exchange and subsequent conversion. If personal use is mixed with an investment return from the property, the like-kind treatment is not lost. Acquiring such property for the sole purpose of personal use would not qualify for a like-kind exchange.

Example 9. Bill trades farmland that he uses in his farming operation for other agricultural land. The property he is acquiring has tillable land enrolled in the conservation reserve program (CRP) with the balance in timber. Bill agrees to continue the land's enrollment in the CRP and also uses the property for hunting. Even if the hunting use is solely for Bill (i.e., Bill doesn't lease the property for hunting) the exchange still qualifies for tax-deferred status. Bill is deemed to hold the acquired property for investment or business purposes.

If qualifying investment property acquired in a tax-deferred exchange involves a residence that is later converted to personal use, the taxpayer can, at a later date, exclude gain on the sale of the personal residence under the IRC §121 exclusion. However, when a residence is acquired in a tax-deferred exchange, the sale of the residence cannot qualify for the IRC §121 exclusion if the sale occurs within five years of its acquisition.[34]

PARTNERSHIP INTERESTS

A partnership interest is not a property interest considered eligible for a tax-deferred exchange.[35] The partnership, as an entity, can sell and reinvest property in a tax-deferred exchange. However, a partner cannot sell a partnership interest in a tax-deferred exchange. The partnership interest is a capital asset, and it is not eligible like-kind property. The same is true for a multimember LLC interest because it is considered a partnership for federal tax purposes.

Partners seeking to exchange out of partnership property into separately-owned replacement properties should consider liquidation of the partnership and distribution of partnership shares to the partners as tenants-in-common.

Note. A final partnership return should be filed to confirm that the partnership has been concluded. A deed should be executed and recorded to transfer the partnership property to the former partners. Other partnership assets should be transferred to the former partners individually, and leases should be assigned from the partnership to the former partners as tenants-in-common. Preferably, these steps should be taken **before** the exchange and **before** the execution of a contract for sale of the relinquished property. A contract for sale should be executed by the former partners in their capacities as tenants-in-common.

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34. The provision is applicable for sales after October 22, 2004.

35. IRC §1031(a)(2)(D)

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Co-Ownership

Co-ownership, in some instances, may be deemed a partnership. In 2002, the IRS issued Rev. Proc. 2002-22[36] specifying 15 conditions that must be met for a like-kind exchange involving co-owned property.[37] If the conditions are satisfied, the transaction is not treated as involving a partnership interest and qualifies for like-kind exchange treatment.[38]

Note. The key is that the owners of real property not hold themselves out as engaged in a joint venture or partnership. The co-owners must not:

1. File partnership or corporate tax returns;
2. Conduct business under a common name;
3. Execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity; or
4. Hold themselves out as partners, shareholders, or members of a business entity.

It is also critical that the co-owners retain approval rights over important issues that affect the property.

HOLDING REQUIREMENT

THE INTENT ISSUE

Tax-deferred exchange treatment occurs when the taxpayer relinquishes property that was held for use in a trade or business or for investment purposes, and the replacement property is of a like kind and is also held either for investment or for use in trade or business. However, the statute is silent about **how long** the relinquished and replacement properties must be held to satisfy the **holding requirement.** What is clear is that if the taxpayer acquires the relinquished property immediately before the exchange or disposes of the replacement property immediately after the exchange, the holding requirement of IRC §1031(a) is not met.[39] Thus, the taxpayer's intent in holding the exchange properties is key.

The courts tend to consider whether the relinquished property was "held for investment or for use in a business," and whether the replacement property also meets the "held for" test.[40] Clearly, acquiring property in an exchange which is then immediately fixed-up and sold does not meet the "held for" test.[41] Similarly, based on the facts of the case, the IRS may argue that the transaction really involved the intent to make a gift and that the property was not held for investment or for use in a trade or business.[42]

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36. Rev. Proc. 2002-22, 2002-1 C.B. 733

37. The IRS also noted that it was removing the provision signaling that rulings would not be issued in that area. Later, in Letter Rulings 200625009 and 20065010 (March 1, 2006), the IRS approved a two-person tenancy in common arrangement under Rev. Proc. 2000-22, and modified some of the 15 guidelines set forth in the revenue procedure.

38. Under Treas. Reg. §§1.761-1(a) and 301.7701 through 301.7701-3, a partnership for federal tax purposes does not include co-owned property where the owners' activities are limited to keeping the property maintained and leased.

39. See Rev. Rul. 75-291, 1975-2 C.B. 332; Rev. Rul. 77-297, 1977-2 C.B. 304; Rev. Rul. 84-121, 1984-2 C.B. 168. Two other rulings have focused on the replacement property in a corporate formation/liquidation context. See Rev. Rul. 75-292, 1975-2 C.B. 333; Rev. Rul. 77-337, 1977-2 C.B. 305.

40. *Loughborough Development Corp. v. Comm'r,* 29 B.T.A. 95 (1933); *Barker v. United States,* 668 F. Supp. 1199 (C.D. Ill. 1987); *Neal T. Baker Enterprises, Inc. v. Comm'r,* TC Memo 1998-302, August 19, 1998; *Bolker v. Comm'r,* 760 F.2d 1039 (9th Cir. 1985)

41. *Black v. Comm'r*, 35 TC 90 (1960); *Bernard v. Comm'r,* TC Memo 1967-176, August 29, 1967; *Klarkowski v. Comm'r,* TC Memo 1965-328, December 30, 1965

42. *Wagensen v. Comm'r,* 74 TC 653 (1980); *Click v. Comm'r,* 78 TC 225 (1982)

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> **Note.** Other than for a primary residence, any taxpayer can claim to be in real estate to make money as an investor. Clearly, significant or substantial personal use of a property can be deemed to override the **held for investment requirement.** Nevertheless, there are some key factors that indicate the property is held for investment. For example, if the taxpayer anticipates a cash flow from the property, or is seeking appreciation in its value, the property is held for investment.

Partnership Transactions

The taxpayer bears the burden to prove the requisite intent.[43] The question of whether the requisite intent is satisfied often arises in the context of exchanges involving partnerships. For example, under the so-called "drop and swap" transaction, a partner receives a distribution of an undivided fractional interest in real property held by the partnership, and shortly thereafter, relinquishes the property in an attempted tax-deferred exchange. The distribution from the partnership is usually tax-deferred under IRC §731(a)(1). However, the real question is whether the partner held the relinquished property (the property received in the "drop") for investment or for use in a business. Under a swap and drop transaction, the partnership exchanges the real property first and then distributes the replacement property to the partner. That raises the question of whether the partnership held the replacement property (the property received in the "swap") for investment or for use in a business during its brief period of ownership.[44]

Along with the issue of intent, another issue is presented by IRC §1031(a)(2)(D), which provides that a partnership interest does not constitute replacement property. The IRS could argue (under a step-transaction theory) that a swap and drop transaction really involves the acquisition of a partnership interest as replacement property — the seller of the replacement property transferred that property to a partnership with a subsequent transfer of the property interest to the taxpayer. The courts, though, have not agreed with the step-transaction doctrine in this context. Instead, the courts noted that actually real property is exchanged for real property, and the subsequent drop of the replacement property into another entity should be tested separately for tax purposes.

Summary

Several conclusions can be drawn:

1. Taxpayers intending to acquire the relinquished property immediately before the exchange or to dispose of the replacement property immediately after the exchange are at risk of IRS challenge.
2. Disposing of replacement property immediately after the exchange is riskier than acquiring relinquished property immediately before the exchange.
3. Taxpayers involved in a drop and swap or swap and drop transaction must be careful to structure and complete the transactions properly.

OTHER REQUIREMENTS

The same taxpayer that sells the relinquished property must buy the replacement property. If a husband and wife own property as tenants-in-common or in joint tenancy, the replacement property must be deeded to both spouses, either as tenants-in-common or joint tenants. Corporations, partnerships, LLCs, and trusts must also be on title to the replacement property the same way they were on the relinquished property, except in the case of disregarded entities. This matter is usually very straightforward for any one entity, individual or married couple. However, some transactions may present certain challenges to using identical ownership vesting.

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43. *Land Dynamics v. Comm'r,* TC Memo 1978-259, July 12, 1978

44. *Maloney v. Comm'r,* 93 TC 89 (1989)(corporation exchanged investment property for other investment property and one month later liquidated and distributed the replacement property to its shareholder; exchange qualified under IRC §1031(a)); *Magneson v. Comm'r,* 753F.2d 1490 (9th Cir. 1985)(taxpayer received undivided 10% interest in investment property and immediately contributed the interest to a partnership for a 10% general partnership interest; exchange qualified); *Chase v. Comm'r,* 92 TC 874 (1989)(drop and swap transaction did not qualify for exchange treatment because taxpayer had no property to relinquish in the exchange).

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DEPRECIATION RULES[45]

GENERAL RULE

IRS Notice 2000-4 provides mandatory depreciation rules for MACRS property acquired on or after January 3, 2000, and on or before February 27, 2004, in a like-kind exchange (or in an involuntary conversion). For property acquired after February 27, 2004, the regulations under IRC §168 control the method and manner of depreciating MACRS property acquired in a like-kind exchange.[46]

Note. Taxpayers are allowed to apply the new IRC §168 regulations retroactively to transactions in open tax years.[47]

Before the IRS issued Notice 2000-4, when property was acquired in a like-kind exchange (or involuntary conversion), the remaining basis in the relinquished property was added to any new basis in the acquired property, with the total being depreciated over the life of the acquired property. However, under Notice 2000-4, MACRS property acquired in a like-kind exchange is treated as having two cost components for depreciation purposes — the **old basis** and the **new basis.** The old basis is the remaining basis from the relinquished property which continues to be depreciated over the remaining recovery period of the relinquished property, using the same depreciation method and convention used for the relinquished property. The new basis is the boot paid in the exchange. This is required to be separately depreciated as newly purchased MACRS property.

Note. While there are two cost components for depreciation purposes, the asset continues to have a single adjusted cost basis for purposes of calculating any gain or loss on disposition.

Example 10. Tom Tiller purchased a new tractor in August 2006 at a cost of $80,000. Tom did not purchase any other assets during the tax year and did not claim expense method depreciation. Thus, his depreciation for the tractor for 2006 is $8,568 ($80,000 × .1071). In January 2007, Tom trades the tractor for a new tractor, paying $15,000 boot. Tom makes no other acquisitions during the year and does not elect expense method depreciation.

2006 depreciation	$ 8,568
2007 depreciation ($80,000 × .1913)	15,304
Total	$23,872
2007 depreciation on new tractor ($15,000 × .1071)	1,607
Total	$25,479

Observation. Tax practitioners must determine how to link the different components of the same asset following a trade. It may be helpful to renumber or reorder the old asset in order to bring it to the current location of the new asset on the depreciation schedule. In addition, the asset may need to be relabeled.

45. This section is drawn largely from the *2006 Tax Manual,* prepared by Orville W. Bloethe, A. David Bibler, and Lee E. Wilmarth, for the 2006 Bloethe Tax School, Des Moines, Iowa.

46. The final regulations are effective for exchanges occurring after February 27, 2004, Treas. Decision 9314, 2007-14 IRB 845. The final regulations are largely the same as the proposed regulations, but with some minor changes.

47. Temp. Treas. Reg. §1.168(i)-6T(k)

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ASSETS OTHER THAN PASSENGER VEHICLES

The depreciation rules established by the notice and the regulations specify one special set of rules for trades of passenger vehicles. For traded assets other than passenger vehicles, the depreciation rules take the form of a four-step process that can be illustrated as follows:

Step 1. Calculate one-half year disposition depreciation on the traded (relinquished) asset before determining eligible basis for depreciation. Only boot paid is eligible basis for an IRC §179 election.

Eligible basis for depreciation = Remaining basis of traded asset + boot paid for replacement asset – IRC §179 election

Step 2. Determine IRC §179 expense election amount and reduce basis.

Step 3. Apply depreciation rules of Temp. Treas. Reg. §1.168(i)-6T(i) to remaining basis of relinquished asset:

Exchanged Assets	Depreciation Rules
Same MACRS recovery period and **same or faster** depreciation method	(a) General rule: Follow rules promulgated under Notice 2000-4; **or** (b) Elect out of rules: Temp. Treas. Reg. §1.168(i)-6T(i)
MACRS recovery period of replacement asset **shorter** than traded asset and **same or faster** depreciation method	(a) General rule: Follow rules promulgated under Notice 2000-4; **or** (b) Elect out of rules: Temp. Treas. Reg. §1.168(i)-6T(i)
MACRS recovery period of replacement asset **longer** than traded asset and **same or slower** depreciation method	(a) Depreciate exchanged basis using the **slower depreciation method over the remainder of the longer period** that would have applied had the longer recovery period been in effect when the traded property was acquired; **or** (b) Elect out of rules: Temp. Treas. Reg. §1.168(i)-6T(i)

Step 4. Depreciate remaining boot basis as of date of acquisition using the regular IRC §168 recovery periods, depreciation methods, and conventions.

Observation. The like-kind exchange depreciation rules do not impact the determination of required usage of the mid-quarter convention.

Note. An election out of the procedures of the temporary treasury regulations can be made. If the election is made, the entire basis of the replacement asset (reflecting both the remaining adjusted basis of the relinquished property and any boot paid) is depreciated using the recovery period for the replacement asset. Depreciation begins on the date the replacement property is placed in service. The election out is made on an asset-by-asset basis by the due date (including extensions) of the return for the year of replacement. A notation must be placed at the top of the return of Form 4562, *Depreciation and Amortization,* stating **"Election Made Under Section 1.168(i)-6T(i)."**

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> **Observation.** While electing out of the depreciation rules may seem the simplest or easiest route to compliance, electing out produces the slowest and smallest depreciation expense deduction per year when compared to other acceptable methods.

Example 11. On September 1, 2007, John trades two combines and acquires a larger JD 9660 STS combine. He pays $90,000 boot in addition to the traded combines. The combines that John trades in this transaction have an FMV of $70,000 on September 1, 2007.

Temp. Treas. Reg. §1.168(i)-6T)(i) Election

Date	Property	12/31/06 Accum. Depr. Using MACRS 7-Yr. 150% DB	2007 Depr. Using ½-Yr. Disposition	Remaining Basis
10/01/2002	JD 9510 combine (trd 10/03): $85,859 cost	$59,560	$ 5,259	$ 21,040
10/01/2003	JD 9550 combine: $21,000 boot	11,995	1,287	7,718
	Subtotal	$71,555	$ 6,546	$ 28,758
9/01/2007	JD 9660 STS combine: $90,000 boot + $28,758		12,724	77,276
	Total		$19,270	$106,034

Basis in new combine is $118,758 ($90,000 boot + old basis):

Notice 2000-4
Like-Kind Exchange Rules Apply

Date	Property	12/31/06 Accum. Depr. Using MACRS 7-Yr. 150% DB	Actual 2007 Depr.	Remaining Basis
10/01/2002	JD 9510 (trd 10/03): $85,859 cost	$59,560	$10,518	$15,781
10/01/2003	JD 9550 combine: $21,000 boot	11,995	2,537	6,468
	Subtotal	$71,555	$13,055	$22,249
9/01/2007	JD 9660 STS combine: $90,000 boot		9,643	80,357
	Total		$22,698	$102,606

GENERAL ELECTIONS **PAGE 1**

ELECTION TO NOT APPLY LIKE-KIND EXCHANGE REGULATIONS

PURSUANT TO REGULATION SECTION 1.168(I)-6T(I), THE TAXPAYER HEREBY ELECTS TO NOT APPLY THE PROVISIONS OF REGULATION SECTION 1.168(I) FOR THE FOLLOWING PROPERTY OR PROPERTIES:

DESCRIPTION OF PROPERTY: JD 9510 COMBINE
COST OR BASIS OF PROPERTY: $85,859
DATE PLACED INTO SERVICE: 10/01/2002
DATE OF EXCHANGE: 9/1/2007

DESCRIPTION OF PROPERTY: JD 9550 COMBINE
COST OR BASIS OF PROPERTY: $21,000
DATE PLACED IN SERVICE: 10/01/2003
DATE OF EXCHANGE: 9/1/2007

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HANDLING DEPRECIATION FOR TRADED PASSENGER VEHICLES

Under the regulations, if the replacement vehicle is subject to the IRC §280F luxury auto limitations, the overall vehicle depreciation limit for the acquisition year (traded and replacement vehicle) is the limit in effect on the date the replacement vehicle is placed in service. This applies to both the traded vehicle and the replacement vehicle. Therefore, 2007 limits apply to 2007 acquisitions.

The depreciation for the **relinquished vehicle** for the year of disposition is limited to the traded vehicle's IRC §280F allowable amount for the current year, as if the transaction had not occurred. For the **replacement vehicle,** the limit is the depreciation expense claimed on any remaining basis from the traded asset plus additional boot paid. The depreciation is limited to the remaining overall IRC §280F depreciation limit for the year of acquisition after reduction by year of disposition depreciation on the traded vehicle. This applies whether regular depreciation or expense method depreciation is used.

Example 12. Willie purchased a car in 2004 for $30,000. In 2007, he exchanged the car plus $15,000 cash for a new vehicle. No IRC §179 allowance or additional first-year bonus depreciation was claimed on the vehicle purchased in 2004. Willie used the vehicle 100% for trade or business purposes in 2004. Willie depreciated the vehicle using the 200% declining balance method and the half-year convention. Willie's annual depreciation deduction on the purchased vehicle is shown below.

Year	Annual Limit	Depreciation Deduction	Deduction Limitation
2004	$2,960	$6,000	$2,960
2005	4,800	9,600	4,800
2006	2,850	5,760	2,850
2007	1,675	3,878	1,675

Each deprecation deduction is computed using 40% as the double declining balance rate for 5-year property. Fifty percent is used to reflect the half-year convention in the acquisition year and trade-in year. The computations are as follows:

- 2004 (year of acquisition): $30,000 × 40% × 50% = $6,000
- 2005: $24,000 × 40% = $9,600
- 2006: $14,400 × 40% = $5,760
- 2007 (trade-in year): ($30,000 – $2,960 – $4,800 – $2,850) × 40% × 50% = $3,878

In accordance with Temp. Treas. Reg. §1.168(i)-6T(e), the deduction in the year of the relinquished vehicle's disposition is determined by multiplying the "unadjusted depreciable basis" by the recovery percentage for the year of disposition. The product is then multiplied by .50 under the half-year convention.

The exchanged basis of the replacement vehicle is calculated by reducing the original cost of the acquired vehicle by the depreciation actually allowed on the replacement vehicle before the trade-in, plus any boot paid. Therefore, the exchanged basis of the replacement vehicle in 2007 is $32,715. This is computed as follows:

Original purchase price	$30,000
Plus: cash (boot)	15,000
Less: annual limit 2004	(2,960)
Less: annual limit 2005	(4,800)
Less: annual limit 2006	(2,850)
Less: annual limit 2007	(1,675)
Exchange basis	**$32,715**

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The depreciation deduction for 2007 on the replacement vehicle would be $6,543 ($32,715 × 40% × 50%). However, it is limited to $3,060 (under IRC §280F) less the depreciation allowed on the relinquished vehicle in 2007 before the exchange. Thus, the depreciation deduction claimed on the exchanged basis of the replacement vehicle in 2007 is $1,385, computed as follows:

Depreciation deduction limit	$3,060
Less: deduction allowed for 2007	(1,675)
Depreciation deduction claimed	**$1,385**

As of the end of 2007, the adjusted depreciable basis of the replacement vehicle is $31,330.

Note. An election out of the above rules can be made when dealing with the like-kind exchange of a passenger vehicle subject to the IRC §280F limitations. The election out simplifies reporting of the transaction and usually provides the highest overall amount of depreciation expense for the year of the exchange and subsequent years.[48] The election out may also be important if a taxpayer trades a passenger vehicle (subject to the auto depreciation limits) for a vehicle with a gross vehicle weight of more than 6,000 lbs. If the election out is not made, the general depreciation rule for passenger vehicles applies. As a result, the depreciation caps continue to apply to the remaining adjusted basis of the traded vehicle. If the election out is made, the remaining adjusted basis of the traded vehicle is no longer subject to the IRC §280F depreciation limits.

Observation. For Notice 2000-4 reporting purposes, only vehicles utilized in the current tax year should be listed on Form 4562, Part V.

Vehicle Trades — Excluded Transactions

The §280 rules do not apply to:

1. Exchanges involving traded (relinquished) assets that are not depreciated under MACRS, and
2. Exchanges involving relinquished vehicles when the taxpayer used the standard mileage rate to calculate vehicle deductions.

OTHER DEPRECIATION ISSUES

For deferred exchanges, when disposition of property occurs before the acquisition of the replacement property, the taxpayer is not allowed depreciation on the relinquished property for the period between disposal and acquisition. Also, if the replacement property is acquired before the disposition of the traded property, the taxpayer can depreciate the unadjusted basis (e.g., boot paid) of the replacement property until the date of the trade.

Presumably, under Notice 2000-4 and the regulations, if a taxpayer was involved with an exchange of improved real estate for bare cropland, any buildings on the traded property would continue to be depreciated over their remaining deductible life as a component of the basis in the cropland. The problem with this continued depreciation is the possible taint the former building depreciation would have upon the disposition of the land (e.g., conversion of long-term capital gain into maximum tax at 25% compared to 20%.) It is the IRS's position that the nondepreciable nature of land is an overriding distinction. Thus, any basis assigned to the land, even if it carries over from a depreciable asset, is nondepreciable.

48. See Temp. Treas. Reg. §1.168(i)-6T(d)(3)(iii), Example 3

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DEPRECIATION RECAPTURE

Basic Rules

Because the rules governing real property exchanges are so broad, such as trading bare land for developed real estate, it is possible that both IRC §1245 and IRC §1250 property could be involved in the exchange. Therefore, while the real property exchange may qualify for tax-deferred treatment, the possibility of depreciation recapture associated with other property connected with the real estate may be likely.

IRC §1245 property is depreciable personal property, such as machinery and equipment, and other tangible property (except buildings or structural components) used in conjunction with manufacturing, production, or extraction. IRC §1245 also includes various utility-type services. When real estate is traded in a tax-deferred exchange, items such as fences, tile lines, feeding floors, grain bins, single-purpose livestock facilities, and similar items may also be involved. For this purpose, §1245 property includes ACRS property that was depreciated using an accelerated method. IRC §1245 recapture must be recognized to the extent of the amount of gain recognized on the exchange plus the fair market value (FMV) of the property acquired that is not IRC §1245 property.[49] Recapture income is recognized even if the transaction is **otherwise tax-deferred.**

In an exchange of improved for unimproved land in which part or all of the improvements are IRC §1245 property, the exchange is likely to lead to recapture consequences for the transferor of the improved property.[50]

> **Example 13.** Tom entered into a like-kind exchange. He traded his §1245 property, with an adjusted basis of $100,000, for a like-kind property with an FMV of $90,000 and an unlike-kind property with an FMV of $35,000. Upon the exchange, $25,000 (($90,000 + $35,000) – $100,000) of gain is recognized because the property worth $35,000 is not IRC §1245 property. The basis of the properties received in the exchange is $125,000 ($100,000 + $25,000). Of that amount, $35,000 is allocated to the property worth $35,000, and the $90,000 balance is allocated to the other property.

In some cases, depreciable real property (other than IRC §1245 property such as a farm shop, machinery storage shed, or general purpose building or barn) is transferred in a like-kind exchange. The amount of gain taken into account as recapture income is the larger of:

- The gain recognized on the exchange; or
- The excess, if any, of the gain reported as ordinary income because of additional depreciation had the property been sold less the FMV of the IRC §1250 property acquired in the transaction.

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49. IRC §1245(b)(4) and Treas. Reg. §1.1245(d)(1)

50. Depreciation recapture is reported on IRS Form 8824, line 21.

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Example 14. On September 1, 2007, Mike exchanged his fee interest in a 45-acre tract of farm real estate with improvements (FMV of $400,000) for a fee interest in an 80-acre tract of bare farm real estate (FMV of $400,000). Mike intended the transaction to be a like-kind exchange. What is the tax consequence of Mike's exchange?

Like-Kind Property	Fair Market Value	Basis	Gain Realized
Land (40 acres)	$185,000	$32,000	$153,000
Tile (40 acres)	15,000	0	15,000
Land/acreage (5 acres)	10,000	2,500	7,500
Machine shed (2002)	20,000	16,955	3,045
Total	$230,000	$51,455	$178,545
Unlike-Kind Property IRC §1245 Recapture	**Fair Market Value**	**Basis**	**Gain Realized**
Well/water system	$ 3,500	$ 0	$ 3,500
Machine shed (1985) accel. depr.	6,500	0	6,500
Hog confinement bldg.	125,000	0	125,000
Grain bins/drying system	35,000	0	35,000
Total	$170,000	$ 0	$170,000

Fair market value	$400,000
Basis	(51,455)
Gain realized	$348,545
Gain recognized (§1245 recapture)	(170,000)
Gain deferred	$178,545

For IRC §1250 property, recapture is recognized to be the larger of:

1. The excess, if any, of the gain reported as ordinary income due to additional (post-1969) depreciation had the property been sold, less the FMV of the IRC §1250 property acquired in the exchange; or
2. Any gain on the exchange, regardless of the recapture provision.[51]

The recapture of depreciation is partially or fully deferred until there is a disposition of the acquired property. The basis of the property received is the basis of the exchanged IRC §1250 property:

- **Decreased** by the amount of any money received that was not spent acquiring similar property,
- **Increased** by the amount of gain recognized, and
- **Decreased** by the amount of loss recognized. If more than one item of property of each type is received, the total basis is allocated to the individual items of property.

Note. The Form 8824 instructions set forth the above rules and provide a location on the form for calculating the recapture amounts under both IRC §1245 or §1250.

51. IRC §1250(d)(4)

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The recapture for IRC §1250 property is deferred until disposition of the acquired property. For real property, gain is recognized as recapture income in the exchange of like-kind assets to the extent that the amount of recapturable income exceeds the FMV of the acquired depreciable real property. If gain is recognized on the exchange, recapture income is recognized to the extent of the greater of the gain recognized under the like-kind rules, or the amount of recapture income less the FMV of the acquired depreciable real property.

COMPUTATION ISSUES

Before the issuance of IRS Notice 2000-4, failure to account for deferred gain from the relinquished property could result in underreporting IRC §1245 recapture upon the sale of the acquired property and over-reporting the IRC §1231 capital gain at favorable tax rates. After the issuance of Notice 2000-4, failure to account for deferred gain from the relinquished property may result in over-reporting the IRC §1245 recapture upon the sale of the acquired property, and underreporting of the capital gain.

BOOT

Although not contained in the code, the term "boot" is commonly used when discussing tax implications of a tax-deferred exchange. Boot received is the money or FMV of unlike-kind property (other property) received in an exchange. Money includes all cash equivalents, debts, liabilities, or mortgages assumed by the other party, or liabilities to which the exchanged property is subject. **Other property** is property that is unlike-kind, such as personal property, a promissory note from the buyer, a promise to perform work on the property, a business, and so on. Any boot received, in addition to like-kind replacement property, is taxable to the extent of gain realized on the exchange. Taxable boot is not necessarily a bad thing and can play a role in a well-planned exchange depending on the taxpayer's goals. For example, if the taxpayer wants to receive some cash or debt reduction and is willing to pay some tax, having taxable boot may be appropriate. Otherwise, boot should be avoided so the exchange is entirely tax-deferred.

Observation. There are many ways for a taxpayer to receive boot, even inadvertently. It is important for a taxpayer to understand what can result in boot if the goal is to avoid taxable income.

Example 15. Tom sells property for $500,000, and incurs qualified exchange costs of $40,000 for both the relinquished and the replacement properties. Tom must acquire at least $460,000 ($500,000 – $40,000) in replacement property to avoid receiving boot. If Tom trades his $500,000 property, while still incurring $40,000 of qualified costs, for like-kind property worth $600,000 and $10,000 in cash, he will have boot of $10,000, none of which will be recognized because of the qualified cost paid.

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Common Sources of Boot

The most common sources of boot include:

- **Cash boot taken from the exchange.** This will usually be in the form of **net cash received,** or the difference between cash received from the sale of the relinquished property and cash paid to acquire the replacement property(ies). Net cash received can result when a taxpayer is **trading down** in the exchange (i.e., the sale price of replacement property(ies) is less than that of the relinquished.)

- **Debt reduction boot** occurs when a taxpayer's debt on replacement property is less than the debt which was on the relinquished property. As is the case with cash boot, debt reduction boot can occur when a taxpayer is **trading down** in the exchange.

  Under Treas. Reg. §1031(d)-2, a taxpayer may determine whether liabilities are relieved by using a netting concept. Consequently, the taxpayer's liabilities assumed or taken "subject to" by the other party to the exchange may be offset against liabilities encumbering the replacement property or taken subject to by the taxpayer. Liabilities of the taxpayer encumbering the relinquished property may also be offset by cash given to the other party.[52]

- **Sale proceeds being used to pay nonqualified expenses.** This scenario might be a service cost paid at closing which is not a closing expense. If proceeds from the sale are used to service nontransaction costs at closing, the result is the same as if the taxpayer received cash from the exchange and used the cash to pay these costs.

Note. Taxpayers should be encouraged to bring cash to the closing of the sale of their property to pay for the nontransaction costs such as rent prorations, utility escrow charges, tenant damage deposits transferred to the buyer, and any other charges unrelated to the closing.

- **Excess borrowing to acquire replacement property.** In general, borrowing more money than is necessary to close on replacement property does not result in the taxpayer receiving tax-deferred money from the closing. The funds from the loan are the first applied toward the purchase. If the addition of exchange funds creates a surplus at the closing, all unused exchange funds should be returned to the QI and used to acquire more replacement property. Loan acquisition costs, such as origination fees and other fees related to acquiring the loan for the replacement property should be paid at the closing from the taxpayer's personal funds.

Note. Taxpayers usually take the position that loan acquisition costs are being paid out of the proceeds of the loan. However, the IRS may take the position that these costs are being paid with exchange funds. This position is also usually the position of the financing institution. Unfortunately, there is no clear guidance from the IRS on this issue.

- **Unlike-kind property which is received from the exchange,** in addition to like-kind property. Unlike-kind property could include such items as cash and personal property.

Note. In reporting an exchange of farmland, most taxpayers take the position that water on the farmland is like-kind to the land. The IRS has been known to have a different view.

52. Rev. Rul. 2003-56, 2003-1 C.B. 985

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Boot Offset Rules

Only the net boot received is taxed. In determining the amount of net boot received, certain boot offset rules apply. They are as follows:

- Cash boot paid (replacement property) always offsets cash boot received (relinquished property).
- Debt boot paid (replacement property) always offsets debt-reduction boot received (relinquished property).
- Cash boot paid always offsets debt-reduction boot received. Debt boot paid never offsets cash boot received (net cash boot received is always taxable).
- Qualified costs paid (between both the relinquished and replacement property closings) always offset net cash boot received.

Planning Tips for Avoiding and/or Handling Boot

Taxable boot can be avoided if the replacement property is of equal or greater value than the original property, less qualified costs. The general idea behind a tax-deferred exchange is that because the taxpayer is merely exchanging one property for another property(ies) of like-kind, there is nothing received that can be used to pay taxes. All gain remains locked in the transaction and no gain or loss is triggered. The taxpayer can choose to buy more than one property to complete the exchange or even sell multiple properties to buy a more expensive one. Qualified costs include escrow fees, title fees, real estate commissions, exchange fees, and attorney fees, but not loan fees. The recommended practice is to either have loan fees paid within the loan itself or have the taxpayer pay the loan fees with personal funds.

Practitioners can follow some common-sense steps when advising clients on handling boot in a tax-deferred exchange. Some of the most practical steps include:

1. Always trade across or up. Never trade down. Trading down always results in boot received, either as cash, debt reduction, or both. The boot received can be offset by qualified costs paid by the exchanger.
2. Bring cash to the closing of the replacement property to cover loan fees or other charges which are not qualified costs.
3. Do not receive property which is not like-kind.
4. Do not overfinance replacement property. Financing should be limited to the amount of money necessary to close on the replacement property, in addition to exchange funds which are brought to the replacement property closing.

While not a boot issue, depreciation recapture may result from an exchange of highly improved property (that contains many IRC §1245 items) for bare land. For instance, the trade of a dairy farm or swine production facility for bare land will involve the disposition of IRC §1245 property with resulting recapture. If the property acquired in the trade has like and similar improvements that are equal or exceeding that of the property disposed of, recapture is avoided.

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TYPES OF 1031 EXCHANGES

DELAYED EXCHANGE

Prior to the Starker decision in 1979, all exchanges were simultaneous, with the sale of one property and the purchase of another both closing at the same instant. However, in a delayed exchange, the taxpayer, through a QI, sells the relinquished property first and then, through a QI, buys the replacement property at a later time. A taxpayer intending a tax-deferred exchange lists and/or markets the property for sale in the normal manner without regard to the contemplated exchange. A buyer is found and a contract to sell the property is executed.

Presently, the most commonly utilized type of 1031 exchange is one in which the replacement property is closed on at a later date than the closing of the relinquished property. The exchange does not have to be simultaneous or on the same day. This type of exchange is known as a "Starker Exchange." There are strict time frames established by the code and regulations for completion of a delayed exchange.

Timing Restrictions

The first timing restriction for a delayed exchange regards the identification period. The taxpayer must identify all potential replacement property(ies) within 45 days from the date of transfer of the relinquished property.[53] The 45-day rule is satisfied if replacement property is received before the 45 days pass. Otherwise, the identification must be by written document (the identification notice) signed by the taxpayer and sent to the QI. The identification notice must contain an unambiguous description of the replacement property. This includes, in the case of real property, the legal description, street address, or a distinguishable name. During the identification period the taxpayer can change the list of identified properties. However, after midnight on the 45th day, no further changes can be made. Restrictions are also imposed on the number of replacement properties which can be identified in an exchange.

Although the regulations only require written notification within 45 days, it is wise practice for a solid contract to be in place by the end of the 45-day period. Otherwise, if the deal(s) falls apart for any reason and the 45 days pass, and if the taxpayer has no other identified property to buy, the exchange fails and the gain becomes taxable. After 45 days expire, it is not possible to close on any other property which was not identified in the identification notice letter. Failure to submit the identification notice letter before the end of the identification period (45 days after sale closes) causes the exchange agreement to terminate.

Property Identification Rules

More than one potential replacement property can be identified as long as one of the following rules is satisfied:

1. **The 3-property rule.** Any three properties may be identified regardless of their market values.
2. **The 200% rule.** Any number of properties may be identified as long as the aggregate FMV of the replacement properties on the 45th day does not exceed 200% of the aggregate FMV of all of the relinquished properties as of the initial transfer date.

> **Note.** The taxpayer need not acquire all the identified property.

3. **The 95% rule.** Any number of replacement properties may be identified if the FMV of the properties actually received by the end of the exchange period is at least 95% of the aggregate FMV of all the potential replacement properties identified.
4. The 45-day rule is satisfied if replacement property is received before the 45 days pass.

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[53] If multiple relinquished properties are included in the same exchange, the first transfer starts the clock for all the properties. Treas. Reg. §1031(k)-1(b)(2)(iii).

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The replacement property must be received and the exchange completed no later than the earlier of 180 days after the transfer of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the exchanged property was transferred. The replacement property received must be substantially the same as the property which was identified under the 45-day rule. The IRS has never given an extension of the 180- or 45-day deadlines to any individual taxpayer.[54]

Note. There is no provision for extension of the 180 days for any circumstance or hardship, except in the case of natural disaster. If the exchanger, the QI, the identified replacement property, title, escrow, attorney or real estate agent is in an area federally designated as a "disaster area" during the exchange, the identification period and the exchange period may be extended by 120 days. This was the case with Hurricanes Rita and Katrina, when the IRS issued a notice giving extensions to those adversely affected.

As noted, the 180-day rule is shortened to the due date of a tax return if the tax return is not put on extension. For instance, if an exchange commences late in the tax year, the 180 days can be later than the April 15 filing date of the return. If the exchange is not complete by the time for filing the return, the return must be put on extension. Failure to put the return on extension can cause the exchange to terminate on the due date of the return. This can be a trap for the unwary if the tax return is filed before the exchange is completed.

Caution. If the taxpayer combines funds from two sales to buy any one replacement property, then the timing for **both** sales begins when the first relinquished property sale closes. The replacement property must be identified as such for **both** relinquished properties within 45 days from the first relinquished property closing, whether or not the second relinquished property is even sold by that time.

The Exchange Contract

Accommodation language is usually placed in the contract securing the cooperation of the buyer to the seller's intended tax-deferred exchange. However, such accommodation language is not required. When contingencies are satisfied and the contract is scheduled for a closing, the services of a QI are arranged for and the taxpayer enters into an exchange agreement with the QI.

The exchange agreement usually provides for:

- An assignment of the taxpayer's contract to sell the relinquished property as well as buy the replacement property(ies) to the QI;
- A closing in which the QI receives the proceeds due the seller at closing;
- Direct deeding out of the relinquished property as well as into the replacement property;
- An interval of time within which the taxpayer must locate and identify suitable replacement property and another interval within which the taxpayer must receive the replacement property (these intervals of time are subject to the 45-day and 180-day rules); and
- A closing in which the QI uses the exchange funds in its possession to acquire the replacement property(ies).

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54. However, the IRS has granted extensions of the 45- and 180-day periods for both deferred and reverse exchanges in the context of weather disasters. See Rev. Proc. 2005-27, 2005-1 CB 1050. Practitioners can check the IRS disaster relief website for notices.

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Suggested Contract Language

When a delayed exchange is contemplated it may be wise to make sure that all parties to the transactions are aware that the transaction will be a delayed exchange. This may help ensure that there will be no lack of disclosure which may obstruct the transaction. The following language is suggested:

> *Buyer hereby acknowledges that it is the Seller's intent to effect an IRC §1031 tax deferred exchange, which will not delay the closing nor cause additional expense or liability to the Buyer. The Seller's rights and obligations under this agreement may be assigned to a QI, for the purpose of completing such an exchange. Buyer agrees to cooperate with the Seller and the QI in a manner necessary to complete the exchange. Such cooperation shall be at no additional cost or liability to the Buyer.*

Step-by-Step Delayed Exchange

Step 1. The taxpayer retains the services of tax counsel.

Step 2. The taxpayer enters into a sales contract on the property presently owned.

Step 3. The taxpayer enters into an exchange agreement with a QI in which the QI is named as principal in the sale of the relinquished property and the subsequent purchase of the replacement property. Along with the exchange agreement, an amendment to the closing/escrow instructions is signed which names the QI as the substituted seller. Normally, the deed is prepared for recording as directly from the taxpayer to the true buyer. This is called direct deeding. It is not necessary to have the replacement property identified at this time.

Step 4. The sale of the relinquished property closes, and the proceeds from the sale are forwarded to the QI by the closing agent. The day the relinquished property closes is the day the tax-deferred exchange begins and the timelines (45 days and 180 days) begin their countdown.

Step 5. The taxpayer sends written identification of the replacement property(ies), including address or legal description, to the QI on or before day 45 of the exchange (by midnight of the 45th day following the transfer of the relinquished property). It must be signed by every signatory on the exchange. It may be faxed, hand delivered, or mailed. It may be best to have it sent via certified mail with return receipt requested. The taxpayer will then have proof of receipt by the QI, verified by a government agency. The taxpayer has 180 days from the transfer of the relinquished property to complete the acquisition of the replacement property. When the sale closes on the relinquished property, the net proceeds are paid to the QI, who then invests the proceeds in an interest-bearing account for the seller's benefit.

> **Note.** For an individual taxpayer, if settlement of the sale occurs between October 17 and the end of the year, the purchase of the replacement property must be completed by April 15 of the following year unless an extension is requested.

Step 6. At or before the time of closing for the acquired property, the taxpayer enters into an agreement to purchase replacement property (purchase contract). The QI prepares closing instructions for the replacement property closing agent, prepares an assignment to the QI of the purchase contract, and writes a check to the seller of the acquired property (or initiates a wire transfer to the closing agent).

> **Note.** The QI must provide the seller with notice of the assignment of the purchase contract.

An amendment is signed naming the QI as substituted buyer, but again the deeding is direct from the true seller to the taxpayer. The QI is not placed into the chain of title to the real estate. The regulations permit direct deeding when the purchase contract has been assigned to the QI.

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Step 7. When conditions are satisfied and the purchase is ready to close (and prior to the 180th day), the QI forwards the exchange funds to the closing agent. A final accounting is sent by the QI to the taxpayer, showing the funds coming in from one escrow and going out to the other, all without constructive receipt.

Step 8. The taxpayer files Form 8824 when federal taxes are filed, and any other documents required by the state.

REVERSE EXCHANGE

In this type of an exchange, the taxpayer, using the services of a QI, now known as the exchange accommodation titleholder (EAT), acquires the replacement property and closes on it before the relinquished property is sold.[55] Usually, the QI creates a limited liability company (the EAT) for the purposes of acquiring the replacement property, holding title to it until the taxpayer can find a buyer for the relinquished property, and closing on the sale under an exchange agreement with the EAT.

Procedure and Timeframes

The taxpayer performing a like-kind exchange signs a formal document identifying the EAT (which will also be signed by the EAT). The taxpayer advances funds to the EAT. If a loan is required to obtain funds for the purchase by the EAT, the loan must be made to the EAT and guaranteed by the taxpayer. The EAT acquires the property and title is taken in the EAT's name. The deed is recorded and insurance on the property should be endorsed over to the EAT. After the EAT acquires the property, the EAT typically leases the property (on a triple-net basis) to the taxpayer for the term of the parking period. Once the EAT takes title to the property, a qualified exchange accommodation arrangement (QEAA) must be entered into within five business days.

Within 45 days of receipt of title of the acquired property, there must be identification of the property to be disposed of (typically not a problem). Within 180 days of when the replacement property is received, the property to be disposed of must actually be disposed of. Once that happens, the EAT receives and transmits the check and conveys the replacement property to the taxpayer. The replacement property is available for use during the exchange. Subsequent to (or simultaneous with) the closing of the exchange property, the QI conveys the title to the replacement property to the taxpayer. To fall within the safe harbor, the transaction must be completed within the 180-day time period. When the exchange is completed, the EAT is dissolved.

Note. The regulations require the EAT to be a taxable entity and that the EAT prepare a tax return reporting the transaction.

Observation. A reverse exchange benefits the taxpayer when the taxpayer must purchase the replacement property before being able to sell the relinquished property. An **individual** should not serve as the EAT because of the possibility that the taxpayer's property could be subject to attachment in bankruptcy or divorce proceedings, or the individual could begin actions related to the property that are adverse to the interests of the taxpayer.

Note. Some Midwestern states have anti-corporate farming laws. The laws generally prohibit corporations from owning agricultural land and engaging in agriculture. In these states, a question arises as to whether the EAT violates state law. In Iowa (a state that has an anti-corporate farming statute), the Attorney General stated informally that holding agricultural land in an LLC for the sole purpose of executing a like-kind exchange does not violate the state anti-corporate farming law.

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55. Rev. Proc. 2000-37, 2005-2 CB 79, provides a safe harbor that allows the taxpayer to treat the QI as the property owner for tax purposes, thereby enabling the taxpayer to accomplish a reverse exchange.

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The key to a reverse exchange is the exchange agreement with the EAT. The IRS will not challenge the qualification of property as replacement property, or the treatment of the EAT as the beneficial owner of such property for tax purposes if the property is held pursuant to an exchange agreement.

IMPROVEMENT EXCHANGE

With this type of exchange, the taxpayer acquires a property and arranges for construction of improvements on the property **before** it is received as replacement property. The party constructing the improvements must not act as the taxpayer's agent or be the QI or EAT. Typically, the improvements involve a building on an unimproved lot, but may also include enhancements to an already improved property in order to create adequate value to close on the exchange with no boot occurring.

Note. The code and regulations do not permit a taxpayer to construct improvements on a property as part of a 1031 exchange **after taking title** to that property. Therefore, it is necessary for the QI to create an entity (typically an LLC) for the exchange. The entity, on behalf of the taxpayer, purchases and takes title to the property until the improvements are constructed and conveys title to the improved property to the taxpayer as replacement property. When the exchange is completed, the entity dissolves, and its tax return is filed by the QI.

SIMULTANEOUS EXCHANGE

With this type of exchange, the closing of the relinquished property and the replacement property occur on the same day, usually simultaneously. There is no interval of time between the two closings. This type of exchange is covered by the safe harbor regulations, and is the only exception to the IRS's requirement that a QI be used to facilitate each exchange. However, the exchange must be truly simultaneous. Even the delay caused by wiring funds to an escrow company ruins a simultaneous exchange. There is a risk that a short delay in closing can result in full taxes being due. Because the guidelines for a delayed exchange allow for much more time between closings, most taxpayers prefer to utilize a delayed exchange instead of a simultaneous exchange.

Note. If the parties to the exchange are related, each of them must keep their respective properties for at least two years.

TITLE VESTING

While the regulations do not address the issue, title to the replacement property must be held in the same manner in which title to the relinquished property was held. Thus, it is critical to review the title work before preparation and execution of the exchange documentation and deeding of the replacement property. If property is owned by spouses as tenants-in-common, then the exchange should be carried out as tenants-in-common. Likewise, if one spouse owns property solely in the spouse's own name, the replacement property should be titled in that spouse's name only. Single-member limited liability companies (LLCs) are disregarded for federal tax purposes. Thus, if the taxpayer wholly owns the LLC, the LLC can take title to the replacement property even though the relinquished property is individually titled in the name of the taxpayer.

After the exchange, a gift of the replacement property can be later made tax-deferred under IRC §1041.

Observation. There is no distinction as to how long the taxpayer must wait before gifting the replacement property without jeopardizing the tax-deferred status of the exchange. Obviously, the longer the time interval the greater the chance of preserving tax-deferred status.

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SPECIAL ISSUES

Multiple-Asset Exchanges and Personal Residences

A multiple-asset exchange occurs when a taxpayer is selling/exchanging a property which includes more than one type of asset. A common example is farm property that includes a personal residence, farmland, and farm equipment. The treasury regulations govern how multiple-asset exchanges are reported and establish exchange groups which are separately analyzed for compliance with the like-kind replacement requirements and rules for boot.[56] An exchange group is any group of like-kind property (as applied to both the relinquished and acquired property).

> **Note.** All properties falling into asset class 00.28 make up an exchange group, and properties classified under the product codes are an exchange group if they are in the same product codes.

Procedure for Handling Multiple-Asset Exchanges

A multiple-asset exchange involves a 2-step process. The **first step** is to determine the **value of each** of the properties in **each** exchange group. Determining property values reveals whether the aggregate value of properties received is greater or less than the aggregate value of the relinquished properties in each exchange group.

If the values are not the same (which is likely), the **second step** involves determining whether the **aggregate difference** between the values of the properties received in **all** the exchange groups is more or less than the value of the properties relinquished in **all** the exchange groups. The aggregate difference, irrespective of whether it involves received or relinquished properties, becomes a residual group. Properties not falling into any exchange group are assigned to the residual group until all the value of the properties assigned to the residual group equals the value of the residual group. Thus, the properties in the residual group must all be either received or relinquished property in the exchange.

The properties in the residual group are considered made of assets of the following classes in the following order:

Class I Cash, bank deposits, and similar items

Class II Certificates of deposit, U.S. government securities, foreign currency, and similar items

Class III Any asset not falling into the other categories and accounts receivable

Class IV Goodwill, going concern value, and similar intangibles

Once a particular asset class is exhausted, assets from the next class are allocated to the residual group. While the classes must be taken in this order, the taxpayer can select between the assets in the class.

If the grouping technique leaves some properties outside of any particular exchange group (or the residual group), those assets are treated as having been exchanged for each other and the exchange of this property is fully taxable.

Gain or loss on any exchange group is determined by considering only the properties in the exchange group. If the value of the properties received in an exchange group exceeds the value of the properties given up in that group, there is an exchange group surplus.

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56. Treas. Reg. §1.1031(j)-1

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Conversely, if the value of the properties received is less than the value of the properties given up, there is an exchange group deficit. In that case, the deficiency is presumed to be made up by a surplus in another group. Since in this situation the property is not like-kind to the property in the group with the deficiency, gain (or loss) is realized by comparing the aggregate basis of property in the exchange group that is relinquished to the aggregate value of the replacement property. Any loss is not recognized, but losses on properties in the same exchange group are netted against gains on properties in the same exchange group. If the exchange group overall produces a loss, it is not allowed to offset a gain in another exchange group.

Note. Under the regulations, in determining which value is greater, the taxpayer must allocate liabilities to each exchange group, with no amount of liabilities allocated to the residual group. The amount of liabilities allocated equals the amount remaining after assumed liabilities are netted against relief from liabilities. If the net amount is an excess of assumed liabilities over liability relief, the net amount is allocated to the exchange groups in proportion to the FMV of the properties received in the exchange groups. If the net amount is the excess of liability relief over liabilities assumed, the excess is allocated to the residual group and is treated as a Class I asset.

Handling the Personal Residence in a Multiple-Asset Exchange

Clearly, farmland must be replaced with qualifying like-kind real property, and farm equipment must be replaced with qualifying like-kind equipment. However, a personal residence is not qualified property and is handled under the rules applicable to the sale of a personal residence.

Unfortunately, the regulations do not clearly specify how the personal residence portion of a multiple-asset exchange should be accounted for. The common practice is for the closing on the relinquished property to be split into two separate closings: one for the personal residence and the other for the remainder of the property. The proceeds applicable to the sale of the personal residence are usually directly disbursed to the taxpayer. The balance of the proceeds is disbursed to the QI for use in acquiring like-kind replacement property under the exchange agreement.

Farm exchanges often involve the sale of land, buildings, and a personal residence. IRC §121 provides for an exclusion of gain (up to $500,000 on a joint return) on the sale or exchange of a personal residence if, during the 5-year period ending on the date of the sale or exchange, the property was owned and used as a personal residence by the taxpayer for an aggregate of two years or more. Thus, in an exchange involving such property, the personal use property should be split from the IRC §1031 property. Vacant land can be included in the taxpayer's personal residence as long as it is next to the dwelling unit and was used as an integral part of the personal residence.

Note. The allocation of the house and land constituting the personal residence should maximize, to a reasonable and justifiable degree, the taxpayer's utilization of the IRC §121 gain exclusion. This becomes important when defining in the exchange agreement what property will be exchanged. The exchange agreement should only list the property subject to IRC §1031 treatment.

Observation. It may be useful to attach a map of the property that distinguishes the IRC §1031 property from the IRC §121 property. Also, it may be helpful at settlement for there to be two closing statements — one for the IRC §1031 property and one for the IRC §121 property.[57]

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57. Rev. Proc. 2005-14, 2005-1 CB 528, provides guidance on the application of IRC §121 and IRC §1031 to an exchange of a single mixed-use property.

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Another common example of multiple-asset exchanges is a real property sale that includes personal property such as furniture and appliances. Rental properties including this type of personal property and intangibles (e.g., hotel properties) are multiple-asset exchanges. In practice, the value of personal property transferred with a rental property is commonly disregarded for calculation and income tax reporting purposes. However, there is no rule which permits a taxpayer to disregard the value of personal property, even if it is nominal.

Observation. The regulations are complex and require allocation of the selling price and purchase price to the elements of the transaction. Exchanges that include personal property of significant value should reference the personal property in the exchange agreement and be completed in a manner that complies with all the exchange rules concerning identification, and so on.

SALE/LEASEBACK AS AN EXCHANGE

A lessee's interest in a lease with a term of 30 years or longer on real property is considered like-kind to other real property. In addition, property subject to a lease can, if the lease is for a term of 30 years or longer, be the subject of a tax-deferred exchange. However, the receipt of prepaid lease payments in an exchange for a 30-year or longer lease is taxed as ordinary income and does not qualify for tax-deferred treatment.

PARTNERSHIP AND CO-OWNERSHIP ISSUES

Investment real estate is commonly owned by a partnership containing two or more partners or by co-owners as tenants-in-common. An exchange of a tenant-in-common interest in real estate poses no problems and is eligible for tax-deferred exchange treatment. Each tenant can exchange separately from the others. A partnership can exchange real estate that it owns, but an ownership interest in a partnership, by itself, cannot be exchanged under IRC §1031.

Observation. Real property is real property, but a partnership is only an idea, an agreement, and not real property. If a partnership desires to exchange property that it owns, the partnership is the entity that is the exchanger and party to the exchange agreement. The partnership takes title to the replacement property.

If an individual partner in a partnership wants to exchange the partner's share of the sale of the partnership's property, replace it with qualifying property in the partner's own name, and end the partner's relationship with the partnership, problems can result. If members of a 2-partner partnership want to discontinue the partnership, sell the property, and go their separate ways with either cash or a tax-deferred exchange, it is necessary for the individual partners to receive the deed to the property from the partnership in advance of the sale of the property. This is done in the context of a distribution of property from the partnership to its partners. The individual partners are generally required to hold the property as tenants-in-common for a period of time in order to comply with the requirement for a taxpayer to have "held" the property for business or investment purposes before the exchange. If a partnership with multiple partners wishes to exchange property, but some of the partners want to cash-out or go separate ways, it is common for the partnership to do a split-off. With that technique, the partnership distributes tenancy-in-common title to a portion of the partnership property to those individual partners who wish to part ways, and the partnership (and its remaining partners) proceeds separately with an exchange in the name of the partnership.

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INCIDENTAL PROPERTY

For purposes of completing a proper identification within the 45-day identification period, property which is incidental to real property, such as furniture, laundry machines, appliances, pumps, etc., is not treated as separate property from the real estate property (i.e., does not require a separate identification) if two conditions are satisfied:

1. The incidental property must be of a type that is typically transferred together with the real property in standard commercial transactions.
2. The aggregate market value of the incidental property must not exceed 15% of the market value of the real property.

Note. For description purposes, the legal description or street address of the real estate property can be used to describe the entire property. There is no need to list the particular incidental property attached to it.

SELLER CARRY-BACK FINANCING

A loan or note issued by the seller/taxpayer often becomes boot if it is part of a tax-deferred exchange of real estate. The reason is that a promissory note does not meet the requirement that real estate be exchanged solely for other like-kind property (real estate).

If seller financing is necessary, and if a delayed exchange with the use of a QI is employed, consider the following alternatives to triggering tax on the amount of the note:

- The taxpayer can buy the note out from the exchange. By bringing personal funds, the taxpayer trades cash for the note, uses the cash to purchase replacement property, and holds the note personally apart from the exchange. Instead of being taxed on the face value of the note, the taxpayer is only taxed on the income received from the note.
- The taxpayer can direct the QI to sell the promissory note to a financial institution or investor and use the cash received as exchange funds to acquire qualifying replacement property.
- The taxpayer can use the promissory note in the exchange as consideration for the acquisition of replacement property. A taxpayer can take a carry-back note from the buyer of the relinquished property as part of that sale and later trade that note to the seller of the replacement property as a part of that purchase. However, a potential problem occurs. With this note in the hands of the seller of the replacement property, it is considered a third-party note and not eligible for installment sale reporting under IRC §453. It is called a third-party note because it is a note between the taxpayer and the buyer of the relinquished property, now held by the seller of the replacement property — a third party. That person cannot do a tax-deferred exchange with that note and will likely be taxed on its value in the tax year it is received. Accordingly, there is a disincentive for the seller to take the note as part of the consideration received from the sale of the property. This problem is compounded if the seller is also trying to do a tax-deferred exchange of the seller's property.

Caution. These dispositions are not covered by the regulations. So, they are not protected by the safe-harbor provisions. Therefore, if seller carry-back financing is part of the sale of relinquished property, potential tax issues are always possible. Otherwise, the note is boot, unless it is offset by boot paid at the replacement property closing. Cash boot paid by a taxpayer always offsets cash boot received.

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VACATION HOMES

There is no IRS safe harbor that allows the exchange of a vacation home. A significant question is whether a vacation home is held as investment property. There is a risk that the IRS could classify a vacation home as personal property. The key is whether the taxpayer can support treatment as investment property:

1. Income from the property is reported on Schedule E.
2. Loan documents reflect characterization as investment property.
3. The property is listed as an investment with a financial planner, CPA, or attorney.
4. The taxpayer has estimates of cash flow and historical performance.

Clearly, a vacation home or second home that is **not** held as a rental is classified as real estate held for personal use and does not qualify for tax-deferred exchange treatment. However, under the rules of IRC §280A, a dwelling unit held for both personal use and rental purposes must meet a use test each tax year to determine its tax classification for that tax year. The argument is that the rules of IRC §280A should apply in the context of a tax-deferred exchange of a vacation home.

Under IRC §280A, a vacation home is treated as real estate held primarily for personal use and treated as an asset **not** held for profit (for purposes of deducting losses) if the owner's personal use is more than 14 days or 10% of the total rental days, and the unit is rented for one day or more during the tax year. Clearly, a vacation home used in this manner would not qualify for IRC §1031 treatment. On the other hand, the property is treated as rental property if the owner's personal use is no more than 14 days or 10% of the rental days during the tax year, and the property is rented more than 14 days during the tax year. The argument is that this property should qualify for tax-deferred exchange treatment.

In a recent case, the Tax Court denied §1031 treatment for a vacation home which the taxpayer argued was purchased for investment purposes. The court based its decision on the taxpayer's actions over the years and the fact that deductions claimed on their tax return for interest showed the property was for personal use.[58]

> **Observation.** With appropriate planning, it is possible to convert a vacation home into an investment property that qualifies for tax-deferred exchange treatment irrespective of the possible application of IRC §280A to the transaction. Such planning includes either discontinuing or substantially reducing the taxpayer's personal use of the vacation home and renting it out. The point is to build up a solid history of creating investment income from the property, probably for at least two years.

NEW CONSTRUCTION OF REPLACEMENT PROPERTY

Under the regulations, a taxpayer can exchange real estate for real estate on which construction is to occur. A transfer still qualifies for tax-deferred exchange treatment if the new construction is identified within the 45-day period and received within the 180-day exchange period. This property must be carefully identified. Property identification should include the legal description of the underlying ground and as much of the new construction description as possible. The new construction must be completed and received in substantially the same form as described in the identification documents.

> **Observation.** Property cannot be exchanged for services, such as a contractor's obligation to do work or build on the property. Partially completed real property can be received in a like-kind exchange if properly identified.

58. *Barry and Deborah Moore v. Comm'r,* TC Memo 2007-134, May 30, 2007

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There are two ways that new construction is handled in a delayed exchange:

1. A contract is entered into with a builder to purchase a property that will be completed and closed before the end of the 180-day exchange period. This is likely the least expensive and easiest method.
2. A contract can be structured as a build-to-suit exchange. Similar to a delayed exchange, the sale property closes first and exchange funds are used to buy replacement property. The replacement property could be vacant land or it could already be developed. Through a special agreement with the QI, the taxpayer's chosen builder draws on the exchange proceeds as certain steps of the construction are completed. All work that is part of the exchange must be complete, and the taxpayer must take ownership of the property before the 180-day exchange period expires.

In both cases, the contract (purchase and sale agreement) should contain language that requires the builder to bear responsibility for any resulting taxes if the exchange fails due to the builder's failure to complete the construction before the 180th day. If a taxpayer's exchange is approaching its 180th day and construction will not be complete, the taxpayer can have the builder convey ownership to that portion of the property that is complete. In such an instance, the value of that portion is added to the total amount of replacement property purchased for the exchange. The value of the replacement property must be figured on the day of transfer. Construction work completed after the day of transfer will not be treated as part of the exchange.

RELATED PARTIES

Basic Rules

If not handled properly, selling to or buying from a related party can disqualify a transaction from a tax-deferred exchange. In general, an exchange between related parties should be avoided unless **both parties** agree to retain ownership of the properties involved for two consecutive years. The taxpayer cannot purchase replacement property from a related party if the relinquished property was sold to an unrelated party.[59] An exception to this rule exists when neither party is cashing out of his investment.[60]

There are two basic rules governing related party transactions:

1. A taxpayer can only sell relinquished property to a related party if the related party holds that property for at least two years after the exchange.
2. A taxpayer can only buy from a related party if the related party also does a complete tax-deferred exchange, receiving no boot, and both the taxpayer and the related party hold their respective replacement properties for at least two years after the exchange.

There are three exceptions to the 2-year disposition rule:

1. Dispositions involving the death of the taxpayer or related person,
2. Dispositions involving a compulsory or involuntary conversion, and
3. Situations in which the IRS is satisfied that tax avoidance is not a principal purpose of the transaction.[61]

> **Note.** If a transaction is a related-party exchange, Form 8824 must be filed for the two years following the year of the exchange.
>
> Use of a QI does not avoid the related-party rules.[62]

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

60. Letter Ruling 200440002 (June 14, 2004). Both related parties executed a deferred like-kind exchange and agreed not to sell their properties for two years. The prohibition against cashing out is contained in IRC §1031(f).

61. Letter Ruling 200706001 (October 31, 2006). Like-kind exchange of real property among related parties did not result in "basis-shifting" and, as a result, tax avoidance was not a principal purpose of the exchange; disposition within two-years after exchange did not trigger gain recognition.

62. Letter Ruling 200616005 (December 22, 2005)

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Definition of Related Party

Under the regulations, the following are related parties:

- Members of a family, including siblings, half-siblings, spouses, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.);
- An individual corporate shareholder when the individual owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation;
- Two corporations that are members of the same controlled group as defined in IRC §1563(a), except that more than 50% is substituted for at least 80% in that definition;
- A trust fiduciary and a corporation when the trust or the grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation;
- A grantor and fiduciary, and the fiduciary and beneficiary, of any trust;
- Fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts;
- A tax-exempt educational or charitable organization and a person who, directly or indirectly, controls such an organization, or a member of that person's family;
- A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation, and more than 50% of the capital interest, or profits interest in the partnership;
- Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation, or two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation;
- An executor of an estate and a beneficiary of such estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest;
- Two partnerships, if the same persons own, directly or indirectly, more than 50% of the capital interests or profits in both partnerships, or a person and a partnership when the person owns, directly or indirectly, more than 50% of the capital interest or profits interest in the partnership.

The Cashing Out Problem

Historically, a primary objective of a related-party exchange was to trade properties among family members when one property had a high basis and the other property had a low basis, with the sale of the low basis property taking place after the exchange. That is what is meant by cashing out, and the original exchange does not receive tax-deferred treatment. The related-party rules were designed, in large part, to deny tax-deferred treatment in such a situation.

In Rev. Rul. 2002-83,[63] the IRS illustrated the hazards of a related-party exchange when one party to the exchange cashes out in the process. The following example is based on the facts of the ruling.

Example 16. Mary transferred Blackacre to a QI. This was done at a time when the property was worth $150,000, and had a basis of $50,000. It was exchanged for Whiteacre. Whiteacre was owned by Mark, Mary's brother. Whiteacre had an FMV of $150,000 and a basis of $150,000.

Sid, who is unrelated to either Mary or Mark, wants to acquire Blackacre. Sid obtains Blackacre. A few days later, Mark is paid the $150,000 sale price. Mary receives Whiteacre, Sid receives Blackacre, and Mark cashes out of the deal receiving $150,000.

[63] Rev. Rul. 2002-83, 2002-2 CB 927

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If Mary exchanged directly with Mark, it would have been a related-party exchange, and a sale within two years would have triggered gain on the exchanged property. In this situation, the exchange would have been viewed as an exchange which is part of a transaction (or series of transactions) to avoid the related-party rule and the nonrecognition provisions of IRC §1031 would not apply.

Using Sid (an unrelated third party) to circumvent the related-party rule is ineffective in avoiding the strictures of the related-party provision. Essentially, third party involvement is disregarded. The transaction is viewed as an exchange between Mary and Mark who are related parties, with a sale occurring within the 2-year period specified by the related-party rule.

A similar fact pattern was involved in *Teruya Brothers, Ltd. & Subsidiaries.*[64] This case involved an unsuccessful attempt to avoid the related-party rules by using a QI. A sale occurred within two years of the initial exchange, and one of the parties cashed out within that time period. Through a series of transactions, the taxpayers transferred real properties from a related corporation. The taxpayer was not able to demonstrate that tax avoidance was not one of the principal purposes of the exchanges. The court concluded that the use of the QI was interposed to avoid the related-party rule. But, tax avoidance may not be a principal purpose of an exchange if basis of properties involved in an exchange is affected by death.

Example 17. Before he died, Joe acquired several tracts of timberland which he held for the production of income and for investment purposes. Upon Joe's death, parcel #1 was transferred to Jean, Joe's wife. Parcels #2 and #3 were transferred to a trust. Jean subsequently gifted parcel #1 to her four children in equal undivided interests as tenants-in-common. The trust held parcels #2 and #3 for the benefit of Jean during her life, with the children designated as remainder beneficiaries of the trust's assets. The trustee and the children decided to sell all of the real estate holdings including parcels #1, #2 and #3. One of the children, however, did not want to divest herself of the real estate so she agreed to exchange her 25% interest in parcel #1 for a 100% interest in parcel #3. The interests transferred were of equal value and, because of Joe's death, the basis figures bore the same relationship to FMV. After the exchange, the trust and the children sold parcels #1 and #2 to an unrelated third party.

Result. In Letter Ruling 200706001, the IRS concluded that the exchange of the daughter's 25% interest in parcel #1 for a 100% interest in parcel #3 was a like-kind exchange. In addition, the subsequent sale by the trust of its interest in parcel #1 was not a disposition that caused recognition of gain under IRC §1031(f) because tax avoidance was not one of the purposes of the exchange or subsequent disposition of parcel #1. Thus, the 2-year rule did not apply and no gain was triggered with the sale of parcel #1.

The IRS referred to Rev. Rul. 2002-83 in holding that a cashing out did not occur, and no sale was contemplated within the 2-year period even though one property ended up being acquired by a buyer.[65] The IRS noted that when the series of transactions was complete, both parties wound up owning property that was like-kind to the property they exchanged. In addition, the IRS noted that neither party was ever in receipt of cash or other unlike-kind property (other than boot received in the exchange) in return for the relinquished property.

If an exchange involves tracts with substantially similar income tax basis, the IRS may be satisfied that the transaction does not have tax avoidance as a principal purpose.

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64. *Teruya Brothers, Ltd. & Subsidiaries v. Comm'r,* 124 TC 45 (2005)

65. Letter Ruling 200440002 (June 14, 2004)

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Example 18. Everett died owning several tracts of timberland which he held during his life for the production of income and for investment purposes. Upon his death, tract #1 was transferred to his wife, Evelyn. Tracts #2 and #3 were transferred to a trust. Evelyn then gifted tract #1 to her children in equal undivided interests as tenants-in-common. The trust held tracts #2 and #3 for Evelyn's benefit during her life with the children designated as remainder beneficiaries of the trust's assets. The trustee and the children then sold all of the tracts. One of the children, however, did not want to sell her portion, but agreed to exchange her 25% interest in tract #1 for a 100% interest in tract #3. The interests transferred were of equal value and their income tax basis bore an identical relationship to FMV (due to the impact of stepped-up basis on Everett's death). After the exchange, the trust and the children sold tracts #1 and #2 to an unrelated third party.

The exchange of the 25% interest in tract #1 for a 100% interest in tract #3 qualifies for like-kind exchange treatment. Likewise, the trust's sale of its interest in tract #1 does not trigger gain because there was no basis shifting, and tax avoidance was not a principal purpose of the sale.[66]

[66.] Letter Ruling 200706001 (October 31, 2006)

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