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CREATIVE USES OF SECTION 1031

by

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Table of Contents

	<u>Page</u>
1. PARTNERSHIPS DOING TAX-FREE EXCHANGES.	2
1.1 Dissolution and Liquidation of the Partnership, Immediately Followed By a Section 1031 Exchange of the Property.	3
1.2 Solution to First Liquidate the Partnership and Then the Former Partners Hold the Liquidated Relinquished Property as Tenants-In-Common Before Doing an Exchange.	4
1.3 Alternative Solution For the Partnership To First Do the Exchanges Into the New Properties, Followed By a Distribution of the Properties to the Former Partners.	5
1.4 IRS Guidelines On How to Be Classified as a Tenancy-in-Common and Not as a Partnership For Tax Purposes.	6
1.5 Using Disregarded Entities to Own Tenancy-In- Common Interests.	14
1.6 Using a Delaware Statutory Trust to Own Property in an Exchange.	15
2. CASHING OUT PARTNERS WHERE THE PARTNERSHIP ENGAGES IN A TAX- FREE EXCHANGE.	17
2.1 Attempting to do a Special Allocation of the Partnership's Gain to the Cash-Out Partners.	18
2.2 Solution of Redeeming the Cash-Out Partners For Cash Before the Exchange.	19
2.3 Have the Cash-Out Partners Receive a Promissory Note in the Sale of the Relinquished Property.	19
2.4 Alternative Tax Plan of the Partnership Distributing a Fractional Tenancy-In-Common Interest in the Relinquished Property to the Cash-Out Partners Prior to the Exchange.	21

3.	<i>PROBLEM OF CONTRIBUTING REPLACEMENT PROPERTY TO A NEW PARTNERSHIP IMMEDIATELY AFTER THE COMPLETION OF THE EXCHANGE (OR THE SO-CALLED "SWAP AND DROP")</i>	22
3.1	Asserting That the "Holding" of Replacement Property is Attributed to the Original Exchanging Party.	23
3.2	An Alternative Safer Tax Structure is For the Exchanging Party to Hold the Replacement Property as a Tenant-in-Common After Completing the Exchange.	24
4.	<i>USING SECTION 1031 TO EXCHANGE INTO REPLACEMENT PROPERTY TO BE CONSTRUED IN THE FUTURE</i>	25
4.1	Improvements Constructed in a Deferred Exchange.	25
4.2	Use a Reverse Tax-Free Exchange to Acquire Future Constructed Improvements.	26
4.3	Doing a "Safe Harbor" Reverse Exchange Under Rev. Proc. 2000-37.	27
4.4	Solution of Doing a Reverse Exchange Outside of Rev. Proc. 2000-37 (So-called "Non-Safe Harbor Construction Exchange").	29
5.	<i>PROPERTY BEING EXCHANGED MAY INCLUDE BOTH REAL ESTATE AND PERSONAL PROPERTY</i>	36
5.1	Real Estate Cannot Be Exchanged For Personal Property.	36
5.2	A Common Taxpayer Mistake is Failing to Understand That the Incidental Property Exception Only Applies to the Deferred Exchange Identification Rules, and Does Not Apply to Determine If Properties Are "Like-Kind".	37
5.3	What Happens When Personal Property Comprises Part of the Building.	38
5.4	Recapture Rules of Sections 1245 and 1250 Can Also Trigger Gain On An Exchange.	40
5.5	Solutions Where the Relinquished Property Contains Personal Property.	41

6.	<i>HOW TO USE THE SECTION 1031 LIABILITY RULES TO HAVE THE EXCHANGING PARTIES RECEIVE CASH TAX FREE.. . . .</i>	44
6.1	Section 1031 Rules on Indebtedness.	44
6.2	What Happens Where the Encumbered Relinquished Property Consists of Both Real Estate and Personal Property.	46
6.3	Consequences of Reducing a Partner's Share of Partnership Liabilities When Doing an Exchange. .	46
6.4	Client Can Receive Cash Tax Free in a Section 1031 Exchange By Refinancing the Relinquished Property Before an Exchange.	48
6.5	Client Can Receive Cash Tax Free in a Section 1031 Exchange By Refinancing the Replacement Property After an Exchange.	49
6.6	Clients Must Avoid a Step Transaction When Refinancing the Property.	49
7.	<i>HOW TO AVOID APPLICATION OF THE RELATED PARTY EXCHANGE RULES.. . . .</i>	50
7.1	Purpose of the Section 1031(f) Related Party Rules.	51
7.2	Section 1031(f) Has Broad Application and Applies to Indirect Transfers Between Related Parties.	52
7.3	How to Avoid Violating the Section 1031(f) Related Party Rules When Using a Qualified Intermediary.	56
7.4	Permitted Exchange Involving Related Parties. . .	57
7.5	Exchanging Properties Between Related Family Members.	58
8.	<i>AVOIDING THE PROBLEM OF THE CLIENT NOT HAVING ENOUGH TIME TO IDENTIFY AND CLOSE ESCROW ON THE REPLACEMENT PROPERTY IN A DEFERRED TAX-FREE EXCHANGE.. . . .</i>	60
8.1	Rules For Identifying the Replacement Property. .	60
8.2	Do Not Commit Tax Fraud By Backdating Documents. .	61

8.3	How Clients Can Obtain More Time to Identify the Replacement Property.	61
8.4	The 45-Day and 180-Day Time Periods Can Be Extended in the Event of a Presidentially Declared Disaster.	62
9.	<i>VERIFY THE CREDITWORTHINESS OF THE QUALIFIED INTERMEDIARY.. . . .</i>	63
9.1	Solution to Hold Relinquished Property's Sales Proceeds in a Separate Escrow or Trust Account. . .	64
9.2	Solution to Use a Deed of Trust, Letter of Credit or Guarantee as Security.	64
10.	<i>USING SECTION 1031 WITH A PERSONAL RESIDENCE.. . . .</i>	65
10.1	Solution of Converting a Personal Residence to Investment Property.	65
10.2	Apply Both Sections 1031 and 121 to Sell a Prior Principal Residence Which is Currently Being Held as Investment Property.	69
10.3	Example of Applying Rev. Proc. 2005-14 and Section 121 to An Investment Residence Being Exchanged Under Section 1031.	73
10.4	Selling A Personal Residence Which Was Previously Received in a Section 1031 Exchange. . .	74

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Clients contemplating exchanging their real estate should determine the amount of tax that the client would otherwise pay if that client elected to not do a tax-free exchange into Replacement Property, and instead sold their Relinquished Property and recognized gain. The federal long-term capital gain rate is currently at a low maximum 15% rate, with straight-line depreciation recapture on real estate taxed at 25%. Additionally, California imposes a 9.3% maximum tax rate¹ and in some cases the

¹ There is an additional California tax of 1% on income over \$1,000,000.

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This article provides a general description of Section 1031, and is not tax or legal advice for any transaction. Each client's transaction and situation contain unique facts. Accordingly, nothing in this article is intended to, or shall, provide any tax or legal advice to any person. Clients should consult their own tax advisors as to any transaction or situation and should obtain tax and legal advice from their own professionals.

alternative minimum tax may apply. Will tax rates increase in 2009?

1. PARTNERSHIPS DOING TAX-FREE EXCHANGES.

When partnerships² desire to split up, they sometimes first liquidate and distribute all of the partnership's Relinquished Property to its partners as tenants-in-common, followed by those former partners immediately selling the Relinquished Property. The selling former partners then exchange into different properties and some partners even receive cash. However, this "drop and swap" arrangement risks violating a basic requirement of Section 1031, which is that exchanging partners must "hold" both the Replacement Property and the Relinquished Property for "productive use in a trade or business or for investment." Although there is no specified length of time that the exchanging former partners must "hold" the Relinquished Property before entering into an exchange, the former partners should own the Relinquished Property as tenants-in-common long enough to evidence their intention to hold the property for investment, or trade or business purposes. The former partners want to hold the Relinquished Property long enough to be classified as a valid tenancy-in-common relationship after the liquidation of the Relinquished Property and not be classified as a "partnership" for federal income tax purposes.

² These tax rules also apply to limited liability companies.

1.1 Dissolution and Liquidation of the Partnership,
Immediately Followed By a Section 1031 Exchange of the Property.

The IRS has ruled that taxpayers did not "hold" the Relinquished Property for the required qualified use, where the property was received by the taxpayer as a liquidating distribution from a legal entity and then immediately exchanged for the Replacement Property.³ Contrary to this IRS ruling, the Tax Court in **Mason**⁴ held that exchanges by partners who received the Relinquished Property in a partnership liquidation qualified for tax-free exchange treatment. Similarly, in **Bolker**⁵, the Ninth Circuit Court of Appeals held that shareholders qualified for tax-free exchange treatment even though the shareholders exchanged the Relinquished Property after they received that property in a corporate liquidation. The Ninth Circuit in **Bolker** held that Section 1031 only requires a taxpayer to own the Relinquished Property before entering into the exchange and to have no intent either to

³ See Rev. Rul. 77-337, 1977-2 C.B. 305.

⁴ T.C. Memo 1988-273. **Mason** did not specifically address the §1031 "holding" requirement issue.

⁵ 760 F.2d 1039 (9th Cir. 1985). In **Bolker**, the corporation liquidated under former §333 followed by the shareholders entering into an exchange of the liquidated property.

liquidate the Relinquished Property or to use the Relinquished Property for personal purposes.⁶

1.2 **Solution to First Liquidate the Partnership and Then the Former Partners Hold the Liquidated Relinquished Property as Tenants-In-Common Before Doing an Exchange.**

A safer tax strategy is to have the former partners hold their tenant-in-common interests in the Relinquished Property (after the partnership liquidates) for an extended time period before they exchange those interests for the Replacement Property. However, for tax purposes the former partners' tenancy-in-common relationship must be structured so as not to be treated as a partnership for tax purposes.⁷ Thus, the formalities of a tenancy-in-common

⁶ Taxpayers who desire to split up partnerships must also be aware that the IRS could attack the "drop and swap" transaction or similar split-up transactions under a step-transaction doctrine. In a step-transaction, if the steps are in substance integrated and focused to a particular result, then the tax significance of each of the separate steps is ignored, and instead the tax consequences of the step transaction as a whole is considered. The step transaction was utilized in **Crenshaw**, 450 F2d 472 (5th Cir. 1971), to find that a transaction did not qualify as a §1031 exchange where the taxpayer exchanged the property shortly after the taxpayer acquired the property in a partnership distribution.

The IRS may also attack a drop-and-swap transaction under a "substance-over-form" argument as it successfully did in **Chase**, 92 TC 874 (1989).

⁷ The Regulations allow a co-tenancy to avoid being classified as a partnership if the co-tenancy is simply maintaining, repairing and renting the property. See Treas. Regs. §301.7701-1(a)(2). Management activities by the co-tenancy should be limited as much as possible in order that the relationship does not rise to a business relationship resulting in partnership tax status. There should be a written co-tenancy agreement which preserves the normal rights of a co-tenancy under state law.

relationship should be observed. To formalize the appearance of a tenancy-in-common, the individual tenants-in-common names should be titled on the property's deed, and the partnership's liquidation should be legally formalized by filing the requisite state dissolution and termination documents, such as a Form LP-3 Certificate of Dissolution for liquidating California limited partnerships.⁸

1.3 **Alternative Solution For the Partnership To First Do the Exchanges Into the New Properties, Followed By a Distribution of the Properties to the Former Partners.** An

alternative solution is that the partnership first completes the Section 1031 tax-free exchanges at the partnership level into multiple Replacement Properties. Second, the partnership then liquidates and distributes each Replacement Property to a specific group of partners. This alternative solution has several tax issues which must be addressed. First, the IRS may argue that the distributed Replacement Property was not held after the exchange for investment purposes since it was immediately distributed out of the partnership. Second, since many exchanges utilize the Section 1031 deferred exchange 45-day identification rules, there will be

⁸ For an example on how not to create a valid co-tenancy relationship, see **Chase**, 92 T.C. 874 (1989), where the tenant-in-common did not execute the sale's escrow agreement, and the partnership continued to manage the property and allocate economic benefits as though the tenancy-in-common distribution had not occurred.

limits on the number of identified Replacement Properties. Accordingly, the limitation on the number of alternative Replacement Properties may prevent this alternative solution from working.

1.4 **IRS Guidelines On How to Be Classified as a Tenancy-in-Common and Not as a Partnership For Tax Purposes.** The IRS issued Rev. Proc. 2002-22 to list the conditions under which the IRS will consider a revenue ruling request that a tenancy-in-common interest (sometimes known as a "TIC") will not be treated as a partnership interest for tax purposes under Section 7701 (in order to qualify for Section 1031 purposes). Rev. Proc. 2002-22 was issued in response to the real estate syndication industry that has grown up to market tenancy-in-common interests in large real estate properties to those persons needing Replacement Property to complete their Section 1031 exchanges.

(a) **Consequences of Not Complying With Rev. Proc. 2002-22.** Rev. Proc. 2002-22 states that its conditions are "not intended to be substantive rules and are not to be used for audit purposes," and rather are only a list of items to be complied with in order to obtain a favorable IRS revenue ruling. However, because of the uncertainty of when a tenancy-in-common becomes a partnership for tax purposes, IRS field agents are likely to defer to this Rev. Proc.'s listed conditions on audit. Nonetheless, many

tax advisors feel that violating certain of Rev. Proc. 2002-22's conditions does not automatically trigger partnership classification. As a practical matter, Rev. Proc. 2002-22 provides guidelines for structuring TICs which are acquired as Replacement Property in like-kind exchanges.

(b) **Rev. Proc. 2002-22's Requirements.** A summary of Rev. Proc. 2002-22's major requirements in order for the IRS to issue a favorable revenue ruling are as follows:

(i) Each TIC owner must hold title to the real property directly or through a single member limited liability company as a tenant-in-common, but not by a separate taxable legal entity.

(ii) The number of TIC co-owners may not exceed 35 persons.

(iii) The co-owners should not hold themselves out as a separate legal entity. Thus, the TIC co-owners should not file a partnership return, conduct business under a common name, nor hold themselves out as a business entity.

(iv) The TIC co-owners may enter into a tenancy-in-common agreement.

(v) The TIC co-owners must unanimously approve sales agreements, leases, deeds of trust and encumbrances, and management agreements (and hiring of the manager) of the

property. Other agreements may require only a majority approval of the TIC co-owners.

(vi) A manager cannot be hired for a period in excess of one year, and the TIC owners cannot give a general power of attorney to the manager.

(vii) Each TIC co-owner must be able to transfer, partition and encumber their respective TIC interest without the approval of another TIC owner. To enable the tenancy-in-common agreement to comply with lender requirements, the Revenue Procedure states that lender requirements which are consistent with customary commercial lending practices will not be prohibited, such as lender requirements to control the alienation of the TIC interests. Thus, there is an exception that permits a TIC co-owner to waive partition rights where a lender asks for this partition waiver by the TIC co-tenants.

(viii) Each TIC owner must share profits and losses in proportion to their tenancy-in-common percentage interest. The reason for this requirement is that if losses or profits are specially allocated to only certain TIC co-owners, this appears to be more like a partnership than a TIC co-ownership arrangement.

(ix) The TIC co-owners must share any debt secured by a lien on the real property in proportion to the co-

owners' TIC interests, and such debt's must be recorded against the property. If the property is sold, any debt encumbering that property must be repaid, and the net sales proceeds must be distributed to the TIC owners on a pro rata basis.

(x) Each TIC co-owner may have an option to acquire an interest of another TIC co-owner at a fair market value on the date of exercise, but a TIC co-owner may not acquire an option to sell its interest to the promoter, a lessee, or another TIC co-owner (*i.e.*, a "put"). There is no permission in the Rev. Proc. to have a right of first refusal in the other TIC co-owners' interests.

(xi) The TIC's activities must be limited to those customarily performed in connection with the maintenance of real estate.

(xii) Any lender on the TIC's property may not be related to any TIC co-owner or the sponsor, manager or lessee of the property.

(xiii) Any payments to a sponsor that sets up the TIC or for the acquisition of the TIC interest and any of the sponsor's other services must be at fair market value and may not depend on the income or profits of the TIC-owned property. Therefore, a sponsor of a TIC interest cannot share in the net profits of the property for its services.

Rev. Proc. 2002-22 requires each TIC co-owner to retain the right to approve the major decisions of the tenancy-in-common. Thus, Rev. Proc. 2002-22 states that each co-tenant must retain the right to approve: (i) the hiring of any manager; (ii) the sale of the Property; (iii) the disposition or lease of the property; or (iv) creation of a lien on the property. Because it may be cumbersome with large numbers of co-tenants to approve a sale or lease, or to make a major decision, some tax professionals structure tenancy-in-common agreements with an "implied consent" provision under which each co-tenant is provided notice of a major event (i.e., a sale, lease, finance or reappointment of the manager), and then each co-tenant has a specified time period to object (such as 60 or 90 days). If none of the co-tenants object to the proposed action, then that action is deemed to have been approved. Some tax professionals feel that this provision of a "time period to object" can only be applied to the manager's agreement (and such "objection method" may not be applied to the lease, sale or financing of the property).

Some TIC agreements have a long triple-net master lease of the Replacement Property to a master tenant (who may be related to the syndicator/sponsor of the TIC), and then this master tenant subleases the property to the tenants who are the actual property tenant users. Using a master lease removes the need of each co-

tenant to approve the leases for all the various property's tenants (such as in an office or apartment building). Query: Does a "master lease" violate Rev. Proc. 2002-22?

(c) **Rev. Proc. 2002-22 By Its Terms Does Not Apply to Liquidating Partnerships.** Having a partnership liquidate its properties to partners as tenants-in-common (followed by the property's sale) is probably the most frequently used technique when some partners want to exchange for property and others want to cash out. Taxpayers have relied on **Bolker** (discussed above) for the Section 1031 "holding" issue, and on Rev. Proc. 2002-22 to be treated as tenants-in-common. However, clients should note that Rev. Proc. 2002-22 states that the IRS will not issue a favorable ruling when the exchanging tenants-in-common previously held their property interests through a partnership. This prohibition on previously owning the property through a partnership, contained in Rev. Proc. 2002-22, sends a "warning" of how the IRS might treat a partnership liquidation followed by a Section 1031 exchange.

(d) **Why Has the IRS Not Issued Many Revenue Rulings Under Rev. Proc. 2002-22?** Rev. Proc. 2002-22 provides the IRS requirements for obtaining an advance favorable revenue ruling as to whether an arrangement will be classified as a TIC (and not a partnership). Rev. Proc. 2002-22's requirements are not absolute rules of tax law, and this Revenue Procedure does not create a safe

harbor. Because it is difficult to satisfy each and every requirement of Rev. Proc. 2002-22, most sponsors of TIC interests have not obtained a revenue ruling from the IRS. Instead, many TIC sponsors obtain tax opinion letters from law firms to indicate whether their particular TIC arrangement complies with tax laws to be a valid tenancy-in-common.

There have only been a few private letter rulings in the TIC area. In Priv. Ltr. Rul. 200513010, a company acquired a property that was triple-net leased to unrelated tenants. The acquiring company then proceeded to sell TIC interests in the acquired property to no more than 35 persons. The co-tenancy agreement between the TIC co-owners required unanimous TIC owner consents to enter into any leases of the property, sale of the property, reappointment of a property manager or the incurrence of debt on the property. For all other actions, the approval of more than 50% of the undivided TIC owners was required. All of the property's income, expenses and net sales proceeds were allocated among the TIC owners in proportion to their TIC percentage ownership interests. Each TIC owner retained the right to exercise its right of partition, but before exercising such right, it had to offer to sell its co-tenancy interests to the other TIC owners at fair market value. There was also a management agreement with a related management company to manage the property. There was a procedure

for non-renewal of this management agreement and allowing TIC co-owners to object to provisions in the management agreement. The IRS held that this co-ownership arrangement satisfied all of the conditions set forth in Rev. Proc. 2002-22. The structure satisfied the requirement of each TIC owner retaining the right to approve the hiring of the manager, the sale of the property and the lease of the property. Of special importance was that each TIC owner could exercise a right to terminate the management agreement annually. Additionally, the IRS held that this tenancy-in-common arrangement did not become a "business" because the activities of the management company and the TIC owners were only those customarily done in triple-net leasing. Thus, the IRS held that the property did not constitute an interest in a partnership. [Also see Priv. Ltr. Ruls. 200826005, 200829012 and 200829013.]

(e) **Application of Rev. Proc. 2002-22 to Syndicated TICs.** TICs offer clients the ability to quickly exchange into a suitable Replacement Property, which fits their cash return and replacement liability amount needs. TICs also allow clients to exchange into properties of a lesser value (since the client is only receiving a fractional tenancy-in-common interest in the property rather than having to exchange into an entire higher-priced property). TICs enable clients to have immediate professional management of their Replacement Property,

and allows the clients to disburse their exchange proceeds among multiple Replacement Properties. Clients can compare various TICs, their rates of return and financing arrangements in order to competitively purchase a TIC Replacement Property on the most advantageous terms and for the most advantageous price. Clients who consider purchasing TIC interests must carefully review non-tax issues such as the quality of the underlying property, the property's tenants, the amount of management costs and fees, whether there are any tenant guarantees, and how the client will be able to sell the client's TIC interest at a later date and for how much. The TIC syndicator/sponsor under Rev. 2002-22 Proc. cannot have a buy back right.

Syndicated TICs are securities which must comply with federal and state securities laws. Because real estate brokers generally do not have a securities license, TICs are often marketed through the securities industries.⁹

1.5 **Using Disregarded Entities to Own Tenancy-In-Common Interests.** Persons owning tenancy-in-common interests in the Replacement Property may wish to limit their personal liability by not owning the TIC interest in their individual names. Rather,

⁹ For a good discussion on the advantages of TICs, TIC due diligence items, and the tax and business issues of TICS, see Christine Tour-Sarkissian, *Section 1031 Exchanges and Tenancy-in-Common Interests*, **Real Property Law Reporter**, Continuing Education of the Bar of California, July 2006.

they may choose to utilize a disregarded entity, (such as a single-member limited liability company) to own their TIC interests. Owning the TIC interest in a single-member limited liability company is advantageous since the death or bankruptcy of the individual who owns the LLC (which in turn owns the TIC interest) will not affect the other TIC owners. Rev. Proc. 2002-22 specifically states that disregarded entities can hold a TIC interest.

Additionally, many lenders today require that a TIC co-owner own their interest in a single-member LLC, since this will remove the TIC interest from the risk of an individual's creditor problems, bankruptcy or death. Additionally, if the single-member LLC files for bankruptcy under federal bankruptcy laws, it will facilitate an earlier dismissal or relief from an automatic stay. Finally, the single-member LLC is unlikely to have other creditors outside of the property's lender.

1.6 **Using a Delaware Statutory Trust to Own Property in an Exchange.** When a Delaware statutory trust, which is a grantor trust, engages in a Section 1031 exchange, the trust beneficiaries' interests are treated as ownership interests in the underlying real properties if the requirements of Rev. Rul. 2004-86, 2004-33 IRB 191 are satisfied. Thus, a Delaware statutory

trust could be used instead of a TIC ownership arrangement in certain circumstances.

Rev. Rul. 2004-86 allows the use of a Delaware statutory trust as a disregarded entity in limited situations. This Revenue Ruling states when a Delaware trust will be classified as a "trust" for tax purposes under Reg. Section 1.7701-4 or when it will be classified as a "business entity." Where the trust entity is classified as a "trust," then this trust must also satisfy the grantor trust rules under Section 671 in order for the trust to be deemed to own an interest in the property for purposes of Section 1031. If a Delaware statutory trust is not treated as a "trust" for tax purposes (and is instead treated as a business entity), then the trust's beneficial interests are treated as either an interest in a partnership or a corporation under Section 7701, which in turn would not constitute valid like-kind "Replacement Property" under the Section 1031 rules.¹⁰ In summary, a Delaware statutory trust qualifying under Rev. Rul. 2004-86 can have its beneficial interests exchanged tax free for real property under Section 1031, which is similar to exchanging TIC interests.

¹⁰ If the beneficial interests in a trust were classified as a partnership, this would violate §1031 rules on prohibiting exchanging real estate into partnership interests or from exchanging partnership interests for other partnership interests.

To qualify under Rev. Rul. 2004-86, the trust beneficiaries cannot be involved in the operation or management of the trust, and the trustee cannot have any of the following powers:

(i) The trustee cannot dispose of the trust's property and then acquire new property (although the trustee can sell the trust's assets and dissolve the trust).

(ii) The trustee cannot enter into new leases.

(iii) The trustee cannot renegotiate a lease with an existing tenant.

(iv) The trustee cannot have new debt encumber the trust's assets.

(v) The trustee cannot renegotiate any existing debt.

(vi) The trustee cannot invest cash received to profit from market fluctuations (all cash must be invested in short-term Treasuries that will be distributed at the end of each calendar quarter).

(vii) The trustee may not make more than minor common nonstructural modifications to the trust's property not required by law.

The purpose of the above restrictions is to have a qualifying Delaware statutory trust, whose interests are to be exchanged tax free under Section 1031, engage only in the passive holding of rental real estate.

2. CASHING OUT PARTNERS WHERE THE PARTNERSHIP ENGAGES IN A TAX-FREE EXCHANGE.

Commonly, real estate partnerships desire to split up with certain partners receiving cash (referred to as the "cash-out partners"), and then the remaining partners exchange tax-free into other real estate. To achieve these dual goals, partnerships sometimes sell their real estate and use a portion of the sales proceeds to exchange tax-free into other real estate, while simultaneously distributing cash to the cash-out partners in full redemption of the cash-out partners' partnership interests. The partnership's intent is only for the cash-out partners to report taxable gain proportionate to the sales proceeds which they receive and for the remaining partners in the exchanging partnership to receive tax-free exchange treatment. However, distributing cash to only the cash-out partners may result in all of the partners (including the remaining partners who desire to receive tax-free exchange treatment) being taxed on the property's sale's recognized gain if the partnership agreement allocates gain to all partners in proportion to their percentage interests.

2.1 Attempting to do a Special Allocation of the Partnership's Gain to the Cash-Out Partners. Partners may consider amending their the partnership agreement to specially allocate all of the gain on a property's sale to only the cash-out partners, and

none of the gain to the remaining partners who do a Section 1031 exchange. However, this special gain allocation is likely to fail Section 704(b)'s substantial economic effect test, because the special gain allocation would have to be reflected in the cashed-out partners' capital accounts, which in turn could alter the economic deal among the partners.¹¹

2.2 **Solution of Redeeming the Cash-Out Partners For Cash Before the Exchange.** An alternative tax structure is that prior to the Relinquished Property's sale, the partnership fully redeems the cash-out partners' partnership interests using existing partnership cash reserves. The partnership could then proceed to exchange the Relinquished Property for the Replacement Property in a qualifying tax-free exchange.

2.3 **Have the Cash-Out Partners Receive a Promissory Note in the Sale of the Relinquished Property.** Another alternative tax structure is for the partnership to sell the Relinquished Property for cash and a promissory note. After the Relinquished Property's sale, the cash-out partners receive a distribution of the promissory note in exchange for the redemption of their partnership interests. The promissory note is structured to pay the cash-out partners principal and interest in the year of the

¹¹ For a further discussion, see **Real Property Exchanges**, 3rd Ed., California Continuing Education of the Bar, pp. 455-458.

exchange and in the following calendar year.¹² Thus, only those partners who receive a distribution of the promissory note will have to recognize gain. Those partners desiring to receive tax-free exchange treatment then continue as partners in the partnership and have the partnership use their share of the Relinquished Property's sales proceeds to engage in a Section 1031 tax-free exchange. In a typical transaction, substantially all of the promissory note is paid to the cash-out partner shortly after the close of the Relinquished Property's sale, with the remaining payments (sometimes three percent or less of the promissory note's principal amount) made immediately after the beginning of the immediately next tax year, in order to qualify for installment sale treatment under Section 453(b)(1). Thus, distribution of the promissory note to the cash-out partners will not trigger recognized gain to the partnership nor to those partners until they receive payments. [See Sections 453 and 731.]

For Section 731 purposes, "unrealized receivables" are defined under Regs. Section 1.751-1(c)(1) as rights to payment for property other than a capital asset. Accordingly, an installment note sale of a capital or Section 1231 asset, and its distribution by the

¹² If an installment promissory note is received in a §1031 exchange, then any gain recognized is deferred under the installment method of reporting until the note payment is received. The distribution of the promissory note to the partners will not accelerate the note's gain under §453, since Treas. Regs. §1.453-9(c)(2) states that a partner's receipt of an installment note in a §731 distribution does not result in gain under §453B.

partnership, would not be subject to Section 751(a), except perhaps to the extent gain on a Section 1231 asset is treated as ordinary income.

A concern with using this installment promissory note tax planning strategy is that if the buyer of the Relinquished Property has a weak credit rating, there may be a hesitancy by the cash-out partners to accept the buyer's promissory note. However, one way to overcome a poor credit-rated buyer is to have that buyer post a standby letter of credit as further collateral. A standby letter of credit is not treated as a payment under Temp. Reg. 15A.453-1(b)(3)(i).

2.4 Alternative Tax Plan of the Partnership Distributing a Fractional Tenancy-In-Common Interest in the Relinquished Property to the Cash-Out Partners Prior to the Exchange. Another alternative tax structure is as follows: First, the partnership distributes a fractional tenancy-in-common portion of the partnership's Relinquished Property to the cash-out partners in redemption of the cash-out partners' partnership interests. Second, the cash-out partners and the partnership (which have become TIC owners of the Relinquished Property) then engage in a sale of the Relinquished Property. In the sale, the cash-out partners retain their cash sales proceeds (and report the sale's gain thereon), while the partnership uses its portion of the

Relinquished Property's sales proceeds to enter into a tax-free exchange.

The above tenancy-in-common relationship must be structured so as not to be treated as a continuation of the former partnership for income tax purposes (see discussion of preserving tenancy-in-common tax status, above). The Section 1031 requirement that the tenants in common hold the Relinquished Property for use in a trade or business or for investment should not be an issue since the partnership, which always owned and held the Relinquished Property, will be doing the Section 1031 exchange.

3. PROBLEM OF CONTRIBUTING REPLACEMENT PROPERTY TO A NEW PARTNERSHIP IMMEDIATELY AFTER THE COMPLETION OF THE EXCHANGE (OR THE SO-CALLED "SWAP AND DROP").

Sellers of Relinquished Property in a tax-free exchange may attempt to pool their property's equity with other persons by: first, receiving their Replacement Property in a complete tax-free exchange; and second, the contributing that Replacement Property (or a tenancy-in-common interest in that Replacement Property) to a partnership with other persons. However, contributing Replacement Property to a partnership immediately following an exchange risks violating the "holding" requirement of Section 1031

discussed above.¹³ In other words, the Replacement Property was not "held" for productive use in a trade or business or for investment purposes. Instead, the Replacement Property was immediately disposed of by the Replacement Property's contribution to a partnership.

3.1 **Asserting That the "Holding" of Replacement Property is Attributed to the Original Exchanging Party.** Clients who contribute their interests in the Replacement Property to a partnership immediately after an exchange could rely upon the Ninth Circuit Court of Appeals **Magneson**¹⁴ decision to attribute the partnership's holding of the Replacement Property to the clients. Relying on **Magneson**, however, could be a risky tax strategy. The Ninth Circuit in **Magneson** stated that the taxpayer's contribution of the Replacement Property to a partnership did not violate the "hold for" requirement because the taxpayer intended to, and did

¹³ The IRS ruled in Rev. Rul. 75-292, 1975-2 C.B. 333 that a prearranged transfer to a newly owned corporation of the Replacement Property did not qualify for tax-free exchange treatment because the Replacement Property had not been "held" for a permissible use.

¹⁴ 753 F.2d 1490 (9th Cir. 1985). The Ninth Circuit's **Magneson** holding was based upon the fact that the Replacement Property was being contributed to the partnership in exchange for a general partnership interest. Some commentators have argued that **Magneson** is no longer applicable to §1031 exchanges since the **Magneson** decision was based upon an exchange occurring prior to the enactment of §1031(a)(2)(D) (which today would prohibit an exchange of partnership interests from qualifying under §1031), and, furthermore, that **Magneson** was based upon certain California partnership statutes, which have since been amended.

continue to, "hold" the Replacement Property through its ownership of a partnership interest. According to the Ninth Circuit, there was a "mere change" in the form of the taxpayer's ownership of the Replacement Property. Since **Magneson** was decided for tax years before the enactment of Section 1031(a)(2)(D), the IRS might today argue that based upon a step transaction, a "swap and drop" transaction is in substance a taxpayer's acquisition of a partnership interest as Replacement Property which violates Section 1031's requirements. In other words, the IRS might argue today that in a **Magneson** type transaction the taxpayer is effectively receiving back a partnership interest in exchange for real estate, which does not satisfy Section 1031's like-kind property requirement.

3.2 **An Alternative Safer Tax Structure is For the Exchanging Party to Hold the Replacement Property as a Tenant-in-Common After Completing the Exchange.** An alternative and safer tax plan would be for the exchanging party to hold the Replacement Property as a tenant-in-common with the partnership for a substantial time period after completing the exchange and not to immediately contribute the Replacement Property to the partnership. In order to avoid the IRS claim that the exchange and the later partnership contribution should be tied together as a step transaction for tax purposes, the exchanging party should not have

an agreement to later contribute the Replacement Property to the partnership.¹⁵ Additionally, the tenancy-in-common relationship between the exchanging party and the partnership must be structured so as not to be classified as a partnership for income tax purposes.

4. USING SECTION 1031 TO EXCHANGE INTO REPLACEMENT PROPERTY TO BE CONSTRUED IN THE FUTURE.

Clients may desire to sell their Relinquished Property and then exchange into the Replacement Property when improvements are constructed on that Replacement Property at a later date. However, contracts to construct improvements are **not** like-kind to real property for Section 1031 tax-free exchange treatment.¹⁶

4.1 Improvements Constructed in a Deferred Exchange.

In a deferred exchange, a client may acquire Replacement Property to be improved during the 180-day deferral period (or due date of the client's return, if sooner). Under Regs. Section 1.1031(k)-1(m)(3)(iii), improvements not completed before the end of the deferred-exchange period will still be deemed substantially the same as the Replacement Property identified by the client within the 45-day identification period, if: (i) the improved Replacement

¹⁵ See ***Crenshaw v. U.S.***, 450 F.2d 472 (5th Cir. 1971) for the application of the step transaction doctrine to a partnership liquidation followed by a §1031 exchange.

¹⁶ See, for example, ***Bloomington Coca-Cola Bottling Co.***, 189 F.2d 14 (7th Cir. 1951).

Property would have been considered substantially the same property as identified by the client, had it been completed when received by the client; and (ii) when the Replacement Property is received, the partially completed improvements constitute the real property under applicable state law.

4.2 **Use a Reverse Tax-Free Exchange to Acquire Future Constructed Improvements.** To construct improvements on the Replacement Property which will qualify for like-kind exchange treatment, sellers often will have the Replacement Property's improvements constructed by an independent party (sometimes known as an "accommodator"), and then at a later date exchange into that Replacement Property which will also include the constructed improvements.

For example, the seller may do a "reverse tax-free exchange" by first having the Replacement Property acquired by an independent accommodator (who must not be classified as the seller's agent for tax purposes) and then have this independent accommodator construct the improvements upon the Replacement Property. When the improvements are fully constructed and become part of the replacement real property, the Replacement Property (including the newly constructed improvements) are then exchanged for the Relinquished Property.

For construction exchanges, there are generally two ways to do a reverse exchange: the first way is to qualify under the "safe harbor" provisions of Rev. Proc. 2000-37; and the second way is to do a "non-safe harbor" reverse exchange.

4.3 **Doing a "Safe Harbor" Reverse Exchange Under Rev. Proc. 2000-37.** A safe harbor reverse exchange is a "parking arrangement" whereby the Replacement Property is first acquired or "parked" with a third party, who is referred to in Rev. Proc. 2000-37¹⁷ as an "exchange accommodation titleholder" or "EAT." Rev. Proc. 2000-37 provides a safe harbor for parking arrangements whereby the Replacement Property's acquisition is completed prior to the disposition of the Relinquished Property. Where an exchanging taxpayer satisfies all of the requirements of Rev. Proc. 2000-37, the IRS will not challenge the EAT's ownership of the parked Replacement Property.

In Rev. Proc. 2004-51,¹⁸ the IRS stated that Rev. Proc. 2000-37 does not apply to Replacement Property held in a qualified EAT if the Replacement Property had been owned by the taxpayer within the 180-day period ending on the date of the transfer of the Replacement Property to the EAT. Thus, Rev. Proc. 2004-51 follows

¹⁷ 2000-40 I.R.B. 308. The Revenue Procedure allows several alternative safe harbor parking arrangements using a third-party "exchange accommodation titleholder."

¹⁸ Rev. Proc. 2004-51, IRB 2004-33, 294, indicates the IRS continues to study parking transactions in the §1031 area.

the theme of the Tax Court's *DeCleene*¹⁹ decision. In *DeCleene* the taxpayer was denied tax-free exchange treatment when the taxpayer transferred taxpayer-owned land to a third party who then was required to construct the improvements and transfer that land with the newly constructed improvements back to the taxpayer. To avoid the adverse result of Rev. Proc. 2004-51, the Replacement Property should be transferred by the taxpayer to an unrelated party more than 180 days before the Replacement Property is transferred to the EAT.

If the requirements of Rev. Proc. 2000-37 are satisfied, then the EAT is permitted to borrow money from the exchanging party, the exchanging party is permitted to guaranty the EAT's construction loans, and the EAT may enter into an accommodation agreement with the client allowing client loans, leases and indemnification agreements with the EAT that effectively makes the EAT the client's agent. In other words, if all the requirements of 2000-37 are not satisfied (and only a portion of the requirements are satisfied), then the client, by using this Rev. Proc., can unwittingly create an agency relationship with the EAT, thereby denying the client Section 1031 treatment.

One of the difficult requirements of Rev. Proc. 2000-37 (which many clients fail to satisfy) is the requirement that the

¹⁹ *Donald DeCleene*, 115 T.C. 457 (2000).

exchanging party receive the Replacement Property within 180 days of the EAT acquiring title to the Replacement Property. Because of potential construction delays, the EAT likely may take longer than 180 days to construct the improvements.²⁰ Accordingly, clients who cannot satisfy this 180-day time requirement but still utilize the other provisions of Rev. Proc. 2000-37 may walk into a trap by creating an "agency relationship" with their EAT, which will in turn cause the client to not satisfy the Section 1031 exchange requirement. Therefore, if the client/seller desires to exchange into improvements which will be constructed over a period longer than 180 days, the client/seller should instead choose to do a non-safe harbor construction exchange.²¹

4.4 **Solution of Doing a Reverse Exchange Outside of Rev. Proc. 2000-37 (So-called "Non-Safe Harbor Construction Exchange")**. If all of the safe harbor requirements of Rev. Proc. 2000-37 cannot be satisfied, then the construction exchange can still be structured to qualify under Section 1031 based upon case

²⁰ For a thorough discussion of Rev. Proc. 2000-37, see Borden, Lederman and Spear, *Build-to-Suit Ruling Breaks New Ground For Taxpayers Seeking Swap Treatment*, **Journal of Taxation**, Vol. 98. No. 1, January 2003, at 22.

²¹ Rev. Proc. 200-37 specifically states that no inference is intended by this Revenue Procedure as to parking arrangements which are similar to, but outside of, the scope of the Revenue Procedure's requirements.

law.²² In a typical non-safe harbor transaction, an independent accommodator²³ first acquires the Replacement Property on which the improvements are to be constructed. The accommodator's acquisition financing and the construction financing may come from either the client or the client's lender. In many cases, the client has an option to acquire the Replacement Property after the improvements are constructed in order to complete the exchange. When the client is prepared to sell the Relinquished Property to the third party buyer, the client then closes the exchange by using a qualified intermediary to transfer the Relinquished Property to the third party buyer and acquire the Replacement Property from the accommodator.²⁴

²² For an example, see **Fredericks v. Commissioner**, T.C. Memo 1994-27, where the Tax Court upheld tax-free exchange treatment on property constructed in the future.

²³ See **J. H. Baird Publishing Co.**, 39 T.C. 608 (1962), acq. 1963-2CB4. An accommodator is a person independent of the taxpayer who takes title to the Replacement Property in the construction exchange, so that the taxpayer does not own both the Replacement Property and the Relinquished Property at the same time. If the taxpayer were to own both properties (whether legally or beneficially) at the same time, there could not be an "exchange" for §1031 purposes. Also see **Boise Cascade Corp.**, TC Memo 1974-315, and **Coastal Terminals Inc.**, 320 F2d 333 (4th Cir. 1963) for cases where the Relinquished Property's buyer acquired the Replacement Property and constructed the improvements on the Replacement Property.

²⁴ Generally, a qualified intermediary will not want to serve directly as the accommodator for the construction of the improvements because of liability concerns. A qualified intermediary is a person who enters into a written exchange agreement with the taxpayer and, as required by the agreement, acquires Relinquished Property from the taxpayer, transfers it and acquires like-kind Replacement Property and transfers the Replacement Property to the taxpayer. The qualified intermediary cannot be the taxpayer or the taxpayer's agent, nor be related to the taxpayer or to the taxpayer agent; see Regs.

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(a) **Accommodator Must Not Be the Taxpayer's Agent in a Non-Safe Harbor Exchange.** In *J. H. Baird Publishing Co.*²⁵, an accommodator who acquired the Replacement Property and constructed improvements thereon on the exchanging party's/taxpayer's behalf was not held to be the taxpayer's "agent." Similarly, in *Fredericks*²⁶, an accommodator who acquired the Replacement Property was not classified as the taxpayer's "agent," even though the accommodator was owned and controlled by the taxpayer, who acquired the Replacement Property. On the other hand, in *DeCleene*²⁷, the taxpayer was denied tax-free exchange treatment when the taxpayer transferred land to a third party that constructed improvements and transferred the improved land back to the taxpayer. The *DeCleene* holding is similar to Rev. Proc. 2004-51, where the IRS ruled that Section 1031 will not apply to taxpayers who already own the Replacement Property that the taxpayer intends to exchange into. The IRS in Priv. Ltr. Rul. 200111025 emphasized that for a reverse

§1.1031(k)-1(g)(4)(iii).

²⁵ See footnote 23 above.

²⁶ See footnote 22 above.

²⁷ See *Donald DeCleene*, 115 T.C. 457 (2000). However, the IRS in PLR 200111025 recognized a successful §1031 exchange and the accommodator was not the taxpayer's agent, when the documentation showed an intent to do a §1031 exchange. PLR 200111025 used a title company as the accommodator and predated Rev. Proc. 2000-37.

exchange to qualify under Section 1031, the accommodator must not be the taxpayer's agent.

To determine whether the accommodator is the taxpayer's agent, the IRS in Priv. Ltr. Rul. 200111025 indicated that the test of ***National Carbide Corp.***²⁸ should be applied, which is: (i) whether the accommodator is operating in the name of the taxpayer; (ii) whether the accommodator can bind the taxpayer by the accommodator's actions; (iii) whether the accommodator transmits money received by the accommodator to the taxpayer; (iv) whether the receipt of income is attributable to services of employees of the accommodator and to assets belonging to the accommodator; and (v) whether the business purpose of the relationship is the carrying on of an agent's normal duties.

(b) **Have Accommodator Directly Acquire Title to the Replacement Property in a Non-Safe Harbor Exchange.** DeCleene instructs clients who do non-safe harbor construction exchanges to not take title to the Replacement Property, but instead to use an accommodator to take title and construct the improvements on the Replacement Property.

(c) **Evidence an Intent to Achieve a Qualified Section 1031 Tax-Free Exchange, and That There is an Integrated Plan to Exchange the Relinquished Property for the Replacement**

²⁸ 336 U.S. 422 (1949)

Property. In Priv. Ltr. Rul. 200111025 the IRS indicated that the general requirements for a Section 1031 exchange to be realized in a parking arrangement is that: (i) the exchanging party demonstrates an intention to achieve a Section 1031 exchange; (ii) the steps in the various transfers of property are part of an integrated plan to exchange the Relinquished Property for the Replacement Property; and (iii) the accommodator is not the agent of the exchanging party (see the discussion above on agency).

(d) **Shift the Benefits and Burdens of Ownership to the Accommodator in a Non-Safe Harbor Exchange.** Even though Priv. Ltr. Rul. 2001110025 did not directly apply a "benefits and burdens" test to a reverse exchange, the IRS in Field Advice Memorandum 20050203 (discussed below) recently suggested that such a test should be applied to reverse exchanges. Additionally, the IRS argued in the ***Bartell*** Tax Court case which is currently pending a decision (discussed below) that this benefits and burdens test should apply to the accommodator.

Accordingly, exchanging parties should attempt to satisfy this "benefits and burdens" test. Under this test, the Replacement Property acquisition should be structured to shift the "burdens and benefits" of the Replacement Property's ownership (such as having some risk of loss and some profit potential in the accommodator) to the accommodator so that the accommodator, and not the exchanging

client, will be recognized as the Replacement Property's owner for tax purposes until the exchange is completed.

How long can you have all of the Replacement Property's appreciation go only to the client and no benefits of ownership go to the accommodator? The accommodator can be given a risk of loss by having the accommodator contribute money to the Replacement Property's acquisition or make an economic outlay for the Replacement Property. Arguably, ten percent invested by the accommodator should be enough of any investment. What about an investment of only three to five percent of the Replacement Property's cost?

The accommodator could obtain the initial monies to acquire the Replacement Property (and thus have an investment in the Replacement Property) by such methods as: (i) the taxpayer loans monies to the accommodator; (ii) the accommodator pays monies from the accommodator's own pocket to purchase the Replacement Property; or (iii) the accommodator becomes a joint venturer of an unrelated party and the taxpayer (with the taxpayer owning less than 50% of this joint venture) and a bank, by nonrecourse financing, loans monies to the joint venture for the Replacement Property's acquisition and construction thereon.

(e) **IRS Field Advice Memorandum on Non-Safe Harbor Reverse Exchanges.** The IRS chief counsel issued a Field Advice

Memorandum FAA20050203, which discussed a construction exchange predating Rev. Proc. 2000-37. This Field Advice Memorandum discusses which factors evidence the accommodator's beneficial "ownership" of the Replacement Property. The IRS concludes that the taxpayer (and not the accommodator) had beneficial ownership of the Replacement Property for tax purposes (thus causing the taxpayer to not qualify under Section 1031), even though the accommodator had legal title to the Replacement Property. This Field Advice Memorandum found that the taxpayer (and not the accommodator) had all of the economic benefits and economic burdens of ownership. The IRS found that the taxpayer bore the risk of economic loss and physical damage to the property and received the benefits of profits from the property's operations and appreciation, rather than the accommodator. The accommodator invested no money in the Replacement Property and the accommodator paid none of the costs of construction.

(f) **IRS Continues to Study the Reverse Exchange Area.** The IRS in issuing Rev. Proc. 2004-51 stated that the IRS continues to study parking transactions, including transactions in which a person related to the taxpayer: (i) transfers a leasehold in land to an accommodation party; (ii) the accommodation party makes improvements to the land; and (iii) the accommodation party then transfers the leasehold with the improvements to the taxpayer

in exchange for other real estate. Thus, the IRS continues to study construction exchanges and future IRS pronouncements on reverse exchanges are probable.

(g) **There is a Pending Tax Court Case on Construction Exchanges.** Currently, the *Bartell* Tax Court case, dealing with construction exchanges, has been fully briefed, and a decision is pending. The *Bartell* case should determine if the accommodator must invest money in the Replacement Property and assume the economic burdens of constructing improvements on the Replacement Property.

5. PROPERTY BEING EXCHANGED MAY INCLUDE BOTH REAL ESTATE AND PERSONAL PROPERTY.

A basic Section 1031 exchange requirement is that the property sold (the "Relinquished Property") and the property received (the "Replacement Property") must be "like-kind." Generally, real estate is classified as like-kind to other interests in real estate. The Regulations state that the words "like-kind", in the case of real estate, refers to the "nature or character of the property and not to its grade or quality."²⁹

²⁹ Treas. Regs. §1.1031(a)-1(b). However, domestic real estate cannot be exchanged for foreign real estate under §1031(h).

In the case of real estate, land can be exchanged for improved real estate and a 30-year or more leasehold can be exchanged for a fee interest in real estate.³⁰

5.1 **Real Estate Cannot Be Exchanged For Personal Property.** If the Relinquished Property consists of personal property, then the Replacement Property must also consist of similar like-kind personal property or, alternatively, "like-class" personal property to the Relinquished Property's tangible personal property.³¹ Depreciable tangible personal properties are of a like-class if they are within the same "General Asset Class" or "Product Class." Product classes are based on the North American Industry Classification System under Temp. Regs. Section 1.1031(a)-2(b)(3).

Real estate cannot be exchanged tax-free for personal property. Unfortunately, some owners unwittingly violate this like-kind requirement by failing to recognize that personal property is often included as part of the building being exchanged

³⁰ Treas. Regs. §1.1031(a)-1(c). Options to renew a lease are counted in determining whether a lease has 30 years or more to run under Rev. Rul. 78-72, 1978-1 CB 258.

³¹ See Treas. Regs. §1.1031(a)-2(b)(1). When exchanging multiple classes of personal property, then to analyze the amount of gain under §1031 the taxpayer must separate the different types of personal properties into exchange groups by like kind or like class. See Treas. Regs. §1.1031(j).

(such as refrigerators, washers and moveable stoves in apartment buildings), or where cost segregation studies have been performed.³²

5.2 **A Common Taxpayer Mistake is Failing to Understand That the Incidental Property Exception Only Applies to the Deferred Exchange Identification Rules, and Does Not Apply to Determine If Properties Are "Like-Kind".**

Exchanging parties sometimes mistakenly believe that the "incidental property exception," under Reg. Section 1.1031(k)-1(c)(5)(i), which states that minor items of personal property do not have to be separately identified in a deferred tax-free exchange, also applies to the like-kind property requirement of Section 1031.³³ However, this "incidental property exception" only applies to determine whether the property is being properly identified for purposes of complying with the time requirements of the deferred exchange rules. If even a small amount of personal property is exchanged along with real property, then like-kind personal property must also be received in the exchange in order to satisfy Section 1031's like-kind property requirements.

³² Land improvements classified in cost segregation studies still remain §1250 real property for §1031 purposes. Land improvements, which can be depreciated over 15 years (using the 150% declining balance method), are, for example, parking lots, sidewalks, outside lighting, patio areas and outside underground utilities.

³³ For purposes of the deferred-exchange rules, "incidental property" is property transferred with a larger item of property in a standard commercial transaction, which has an aggregate fair market value not exceeding 15% of the larger property's value. The "incidental property" must relate to the larger item of property.

5.3 What Happens When Personal Property Comprises Part

of the Building? Personal property is present where parts of buildings are reclassified in cost segregation studies as personal property. Reclassification of property by cost segregation studies allows sophisticated building owners to reduce their income taxes by accelerating depreciation and amortization deductions and avoiding the 39-year straight-line recover period for commercial real property or the 27½ year straight line period for residential real property.³⁴ Reclassified personal property can be amortized and depreciated over shorter time periods (usually five or seven years) using the double declining method. [See §§168(c)(e)(1).] Most personal property associated with real estate will have a seven-year recovery period. However, certain personal property used in rental real estate, such as appliances, carpeting and furniture, will have a five-year recovery period. Prior to January 2009, an even greater tax incentive exists to reclassify building parts as personal property with first-year bonus depreciation deduction of 50%.

³⁴ The IRS in Rev. Rul. 2003-54, I.R.B. 2003-23, explained how to classify property as personal property. "Personal property" includes tangible personal property as defined in the former investment tax credit rules of Treas. Regs. §1.48-1(c). Rev. Proc. 87-56, 1987-2 C.B. 674 sets forth the class lives of various types of property. For an example of IRS approvals of cost segregation studies, see the IRS internal memorandum issued on December 6, 2003 on "Planning and Examination of Cost Segregation Issues in Restaurant Business."

In order to reclassify parts of buildings as personal property, real estate owners and their accountants commonly perform cost segregation studies.³⁵ These cost segregation studies are based upon the tax rules outlined in *Hospital Corp. of America*.³⁶ The reclassified personal property is then depreciated over a shorter recovery life than the real property.³⁷ Specialized refrigeration, restaurant, medical, manufacturing or computer equipment, and the plumbing, electrical, ventilation, and flooring systems in connection with specialized systems may be classified as personal property to be depreciated over short recovery periods.³⁸ Also, office cabinetry, carpeting, special lighting fixtures,³⁹

³⁵ Many accounting firms and appraisal companies market to clients cost segregation studies as a way to save taxes. For a discussion of cost segregation studies' standards in order to classify building parts as "tangible personal property," rather than as part of the building's inherently permanent structure, see the case of *Whiteco Industries, Inc.*, 65 T.C. 664 (1975), *acq.* 1980-1 C.B. 1.

³⁶ 109 T.C. 21 (1997), *nonacq.* 1999-35 I.R.B. 314.

³⁷ Even real estate owners who in the past may have failed to segregate out "personal property" to receive these increased depreciation deductions can still do so on their current federal income tax returns. See Rev. Proc. 2002-9, 2002-3 I.R.B. 327 for doing an automatic IRS consent to change in accounting method for depreciation methods. Rev. Proc. 2004-11 states that a change or adjustment in a property's useful life is not a change in the method of accounting based on Temp. Treas. Regs. §1.446-1T(e)(2)(ii)(d). Rev. Proc. 2004-11 even allows taxpayers who claimed less than the property's "allowable" depreciation to change to the correct depreciation amount in the year of the property's sale.

³⁸ See *Hospital Corp. of America*, *supra*, note 36; and *Piggly Wiggly Southern, Inc.*, 803 F.2d 1572 (11th Cir. 1986).

³⁹ See *Shoney's South, Inc.*, T.C. Memo 1984-413.

gasoline pump canopies⁴⁰ and retail signs⁴¹ may be classified as personal property to be depreciated over a much shorter time than real estate. In certain real estate projects such as a shopping center, the project's name may have value to be amortized over 15 years under Section 197.

5.4 **Recapture Rules of Sections 1245 and 1250 Can Also Trigger Gain On An Exchange.** In addition to satisfying the Section 1031 "like-kind" property rules, in order for the gain on exchanged Section 1245 property to be deferred, the provisions of Section 1245(b)(4) must be complied with. Section 1245(b)(4) states that when Section 1245 property is exchanged, the property's Section 1245 recapture will not be recognized only to the extent like-kind Section 1245 property is received as Replacement Property having a fair market value equal or greater than the amount which would otherwise be recaptured on a taxable disposition of the Section 1245 property. Thus, when real estate with Section 1245 property (created by cost segregation studies or otherwise) is exchanged, then Section 1245 property must be part of the Replacement Property to avoid gain recognition under Section 1245(b)(4).

⁴⁰ In Rev. Rul. 2003-54 I.R.B. 2003-23, the IRS ruled that gasoline station pump canopies are not inherently permanent structures and are tangible personal property to be recovered over five or nine years, depending on the depreciation system used.

⁴¹ See ***Southland Corp.***, 611 F.2d 348 (Ct. Cl. 1979).

Similarly, Section 1250(d)(4) recaptures excess depreciation deductions over straight-line deductions when improved real property is exchanged. For example, this issue can arise when land improvements are depreciated over 15 years at a 150% declining balance method. Generally, if improved real estate is exchanged for other improved real estate, Section 1250(d)(4) will not be an issue since the Replacement Property improvements should protect recognizing gain under Section 1250(d)(4).

5.5 **Solutions Where the Relinquished Property Contains**

Personal Property. Even minor amounts of personal property involved in real property exchanges can trigger gain recognition. To meet the Section 1031 "like-kind" property requirement, when personal property comprises part of the Relinquished Property or the Replacement Property, like-kind or like-class personal property should be included in the other property. The multiple property like-kind rules apply to determine the classification of the various properties where both real and personal property are being exchanged.⁴²

One tax strategy used by some exchanging parties to avoid recognizing gain when only the Relinquished Property (or

⁴² Even minor amounts of personal property involved in real property exchanges can trigger gain recognition. Under the multiple asset exchange Treasury Regulations where both personal and real property are part of the building's property being exchanged, the real and personal properties must be classified and put into like-kind or like-class exchange groups. Treas. Regs. §1031(j)-1.

Replacement Property) contains personal property is to evidence that the other property's personal property has no value and thus is not part of the exchange. Clients might consider obtaining an appraisal to evidence that the personal property has no value, as well as include a provision in the property's sales agreement with the Relinquished Property's buyer which states that any personal property has no value (however, the Relinquished Property's buyer may refuse to include this provision, instead preferring a high value for its purchased personal property to increase the buyer's personal property's tax basis, and thus the buyer's own depreciation deductions).

An alternative tax strategy for exchanging into like-kind property following a cost segregation study is to argue that the reclassified personal property remains "real property" for purposes of the Section 1031 like-kind exchange rules based upon the definition of real property under California state law. Exchanging parties can argue that reclassified "personal property" is still "real estate" for purposes of the §1031 like-kind exchange rules based upon the fact that it is only the special federal statutory tax rules under §§168 and 167, that allow parts of buildings to be classified as personal property for cost segregation purposes. For §1031 purposes, however, state law determines if property is

personal or real.⁴³ California law classifies items (including prior personal property) which is permanently affixed to the building as "real property." [See California Civil Code Section 658.]

Remember, however, that the Sections 1245(b)(4) and 1250(d)(4) rules, discussed above, must also be complied with to avoid gain

⁴³ See, for example, Rev. Rul. 77-414 1977-2 CB 299, Priv. Ltr. Rul. 8443054, and Priv. Ltr. Rul. 200805012.

The Tax Court relied upon state law to determine whether supply contracts were treated as real estate for §1031 purposes in **Peabody Natural Resources Company**, 126 T.C. No. 14 (2006). In **Peabody** even though the Court found that the supply contracts were real property, the Court said for §1031 purposes the nature and character of the transferred contract rights must also be substantially alike to qualify as like-kind property. The Tax Court held that the supply contracts (which in **Peabody** were the right to extract coal from a mine) were derived from the ownership of the real property (the mine), and thus the supply contracts (being intricately attached to the real property) were like-kind to other fee interests in other real property. In other words, the supply contracts were an integral part of the taxpayer's ownership rights in the real property (the mine) and such supply contracts were inseparable from the fee ownership. **Peabody** supports the tax position that personal property attached to real estate and which becomes real property for state law purposes is "like-kind" to other Replacement Property real property.

The IRS reaffirmed that the determination of whether property is real or personal is made under state law in Priv. Ltr. Rul. 200631012. In this Private Letter Ruling the issue was whether a taxpayer who sold stock in a New York residential cooperative (which was being held for investment) could exchange the sales proceeds tax free into real property. The IRS stated the determination of whether the stock in the cooperative was real or personal property is made under New York state law. New York law holds that stock in a cooperative is equivalent to an interest in real property. As such, the taxpayer could exchange tax free under Section 1031 from stock in a New York residential cooperative into Replacement Property which was real estate.

In Priv. Ltr. Rul. 200805012 the IRS ruled that if development rights are real property for state law purposes then, such development rights are like kind to a fee interest in real estate

recognition in the exchange. Accordingly, if Section 1245 property is part of the Relinquished Property (and does have a value), then Section 1245 property should be part of the Replacement Property to avoid gain recognition under Section 1245(b)(4).

6. HOW TO USE THE SECTION 1031 LIABILITY RULES TO HAVE THE EXCHANGING PARTIES RECEIVE CASH TAX FREE.

6.1 **Section 1031 Rules on Indebtedness.** Gain on a Section 1031 exchange is recognized to the extent of the cash and the fair market value of other property received (known as "boot").⁴⁴ If the Relinquished Property is subject to a deed of trust, then the amount owed on this deed of trust obligation, of which the exchanging party is relieved of in the exchange, is treated as money or "boot" received by the exchanging party under Section 1031.⁴⁵

The Regulations provide that the amount of indebtedness that the exchanging owner is relieved of in the exchange is netted against the amount of the liabilities that the owner assumes or takes the Replacement Property subject to.⁴⁶ The seller is permitted to encumber the Replacement Property as part of the

⁴⁴ Treas. Regs. §1.1031(b)-1(c). There is no distinction between the assumption of a liability and the acquisition of the property subject to a liability. See I.R.C. §1031(d).

⁴⁵ See I.R.C. §1031(b) and Treas. Regs. §1.1031(b).

⁴⁶ Treas. Regs. §1.1031(b)-1(c).

closing of the acquisition of the Replacement Property and then to net such encumbrance against any debt that the taxpayer is relieved of on the Relinquished Property.⁴⁷

Replacement Property indebtedness for purposes of the "netting rules" does include a new deed of trust placed upon the Replacement Property at the time it is acquired by the exchanging party. However, cash or other property received by the seller/client in an exchange cannot be netted against the consideration given in the form of assumed liabilities on the Replacement Property.⁴⁸

6.2 **What Happens Where the Encumbered Relinquished Property Consists of Both Real Estate and Personal Property?** Where the Relinquished Property consists of both real and personal property and is encumbered by a lien or deed of trust, the seller can unexpectedly recognize gain because the Treasury Regulations require that all of the liabilities in an exchange be allocated among each property exchange group (based upon the relationship of each property group's fair market values) even if these liabilities are not secured by a particular exchange group's properties [see Treas. Regs. Section 1.1031(j)-(1)(b)(2)]. Thus, the liability

⁴⁷ See Priv. Ltr. Rul. 9853028 and TAM 8003004 along with **Barker**, 74 T.C. 555 (1980).

⁴⁸ Treas. Regs. §1.1031(d)-2.

netting rules can surprisingly produce recognized gain where both real and personal property are involved in the exchange.

6.3 **Consequences of Reducing a Partner's Share of Partnership Liabilities When Doing an Exchange.** What are the tax consequences of a deferred exchange where the Relinquished Property is owned by a partnership? Section 752(a) states that any increase in a partner's share of liabilities is considered a contribution of money by that partner to the partnership. Any decrease in a partner's share of liabilities is considered as a distribution of money to the partner by the partnership under Section 752(b). On a distribution of property to a partner, that partner must recognize gain to the extent that such deemed distribution exceeds such partner's adjusted basis in its partnership interest immediately before the distribution [see Section 731(a)]. Thus, on the first leg of an exchange when the Relinquished Property (which is encumbered by a loan) is conveyed to the qualified intermediary, there is a reduction in the partner's share of liabilities. Upon the second leg of the exchange, where there is the acquisition of the Replacement Property subject to a loan, there would be an increase in the partner's share of liabilities.

In Rev. Rul. 2003-56 the IRS ruled on the tax consequences of partnership liabilities in Section 1031 exchanges that occur over two taxable years. This Revenue Ruling states that if the

partnership enters into a deferred like-kind exchange in which the Relinquished Property subject to a liability is conveyed in year one, and Replacement Property subject to a liability is acquired in year two, the liabilities are netted for purposes of the Section 752 rules.⁴⁹ Similarly, under Rev. Rul. 2003-56, if the Relinquished Property has relief of liability in excess of the Replacement Property's liabilities, the resulting gain is recognized as taxable income in year one when the Relinquished Property is transferred. This result in Rev. Rul. 2003-56 should be contrasted with the tax result where the cash boot received in year two in a deferred exchange covering two taxable years is recognized as taxable income in year two (and not in year one).

6.4 **Client Can Receive Cash Tax Free in a Section 1031 Exchange By Refinancing the Relinquished Property Before an Exchange.** Sellers of real estate in a tax-free exchange may want to receive cash without having to recognize taxable gain. Normally cash received from an exchange escrow is taxed to the seller as "boot." However, instead of receiving taxable cash as part of the exchange, the client/seller could refinance the Relinquished

⁴⁹ Rev. Rul. 2003-56 is an analysis under the §1031 rules, and not under the 752 Regulations. Thus, it is unclear whether the tax rule of Rev. Rul. 2003-56 applies in the 1033 area.

Property before the exchange and receive these refinancing loan proceeds tax free.⁵⁰

The IRS took the position 20 years ago in a private letter ruling that encumbering property immediately before an exchange may result in "boot" in certain cases [See Priv. Ltr. Rul. 8434015]. The IRS in Priv. Ltr. Rul. 8434015 argued that the result in **Garcia** should not apply. However, to date there has been no case law authority supporting the IRS's position in Priv. Ltr. Rul. 8434015.

The Replacement Property after the exchange still needs to be subject to at least the same amount of indebtedness as the seller was relieved of on the Relinquished Property in order to avoid gain recognition.

6.5 **Client Can Receive Cash Tax Free in a Section 1031 Exchange By Refinancing the Replacement Property After an Exchange.**

An alternate tax strategy is for the seller to first complete the tax-free exchange and then refinance the Replacement Property at a later date after the exchange closes. The seller is able to receive these refinancing loan proceeds tax free. The refinancing of the Replacement Property after completing the exchange allows the taxpayer to withdraw tax free the equity inherent in the Replacement Property. In order to avoid an IRS challenge that the

⁵⁰ See **Garcia v. Commissioner**, 80 T.C. 491 (1983), acq. 1984-1 C.B. 1; and **Fredericks v. Commissioner**, T.C. Memo 1994-27.

financing proceeds received from the Replacement Property are "boot" to the taxpayer, the refinancing of the Replacement Property should be done only after the closing of the acquisition of the Replacement Property, and should be done by a separate loan escrow and separate closing statement.

6.6 **Clients Must Avoid a Step Transaction When Refinancing the Property.** The refinancing of the Replacement Property after the exchange or the Relinquished Property before the exchange should not be tied to the exchange by written or oral understandings or prearranged loans, in order to avoid IRS assertions that the received loan proceeds are instead taxable "boot" from the Section 1031 exchange under a step-transaction theory.⁵¹

7. **HOW TO AVOID APPLICATION OF THE RELATED PARTY EXCHANGE RULES.**

Clients who have related legal entities owning real estate might want to exchange this real estate between their legal entities to accomplish business goals such as liability protection, or may wish to achieve tax goals such as exchanging high tax basis land for low tax basis buildings thereby transferring their land's

⁵¹ In Priv. Ltr. Rul. 200019014, the IRS ruled that liabilities placed on Replacement Property which do not have a bonafide business reason apart from the exchange, may not be applied under the liability "netting" rules.

non-depreciable tax basis to their depreciable buildings' tax basis.

Properties may be exchanged tax free between related parties.⁵²

Example: Taxpayer owns recently acquired land which has a tax basis and a fair market value of \$10 million dollars. Taxpayer and the taxpayer's children own in a limited liability company a depreciable building with a fair market value of \$10 million dollars and a tax basis of \$1 million dollars. Taxpayer exchanges the taxpayer's land with the limited liability company so that after the exchange the taxpayer owns the building and the limited liability company owns the land. The result of this transaction is that the taxpayer owns the building with a new tax basis of \$10 million dollars while the related party limited liability company owns land with a tax basis of \$1 million dollars. This exchange transaction qualifies for Section 1031 tax-free treatment and no gain will be recognized on the exchange so long as neither the taxpayer nor the limited liability company subsequently dispose of their respective properties within the requisite two (2) year holding period.

Section 1031(f) imposes a two-year holding period requirement for related parties engaging in a Section 1031 exchange. Basically, Section 1031(f) requires that where a taxpayer exchanges property with a related party, both parties to that exchange must hold their respective properties for at least two years after that exchange in order to receive Section 1031 tax-free exchange treatment.⁵³ Thus, if either related party to the exchange disposes of the property which they received in the exchange before the end

⁵² See, e.g., *Coastal Terminals, Inc. v. U.S.*, 320 F.2d 333 (4th Cir., 1963); and *Fredericks v. Commissioner*, T.C. Memo 1994-27.

⁵³ The determination of who is a related party is based upon §§267(b) and 707(b)(1).

of this two-year holding period, any gain or loss which would have been recognized in the exchange by either party will be recognized on the date that the disqualifying disposition occurred.⁵⁴

7.1 Purpose of the Section 1031(f) Related Party Rules.

The Section 1031(f) related party rules were added to the Internal Revenue Code to prevent taxpayers from exchanging low-basis property for high-basis property to avoid the recognition of gain on subsequent property sales or to accelerate a loss on retained property.⁵⁵ Without the related party rules of Section 1031(f), taxpayers could exchange low basis Relinquished Property with a related party who had high-basis Replacement Property, and the related party could then sell the Relinquished Property (which acquired a new high tax basis in the exchange) and receive the sale's cash proceeds tax free.⁵⁶ This would result in the related

⁵⁴ I.R.C. §1031(f)(1). There are exceptions for a disposition within the two-year period by reason of the death of either related party, compulsory or involuntary conversion of the exchanged property, or any disposition if neither disposition nor the exchange "has as one of its principal purposes the avoidance of federal income tax." I.R.C. §1031(f)(2).

⁵⁵ The legislative history of §1031(f) states that the reason for the statutory change was that if an exchange of properties between related parties is shortly followed by a disposition of the property, effectively the related parties have "cashed out" of the investment, and thus §1031 non-recognition treatment should not apply. S. Fin. Rep. No. 56, 101st Cong., 1st Sess. 151 (1989).

⁵⁶ The related party's tax basis in the Relinquished Property which the related party receives in the exchange increases to the high tax basis of the Replacement Property that the related party transfers in the exchange. See I.R.C. §1031(d).

party cashing out the Relinquished Property investment tax free. Section 1031(f) was designed by Congress to prevent this result.

7.2 **Section 1031(f) Has Broad Application and Applies to Indirect Transfers Between Related Parties.** The Section 1031(f) related party rules cover "indirect" transfers between related parties. This "indirect" transfer rule may cause clients to unwittingly violate the related party rules, and thereby trigger taxable gain, when they utilize a qualified intermediary to do a deferred Section 1031 exchange.⁵⁷

In *Teruya Brothers, Ltd.*⁵⁸ the Tax Court held that using a qualified intermediary to purchase Replacement Property from the exchanging party's related entity was structured to avoid the "purposes" under Section 1031(f)(4). In *Teruya Brothers, Ltd.* there were two similar exchange transactions. In both exchanges the taxpayer first transferred Relinquished Properties to a qualified intermediary. The qualified intermediary then proceeded to sell these Relinquished Properties to unrelated third parties. However, the qualified intermediary then used the Relinquished Properties' sales proceeds (along with additional monies contributed by the taxpayer) to purchase Replacement Property from

⁵⁷ Furthermore, §1031(f)(4) states that transactions structured to avoid the "purposes" of the related party rules of §1031(f) will not qualify for §1031 tax-free exchange treatment.

⁵⁸ 124 T.C. 45 (2005), Appeal Pending to the Ninth Circuit Court of Appeals.

the taxpayer's subsidiary corporation, which was related to the taxpayer. The subsidiary corporation had large NOLs. The subsidiary corporation retained the Replacement Property's cash sales proceeds and used the NOLs to shelter the gain from one of the Replacement Property's sale.⁵⁹ The Tax Court stated that Section 1031(f) should apply to deny Section 1031 treatment where the Relinquished Property is transferred to an unrelated party (*i.e.*, here the unrelated qualified intermediary), who then exchanges this property with a related party within the two-year period. The Tax Court held that these transactions are "economically equivalent" to direct exchanges of properties between related parties. The economic result in *Teruya Brothers, Ltd.* was that the Relinquished Property investment was "cashed out" immediately and the exchanger's related party subsidiary corporation ended up with the cash proceeds which used its NOLs to shelter the Replacement Property's gain. The Tax Court held that under Section 1031(f)(4), transactions structured to avoid the "purposes" of the Section 1031(f) related party rules will not qualify for Section 1031 tax-free exchange treatment. The taxpayer argued that the exchange did not have as one of its principal purposes the "avoidance of Federal income tax," since there was

⁵⁹ The sale of another Replacement Property by the subsidiary corporation generated a capital loss which was disallowed under §267 as a loss on a sale between related persons.

recognized gain on the sale of the Replacement Property. However, this argument was unsuccessful since the subsidiary related party had a large NOL. Arguably, if the subsidiary did not have a large NOL, this taxpayer argument may have worked. (However, the taxpayer probably would not have engaged in the exchange if there was no NOL in the related party subsidiary!)

Similar to the facts in *Teruya Brothers, Ltd.*, is IRS Rev. Rul. 2002-83⁶⁰ where the property owner transferred its Relinquished Property to a qualified intermediary who then transferred the Relinquished Property to an unrelated third party for cash sales proceeds. The qualified intermediary then utilized the cash proceeds from the Relinquished Property's sale to enter into a deferred exchange to acquire the Replacement Property from a party related to the taxpayer for cash. Thus, the related party retained the cash after the exchange was completed. The IRS in Rev. Rul. 2002-83 ruled that property owners exchanging low basis property would not receive Section 1031 tax-free exchange treatment, since the related party disposed of the Replacement Property for cash within the required two-year holding period. This exchange which was done through a qualified intermediary is characterized by the IRS as being a prohibited disposition of the Replacement Property by the related party within the required two-year holding period.

⁶⁰ 2002-49 I.R.B. 927.

Rev. Rul. 2002-83 can be interpreted to mean that if a qualified intermediary is utilized in connection with exchanges between related parties and either related party receives cash from that exchange, then the Section 1031(f) related party rules apply to prevent tax-free exchange treatment.⁶¹

Many times a client with related party entities owning real properties needs to exchange these properties between these entities in order to have the real properties owned by the correct related entity. Section 1031(f)(4) could unwittingly produce recognized taxable gain to the client in these circumstances, especially where a qualified intermediary is used.

7.3 **How to Avoid Violating the Section 1031(f) Related Party Rules When Using a Qualified Intermediary.** One solution to avoid the result of *Teruya Brothers, Ltd.*, and Rev. Rul. 2002-83 where Replacement Property is acquired from a related party, is to structure the exchange so that neither related party receives cash in the exchange or from the sale of either the Relinquished Property or the Replacement Property during the required two-year holding period.

⁶¹ *However*, see Priv. Ltr. Ruls. 200251008 and 200329021 where the IRS ruled that the §1031(f) related party rules do not apply where improvements on the Replacement Property are constructed by a related party. Here, an EAT constructed improvements on land which was leased from a party related to the exchanging taxpayer. Both construction exchanges qualified under Rev. Proc. 2000-37.

The IRS in Priv. Ltr. Rul. 200440002 held that where related parties successfully engaged in a Section 1031 exchange using a qualified intermediary and neither party "cashed out" of its respective exchanged real property, no gain was recognized.

In Priv. Ltr. Rul. 200810017, two related limited liability companies exchanged through a qualified intermediary real properties. Since neither related party cashed out of their properties, no gain was recognized under Section 1031. The IRS in Priv. Ltr. Rul. 200810017 did not view the exchange through the qualified intermediary as a prohibited disposition within the two year period under Section 1031(f)(1).

Similarly, the IRS in Priv. Ltr. Rul. 200616005 held that there was a qualified tax-free exchange where related parties engaged in two exchanges and neither party at the completion of the exchange "cashed out" their investments in their real properties. In Priv. Ltr. Rul. 200616005 a trust owned building I, and a related S corporation owned building II. The trust sold building I to an unrelated third-party buyer in a sale utilizing a qualified intermediary and through that qualified intermediary utilized the building I sales proceeds to acquire in a Section 1031 exchange building II from a related S corporation. The S corporation then proceeded to utilize the proceeds that it had previously received from the trust for building II, to acquire other Replacement

Property in another exchange. Upon the completion of both exchanges, the trust owned building II, the S corporation owned the S corporation's Replacement Property, and the unrelated third-party buyer owned building I. The IRS pointed out that after the completion of the exchange neither the trust nor the related S corporation are in receipt of cash proceeds from the exchange (or sale) of their respective relinquished properties.

7.4 **Permitted Exchange Involving Related Parties.** A related party to the taxpayer may first acquire the Relinquished Property from that taxpayer; and second the taxpayer, in an exchange, acquires the Replacement Property from an unrelated person.

Commonly a person will sell their Relinquished Property to a related party for cash and will then use that cash to consummate an exchange into Replacement Property from an unrelated party. Subsequent to completing this exchange the related party (that had acquired the Relinquished Property) then sells that Relinquished Property within the prohibited 2-year period.

Normally, the Section 1031(f) related party rules are to prevent the taxpayer from receiving the Replacement Property from a related party. In the above illustration, the related party is acquiring the Relinquished Property from the taxpayer/seller, and then the taxpayer acquires the Replacement Property from an

unrelated third party. Thus, this latter transaction does not "avoid" the Section 1031(f) rules pursuant to three IRS Private Letter Rulings released in 2007⁶², and the exchange qualifies under Section 1031.

7.5 **Exchanging Properties Between Related Family Members**. Many times families with large real estate holdings need to split up these holdings in a tax-free manner. One tool to accomplish this split up is the Section 1031 tax-free exchanges. However, an issue that often arises is that these family members are related to each other for purposes of the Section 1031(f) related party rules. To avoid the application of the Section 1031(f) related party rules to family split-ups, demonstrate that neither the exchange nor a later disposition of the properties by the related family members "had as one of its principal purposes the avoidance of federal income tax." [See Section 1031(f)(2)(C)].

In Priv. Ltr. Rul. 200706001, the IRS held that the Section 1031(f)(2)(C) non-tax avoidance exception to Section 1031(f) applied where there was no shifting of tax basis from one property to another property. The facts in Priv. Ltr. Rul. 200706001 was that the parent's death caused a step up in basis of all of the properties and, thereby, prevented a basis shift on a subsequent Section 1031 exchange.

⁶² See Priv. Ltr. Ruls 200709036; 200712013; and 200728008.

In Priv. Ltr. Rul. 200730002 related family members owned fractional interests in two real properties. The related parties exchanged their fractional interests so that one family member owned 100% of a property and then subsequently sold that property for cash. The IRS held in Priv. Ltr. Rul. 200730002 that there was a lack of tax avoidance motive under Section 1031(f)(2)(C) based on the legislative history that a non tax avoidance will generally apply to a transaction involving the exchange of undivided interests in different properties that results in each taxpayer holding either an entire interest in a single property or a larger undivided interest in any of such properties.⁶³

8. AVOIDING THE PROBLEM OF THE CLIENT NOT HAVING ENOUGH TIME TO IDENTIFY AND CLOSE ESCROW ON THE REPLACEMENT PROPERTY IN A DEFERRED TAX-FREE EXCHANGE.

Clients engaging in deferred tax-free exchanges must identify the Replacement Property within 45 days after closing the Relinquished Property sale. Also, in a deferred exchange, the client must receive Replacement Property on the earlier of the 180th day after the Relinquished Property is transferred or the due date of the client's tax return for the tax year of such transfer (including extensions). [Regs. §1.1031(k)-(b)(2)(i)]. Clients may have difficulty meeting these time requirements.

⁶³ See H.R. Rep. No. 386, 101st Cong., 1st Ses. 614 (1989).

8.1 Rules For Identifying the Replacement Property.

Sellers can identify: (i) three alternative Replacement Properties within 45 days of the Relinquished Property's sale without regard to the fair market value of the Replacement Properties; or (ii) any number of Replacement Properties as long as the aggregate fair market value as of the end of the 45-day identification period does not exceed 200 percent of the aggregate fair market value of the Relinquished Property.⁶⁴ Alternatively, taxpayers can identify multiple Replacement Properties if the taxpayer timely closes the purchase of at least 95 percent of the value of all identified Replacement Properties before the end of the exchange period.⁶⁵

8.2 Do Not Commit Tax Fraud By Backdating Documents.

As some exchanging clients find themselves approaching the 45-day identification deadline without having yet identified their Replacement Property, they may be tempted to "backdate" identification documents in violation of the tax laws. Sellers who falsify documents or change dates in an attempt to fall within the 45-day period should keep in mind the civil fraud case of ***Dobrich v. Commissioner***,⁶⁶ where the taxpayer was liable for penalties for backdating exchange identification documents. The ***Dobrich*** taxpayer

⁶⁴ See Treas. Regs. §1.1031(k)-1(c)(4)(i).

⁶⁵ See Treas. Regs. §1.1031(k)-1(c)(4)(ii)(B).

⁶⁶ See ***Dobrich v. Commissioner***, 188 F.3d 512 (9th Cir. 1999).

also pled guilty in a companion criminal tax case for providing false documents to the IRS.

8.3 **How Clients Can Obtain More Time to Identify the Replacement Property.** One technique for a client to gain more time to identify the Replacement Property is to delay the Relinquished Property's sale closing date. For example, a client/seller can obtain more time to identify the Replacement Property by including a provision in the Relinquished Property's sale agreement giving the seller an option to extend the Relinquished Property's escrow closing date. Another alternative solution to extend the commencement date of the 45-day period is for the seller to first lease the Relinquished Property to the buyer, with the buyer purchasing the Relinquished Property at a later date.⁶⁷

8.4 **The 45-Day and 180-Day Time Periods Can Be Extended in the Event of a Presidentially Declared Disaster.** Taxpayers who are "affected" by a Presidentially declared disaster or other event (such as terrorism or combat) and have difficulty because of the event in meeting the 45-day and 180-day deadlines may obtain an extension of 120 days under Section 7508 and 7508A and IRS Notice

⁶⁷ The lease should be at fair rental value and terms in order to avoid the IRS trying to recharacterize the lease as a sale for tax purposes.

2005-3⁶⁸ (modifying Rev. Proc. 2004-13⁶⁹). Under Notice 2005-3, if the last day of the 45-day or 180-day period falls on or after the date of the Presidentially declared disaster, then such last day is postponed by 120 days.⁷⁰ The exchanging client only qualifies for this postponement if: (i) the Relinquished Property was transferred on or before the date of the Presidentially declared disaster⁷¹, and (ii) the taxpayer is "affected." "Affected" includes if the taxpayer cannot meet the 45-day or 180-day period because the Relinquished Property or Replacement Property is located in the disaster area, or if the attorney, qualified intermediary or taxpayer's principal place of business is in the disaster area, or if the lender will not fund because of the disaster.⁷² Presidential declared disaster areas included Los Angeles, Orange and Ventura counties based upon the fall 2007

⁶⁸ IRB 2005-5.

⁶⁹ 2004-4 IRB 335.

⁷⁰ Section 7508 postpones time for performing specific acts for individuals serving in the armed forces, while §7508A permits the Secretary to postpone deadlines for taxpayers affected by Presidentially declared disasters, terrorism or military action. The IRS will issue News Releases regarding postponements.

⁷¹ There are also provisions for reverse exchanges with EATS under Rev. Proc. 2000-37.

⁷² See Reg. §301.7508A-1(d)(1) for other ways the taxpayer is an "affected taxpayer."

wildfires pursuant to IRS News Release IR-2007-178 dated October 29, 2007.

9. VERIFY THE CREDITWORTHINESS OF THE QUALIFIED INTERMEDIARY.

Some clients engaging in a deferred tax-free exchange leave millions of dollars in the name of the qualified intermediary who is to complete their exchanges. Surprisingly, property owners who are careful to obtain title insurance policies, perform due diligence on the Replacement Property, and verify the credit worthiness of their tenants often fail to verify the financial viability of their qualified intermediary. Exchanging sellers should investigate the financial condition of the qualified intermediary which is holding and investing their exchange funds.

There are several alternative solutions under the Regulations by which sellers can protect their exchange funds being held by the qualified intermediary.

9.1 Solution to Hold Relinquished Property's Sales Proceeds in a Separate Escrow or Trust Account. Most qualified intermediaries do not put the exchange funds into a separate trust or escrow account, which could protect these funds from the qualified intermediary's bankruptcy or creditors. However, the Section 1031 Regulations permit the Relinquished Property's cash sale's proceeds to be held in an escrow or trust account for which

the Replacement Property is later purchased.⁷³ The exchange documents must, however, limit the exchanging party's right to receive, pledge, borrow or otherwise receive the benefits of the cash or cash equivalents held in such trust or separate account, except as permitted by the Regulations.

9.2 **Solution to Use a Deed of Trust, Letter of Credit or Guarantee as Security.** Sellers can also have the qualified intermediary's obligations secured by a deed of trust, conforming standby letter of credit, or a third-party guarantee.⁷⁴

Clients should review the guaranty carefully as to whether it is a normal commercial guaranty with adequate legal protections for the clients, and should verify the financial ability of the guarantor to perform under the guaranty.

The standby letter of credit should be non-negotiable and should provide for the payment of the proceeds to escrow for the purchase of the Replacement Property rather than payment to the exchanging owner.⁷⁵

⁷³ Treas. Regs. §1.1031(k)-1(g)(3).

⁷⁴ Treas. Regs. §1.1031(k)-1(g)(2).

⁷⁵ Payment of the letter of credit proceeds to the exchanging party will result in the exchanging party receiving cash (*i.e.*, "boot"), which in turn could trigger recognized gain in an otherwise tax-free exchange. See Treas. Regs. §1.1031(k)-1(f)(2) and §15A.453-1(b)(3).

10. USING SECTION 1031 WITH A PERSONAL RESIDENCE.

A residence (whether a principal residence or a vacation home) held solely for personal use will not qualify for Section 1031 tax-free exchange treatment. To qualify under Section 1031, the residence must have been "held" for investment or productive use in a trade or business.

10.1 Solution of Converting a Personal Residence to Investment Property. A personal residence can be converted into rental or investment property and then exchanged tax-free under Section 1031. Unproductive real estate held for future use or future realization of the increment in value is deemed held for investment under the Treasury Regulations.⁷⁶

In **Moore**⁷⁷ the taxpayer attempted to exchange one vacation home for another vacation home. The taxpayer utilized the vacation homes regularly, never rented out the vacation homes and did not claim any income tax deductions for maintenance, repairs or for investment interest. The Tax Court in **Moore** stated that the Relinquished Property and the Replacement Property must have been both held primarily for investment, and that the "investment purpose" cannot just be one of many purposes for the taxpayer having held the vacation homes.

⁷⁶ Treas. Regs. §1.1031(a)-1(b).

⁷⁷ See T.C. Memo 2007-134.

The IRS issued Rev. Proc. 2008-16⁷⁸ to provide a "safe harbor" where the IRS will not challenge as violating the Section 1031 "holding" requirement an exchange of "dwelling units" on or after March 10, 2008. This Revenue Procedure is only a safe harbor, and therefore taxpayers should be able to do exchanges of residential property which fall outside of the parameters of Rev. Proc. 2008-16 (provided that the taxpayer satisfies the requisite "holding" provisions of Section 1031 under existing case law and tax principles).

Rev. Proc. 2008-16 provides that a dwelling unit will be deemed to have been held for productive use in a trade or business or for investment under Section 1031 even if that taxpayer "occasionally" uses that dwelling unit for personal purposes. The IRS will not challenge the holding of that dwelling unit under Section 1031 if that dwelling unit meets the qualifying use standard test described as follows: A dwelling unit that is the Relinquished Property will be deemed held for productive use in a trade or business or for investment if that dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange; and within that 24 month period, in each of the two 12-month periods immediately before the exchange, the taxpayer rents

⁷⁸ Rev. Proc. 2008-16 was issued in response to a report issued by the Treasury Inspector General for Tax Administration ("TIGTA") indicating that the IRS needed to increase its oversight of §1031.

the dwelling unit to another person at a fair rental amount for 14 days or more, and the period of the taxpayer's personal use of the dwelling does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

The Replacement Property dwelling unit meets the Section 1031 test of being held for productive use in a trade or business or for investment if that dwelling unit is owned by the taxpayer for at least 24 months immediately after the exchange, and within that 24-month period, in each of the two 12-month periods immediately after the exchange, the taxpayer rents the dwelling unit to another person at a fair rental for 14 days or more, and the period of the taxpayer's personal use of the dwelling does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

The determination of the "personal use" of the taxpayer under this Revenue Procedure is important in order to determine how many days are to be charged against the taxpayer's 14-day or 10% limitations. Rev. Proc. 2008-16 states that the dwelling unit will have been utilized for the taxpayer's "personal use" if the dwelling unit is used by: (i) the taxpayer or any other person who has an interest in such dwelling unit (including a tenant-in-common) or by any member of the family of the taxpayer or such

other person; (ii) any individual who uses the dwelling unit under arrangement that enables the taxpayer to use some other dwelling unit (whether or not rent is charged for such other dwelling unit); and (iii) any individual if rented for less than fair rental value to such individual. The Revenue Procedure states that if the dwelling unit is rented to a family member who then uses it as their principal residence (and not as a vacation home) and that family member pays fair rental value, then same shall not be deemed a personal use by the taxpayer.

For purposes of this Revenue Procedure, a "dwelling unit" is defined to be real property improved with a house, apartment, condominium, or similar improvements that provide basic living accommodations, including sleeping space, bathroom and cooking facilities. Therefore, personal property such as boats or campers would not fall under this Revenue Procedure.

10.2 **Apply Both Sections 1031 and 121 to Sell a Prior Principal Residence Which is Currently Being Held as Investment Property.** What happens when the client wants to do a Section 1031 exchange of a residence which is currently being held by the client as investment property, but which was previously the client's principal residence?

Under Section 121 a taxpayer can exclude up to \$250,000 (\$500,000 if the taxpayer is married and files a joint tax return)

of gain realized on the sale of the taxpayer's principal residence. To qualify under Section 121, the taxpayer must have owned and used that residence as the taxpayer's principal residence for at least two of the five years prior to the residence's sale.⁷⁹

Under the **Housing Assistance Tax Act of 2008** (signed into law on July 30, 2008), Section 121 will not apply to the gain from the sale or exchange of a principal residence which is allocated to periods of nonqualified use after December 31, 2008. [See Section 121(b)(4).] Thus, the taxpayer cannot use Section 121 to shelter gain for those time periods where the taxpayer had nonqualified use of the personal residence after December 31, 2008. For example, a portion of the gain which is realized on the sale or exchange of a vacation home (which is converted into a principal residence after 2008) will not qualify for Section 121 exclusion treatment. Similarly, a portion of any gain realized on the sale of a residence which was acquired in a tax-free exchange as replacement property (which the taxpayer then later converted into a principal residence) and then later sold by the taxpayer may also be affected.

⁷⁹ Vacation homes do not qualify under §121, since §121 only applies to a principal residence. However, a vacation home can still qualify under §1031 if the taxpayer holds that vacation home for investment. Prior to Rev. Proc. 2008-16 many taxpayers took the position that their vacation homes were investments where there was substantial appreciation in value and the taxpayer used that vacation home a de minimus amount of time during the year.

In order to satisfy the Section 1031 requirements, the Relinquished Property must have been held for use in a trade or business (and not as a principal residence) immediately before the exchange. Fortunately, any portion of the Section 121 five-year look back period (for purposes of the two-year-out-of-five-year rule) which is after the last day that such property is used as the principal residence is not a period of nonqualified use.

The amount of gain allocated to periods of "nonqualified use" (to which Section 121 will not then apply) is the amount of gain multiplied by a fraction, the numerator of which is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property. The period of "nonqualified use" does not include any period before January 1, 2009.

For purposes of determining periods of nonqualified use: (i) any period after the last date that the property is used as the principal residence of the taxpayer or spouse (regardless of the use during that period); and (ii) any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health or to the extent to be provided in Treasury Regulations, unforeseen circumstances, are not taken into account.

The IRS issued Rev. Proc. 2005-14 to outline the tax consequences where real property being sold qualifies for both Section 1031 and Section 121 treatment. Rev. Proc. 2005-14 must now be applied only after the new **Housing Assistance Tax Act of 2008** changes to Section 121(b)(4) are applied. The IRS will now need to further clarify Section 121 and its working with Section 1031.

The following is a summary of the Rev. Proc. 2005-14 rules:

- To use Section 1031 at the time of the house's sale, the house must on the date of the sale be held for trade or business or for investment purposes.

- Section 121 is applied before applying Section 1031. The taxpayer first calculates the excluded gain under Section 121 (\$250,000 for an individual return and \$500,000 for a joint return), and then any remaining gain is deferred by applying Section 1031.

- The gain that is excluded by applying Section 121 does not include gain attributable to prior depreciation deductions. Pursuant to Section 121(d)(6), the gain which is excluded under Section 121 cannot apply to gain attributable to depreciation. However, the client can still defer this "depreciation gain" pursuant to Section 1031.

- If the client receives "boot" (such as cash), then the client can exclude gain represented by that boot under Section 121. The client who receives "boot" such as cash in the sale of the residence that is subject to both Section 121 and Section 1031, only has to recognize such received cash as taxable income to the extent that this cash exceeds the amount of gain which is excluded under Section 121. Therefore, the client can exclude their gain under Section 121 (\$500,000 for a client filing a joint return) and still receive cash. This tax result is much more favorable than solely applying Section 1031, which would result in gain recognition.

- The client receives a step up in their Replacement Property's tax basis for the amount of gain which is excluded under Section 121. Any gain excluded under Section 121 is deemed to have been "recognized" effectively by the client in order to determine the client's tax basis in the Replacement Property received in the Section 1031 exchange. Section 1031(d) provides that the tax basis in the Replacement Property is decreased by any money received and increased by any gain recognized, with the remaining basis in the Replacement Property reflective of the prior basis in the Relinquished Property. Thus, the ability to increase this Replacement Property's tax basis by the amount of gain excluded under Section 121 allows the client to increase their property's

basis without having to report that basis increase as recognized gain.

10.3 **Example of Applying Rev. Proc. 2005-14 and Section 121 to An Investment Residence Being Exchanged Under Section 1031.**

Assume the client (who is single) buys a house for \$210,000 which the client has used as the client's principal residence from 2002 to 2004. From 2004 until 2006, the client rents out the residence to tenants and claims depreciation deductions of \$20,000. In 2006 the client exchanges the house for \$10,000 in cash and a townhouse with a fair market value of \$460,000 that the client intends to rent out. The client realizes gain of \$280,000 on the exchange (\$460,000 + \$10,000 less \$190,000 adjusted basis).

The client's exchange of the client's principal residence which the client has rented out for less than three years, in exchange for cash and a rental townhouse, satisfies both Sections 121 and 1031. Section 121 does not require that the residence be used as the client's principal residence on the sale or exchange date. Because the client owned and used the residence as the client's principal residence for at least two years during the five-year period prior to the exchange, the client may exclude gain under Section 121. Because the residence is investment property at the time of the exchange, the client may also defer gain under

Section 1031. Under Rev. Proc. 2005-14⁸⁰, the client applies Section 121 to exclude \$250,000 of the \$280,000 gain before applying the non-recognition rules of Section 1031. The client may defer the remaining \$30,000 of gain under Section 1031, including the \$20,000 gain attributable to depreciation. Although the client receives \$10,000 cash ("boot"), the client is not required to recognize this \$10,000 of cash as gain because the boot is taken into account for purposes of Section 1031(b) only to the extent the boot exceeds the amount of the excluded gain. The client's basis in the Replacement Property is \$430,000 (which equals the basis in the Relinquished Property of \$190,000 increased by the gain excluded under Section 121 of \$250,000, and reduced by the \$10,000 cash that the client receives).

10.4 **Selling A Personal Residence Which Was Previously Received in a Section 1031 Exchange.** Excluding gain under Section 121 is restricted when a taxpayer sells their principal residence which was acquired in a like-kind exchange. The Section 121 gain exclusion does not apply if the principal residence was acquired in a Section 1031 exchange in which any gain was not recognized within the five years prior to that principal residence's sale. The effective date of this provision is for sales or exchanges occurring after October 22, 2004.

⁸⁰ IRB 2005-7.

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