



CHICAGO TITLE INSURANCE COMPANY

TOPIC: §1031 Exchanges -- Traps and Trip Wires

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I. The Basics

A. Internal Revenue Code (I.R.C.) § 1031 – § 1031 allows an owner of property held for productive use in trade or business, or for investment, to defer payment of taxes on gain realized in the sale if they exchange for like kind property. The tax is deferred – not avoided – by transferring the basis in the relinquished property to the replacement property. I.R.C. § 1031 provides as follows:

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

§ 1031 exists because the tax deferred exchange is a revenue generator. Selling and buying property generates taxable income, even if the capital gain is deferred, in the form of commissions, construction, and other transfer related costs. Most economists agree that it is better for the economy if investors move between investments rather than hold them stagnantly.

B. Terminology – As with any legal specialty, the tax deferred exchange world has its own terminology. The following is a sample of some terms and phrases typical to a §1031 transaction:

- 1. Basis:** Method of measuring investment in property for tax purposes. Calculation: Original cost plus improvements minus depreciation taken.
- 2. Boot:** Fair Market Value of non-qualified (not “like kind”) property received in an exchange. (Examples: cash, notes, seller financing, furniture, supplies, reduction in debt obligations.)
- 3. Constructive Receipt:** Control of proceeds by an Exchanger (even though funds may not directly be in their possession).
- 4. Exchanger:** The property owner(s) seeking to defer capital gain tax by utilizing a §1031 exchange. (The Internal Revenue Code uses the term “Taxpayer.”)

5. **Like Kind Property:** Refers to the nature or character of the property, and not its grade or quality. Generally, real property is “like kind” as to all other real property, as long as the Exchanger’s intent is to hold the properties as an investment or for productive use in a trade or business. The “like kind” rules for personal property, however, are very restrictive.
6. **Qualified Intermediary:** The entity that facilitates the exchange for the Exchanger. The term “facilitator” or “accommodator” is also commonly used, although the Treasury Regulations specifies the term “Qualified Intermediary.”
7. **Relinquished Property:** The property “sold” by the Exchanger. This is also sometimes referred to as the “exchange” property or the “downleg” property.
8. **Replacement Property:** The property acquired by the Exchanger. This is sometimes referred to as the “acquisition” property or the “upleg” property.
9. **Identification Period:** Period during which the Exchanger must identify Replacement Property in the exchange. Starts on the day exchanger transfers the first Relinquished Property and ends at midnight on the 45th day thereafter.
10. **Exchange Period:** Period during which Exchanger must acquire Replacement Property. Starts on the date of the transfer of the first Relinquished Property and ends on the earlier of the 180th day thereafter or the due date of the Exchanger’s tax return for the year of the transfer of the Relinquished property.

C. **Why should a Taxpayer do an Exchange - The tax deferred exchange offers** investors one of the last great opportunities to build wealth and save taxes. By completing an exchange, the investor (Exchanger) can dispose of their investment property, use all of the equity to acquire replacement investment property, defer the capital gain tax that would ordinarily be paid, and leverage all of their equity into the replacement property. Two requirements must be met to defer the capital gain tax: (a) the Exchanger must acquire “like kind” replacement property and (b) the Exchanger cannot receive cash or other benefits (unless the Exchanger pays capital gain taxes on this money).

In addition to deferring the capital gain tax, the exchange offers several other benefits to an exchanger. These non-tax reasons to do an exchange include the following:

Increase Cash flow: Trade vacant/raw land for improved property to create a positive cash flow from the rental income.

Appreciation: Exchange from a stagnant or slowly appreciating property to a property in an area with faster appreciation.

Conversion: Acquire property suitable for *future* conversion to primary residence or vacation home. (see HR4520)

Problems with Joint Ownership: Acquire separate property so that co-owners can separate interests.

Reduce Management Burdens: i.e. exchange from several smaller properties to one larger property to consolidate the benefits of ownership and reduce management responsibilities; i.e. exchange from a management intensive fee interest in real estate to a professionally managed triple net leased property where the lease, including options, has 30 or more years remaining.

Tax Write-off: Restore depreciation deductions, exchange from fully depreciated property to a higher value property that can be depreciated.

Estate Planning: Dispose of one property and acquire several properties (example: distribute to each family member).

Relocation: Acquire property in area where Exchanger is relocating.

Financing: Exchange to property which will support new loan. i.e. moving from vacant land to improved property, which can support a new refinance loan, and thereby give the client the ability to obtain cash after the acquisition of the replacement property.

D. Basic Requirements – Certain basic requirements exist regarding the amount of exchange funds required to be reinvested and the type of property which qualifies for § 1031 treatment.

1. Full Deferral Rules - In order to obtain full deferral of capital gain tax, the exchanger must comply with following three rules:

- a) Purchase price greater or equal to net sales price of relinquished property (Buy equal or up in value);
- b) Obtain equal or greater financing on the replacement property than was paid off on the relinquished property (Replacement property debt can be offset with cash put into the exchange);
- c) Reinvest all of the net proceeds from the relinquished property; and,
- d) Receive nothing in the exchange but *like-kind* property.

To the extent the exchanger fails to observe these rules, they will be subject to capital gain tax.

2. Exchange, Qualified Use and Like Kind -The specific language of § 1031 requires that there be an **exchange of property which is held for a **qualified use** and is of **like kind**. These terms are discussed as follows:**

- a) Exchange – The exchange is a reciprocal trade, not a sale followed by a separate and independent purchase. It can be satisfied by a direct trade (swap) or with a Qualified Intermediary (Q.I.) by use of an Exchange Agreement.
 - b) Qualified Use – Both the relinquished property and the replacement property must be held for a qualified use, which can be either investment property or property held for the productive use in a trade or business. Qualified use property does not include property held primarily for sale (inventory), dealer property (property held for sale in ordinary course of business, i.e. builder/developer selling homes or lots), and primary residence or second home (Personal use should be less than 14 days or 10% of rental period – I.R.C. § 280A).
 - c) Like Kind - “Like kind” refers to the nature or character of the property and not its grade or quality. This means the property can be improved or unimproved because this only relates to the grade or quality, not its kind or class. Generally, all real property is “like kind” to all other real property.
- 3. Non-Qualifying Property** - Certain properties do not qualify for exchange purposes. These include the following:
- a) Stock in trade or other property held primarily for sale;
 - b) Securities or other evidences of indebtedness or interest;
 - c) Stocks, bonds, or notes;
 - d) Certificates of trust or beneficial interests;
 - e) Interests in a partnership (Note: the partnership can elect out of partnership status under I.R.C. § 761(a)); and,
 - f) Choses in action

E. Types of Exchanges – In any exchange the Exchanger must enter into the exchange transaction prior to the close of the relinquished property. The Exchanger and the Qualified Intermediary enter into an Exchange Agreement, which essentially requires that (a) the Qualified Intermediary acquires the relinquished property from the Exchanger and transfers it to the buyer by direct deed from the Exchanger and (b) the Qualified Intermediary acquires the replacement property from the seller and transfers it to the Exchanger by direct deed from the seller. The cash or other proceeds from the relinquished property are assigned to the Qualified Intermediary and are held by the Qualified Intermediary in a separate, secure account. The exchange funds are used by the Qualified Intermediary to purchase the replacement property for the Exchanger.

There a number of recognized types of exchanges.

1. **Simultaneous (with or without a QI)** – In a simultaneous exchange, the relinquished property and the replacement property are transferred concurrently. Simultaneous exchanges done without use of a QI run the risk of losing tax deferred status, especially if three parties are involved.

In Keith K. Klein v. Commissioner, 66 T.C.M. 1115 (1993), the Tax Court determined one simultaneous three party exchange as a fully taxable sale. Klein assigned the right to his relinquished property proceeds directly to the replacement property closing. Court stated Klein had unrestricted control over, and thus receipt of the funds in his transaction. Klein argued they had a cooperation clause with Buyer in their contract on relinquished property and this no control. The court disagreed.

The use of a QI in an exchange insulates the exchanger from the constructive receipt issues on the proceeds. While the QI does not receive the proceeds, they do control the flow of all cash. The QI does not take title in Simultaneous Exchange; however, the insertion of 4th party functions in the capacity of creating a reciprocal trade by receiving the relinquished property and acquiring the replacement property for the exchange.

The IRS allows “direct deeding” of the relinquished and replacement properties, thereby avoiding the necessity of the QI holding title to any property. Rev Proc 90-34, 1990-16 C.B. 552 Treas. Reg. § 1.1031(k)-1(g)(4)(v). Direct deeding avoids the assessment of double state, county, or local documentary transfer taxes and any liability on the part of the QI for environmental hazards that may exist on the properties.

2. **Delayed** – The delayed exchange is structured similarly to a simultaneous exchange, but allows for the replacement property to be acquired within 180 days of the transfer of the relinquished property. This provides exchangers with more flexibility and options in acquiring the replacement property. The exchanger assigns the rights in the sale contract for the relinquished property and in the purchase contract for the replacement property to the QI, who essentially becomes the seller of the relinquished property and the buyer of the replacement property. To avoid actual or constructive receipt of the exchange funds by the exchanger the proceeds from the sale of the relinquished property are held by the QI until they are needed for the acquisition of the replacement property. As with a simultaneous exchange, the QI is used to create the reciprocal exchange of properties and “direct deeding” is used, so that the QI does not need to take title to either property.
3. **Build-to-Suit** – The build-to-suit exchange gives the exchanger the opportunity to use exchange funds for the construction of the replacement property and still accomplish a tax deferred exchange. This is a variation of the delayed or reverse exchange that allows the exchanger more flexibility and provides the exchanger with the opportunity to either renovate existing improved property or construct a new improvement on raw land. In the most common type of build-to-suit exchange the exchanger sells the relinquished property in a delayed exchange and then acquires

the replacement property after it has been improved with the exchange funds from the relinquished property. It is important to note that any improvements made to the replacement property after the exchanger takes title are considered to be “goods and services”. These goods and services are not considered “like kind” property and are taxable as boot as are any remaining exchange funds. Treasury Regulations § 1.1031(k)-1(e). Consequently, to be included in the exchange any improvements to the property must occur before the exchanger takes title. Bloomington Coca Cola Bottling Co. v. Commissioner, 189 F.2d 14 (CA7 1951). Some issues relating Build-to-Suit exchanges are addressed below under Section II. F -Improvements to Taxpayer’s Property.

4. **Reverse** – A reverse exchange is the flip side of a delayed exchange. In a reverse exchange the exchanger for various reasons must acquire their replacement property before disposing of their relinquished property. Until September 15, 2000 it was unclear whether reverse exchanges would be given nonrecognition treatment by the IRS. On that date Revenue Procedure 2000-37 answered the question. This Revenue Procedure provides that tax deferral on reverse exchanges will be recognized if the transactions fall within the scope of an announced IRC § 1031 “safe harbor”.

The safe harbor involves use of an entity to facilitate the reverse exchange. This entity is referred to as an Exchange Accommodation Titleholder (“EAT”). The EAT, or a special purpose holding entity formed by the EAT, will take title to either the relinquished or replacement property. This property is referred to as the “parked property”. The holding entity takes title to the parked property pursuant to a Qualified Exchange Accommodation Agreement (“QEAA”), which is entered into by the exchanger, the EAT, and the holding entity.

By parking either the replacement or relinquished property with the holding entity, the exchanger avoids the fatal problem of holding title to both properties at the same time. If the replacement property is parked, then the holding entity will hold title until the exchanger has disposed of their relinquished property or until the exchange period has expired. If the relinquished property is parked, then the holding entity will hold title until that property can be disposed of or until the exchange period has expired. Under Rev. Proc. 2000-37, a safe harbor exchange must be completed within 180 days after the holding entity acquires the parked property. There are several rules, regulations, issues and considerations in completing reverse exchange. A number of these are discussed below in Section II. G – Reverse Exchanges.

II. Problem Areas

- A. **Missing Deadlines** - The deadlines begin to run on the date the Exchanger transfers the relinquished property to the buyer. These deadlines are carved in stone. The date of transfer will be determined by the date of recording or the date of possession, whichever occurs first.

1. **45-Day Rule** - The Exchanger must identify the potential replacement property within the first 45 days. This involves a written notification to the Qualified Intermediary listing the addresses or legal descriptions of the potential replacement properties. The purchase of the replacement property must be completed within 180 days after of the close of the relinquished property. After the 45 days has passed, the Exchanger may not change their Property Identification list and must purchase one of the listed replacement properties or the exchange fails!
2. **180-Day Rule** - The exchange period is 180 days or the date the Exchanger must file their tax return (including extensions), whichever occurs first. The Exchanger must acquire the replacement property within this period of time.

There is no extension for Saturdays, Sundays, or holidays. Arising out of the events of 9/11, extensions are now available in the event of a Presidentially-declared emergency. Rev. Proc. 2004-13 (January 26, 2004) and Rev. Proc 2005-27 (May 16, 2005).

If there is more than one relinquished property in the exchange and the sales of the properties occur on different dates, the 45 and 180-day periods are calculated from the date the first sale transaction closes.

B. Vesting and Holding Issues - The basic rule is that a Taxpayer must “hold” the relinquished property and the replacement property for investment or for productive use in a trade or business. To qualify as an exchange title to the replacement property must be held in the same manner as title to the relinquished property. Therefore, the entity beginning the exchange must be the entity concluding the exchange. However, frequently we find that just before, or just after, the exchange there is a desire to change the legal form of ownership. The two most common examples are:

- Dissolution of a general partnership just prior to sale of the relinquished property
- Formation of a limited liability company (LLC) just after purchase of the replacement property.

This gives rise to a concern about whether the Exchanger has met the “holding” requirement. Exchangers must work with a tax and legal advisor to resolve this situation. Various methods have been employed to work around this problem. All of which may be subject to attack if audited:

1. Dissolve the old partnership at closing, distribute the property to the individuals; close the sale as individuals and acquire the replacement property with the new group of investors all as individuals in a tenancy-in-common arrangement. At some future time form a new partnership.
2. With sufficient notice to tax and legal advisors, the dissolution could take place a year before the sale allowing time to “hold” in this new ownership and better protect the future exchange.

3. Distribute a portion of the property out of the old partnership to the exiting partners who will hold as tenants-in-common with the old partnership; close the sale and acquire the replacement property with the old partnership and the new partners in a tenancy-in-common arrangement. Eventually have the new partners contribute into the old partnership.

Some changes in vesting do not destroy the integrity of the exchange. These include the following:

1. The Exchanger's revocable living trust may acquire the replacement property in the Exchanger as an individual, as long as the trust entity is disregarded for Federal tax purposes.
2. The Exchanger's estate may complete the exchange after the Exchanger dies following the close of the sale of relinquished property.
3. The Exchanger may transfer relinquished property held as an individual and acquire replacement property titled in a single-member LLC or acquire multiple replacement properties in different single-member LLC's. Single-member LLC's are disregarded for Federal tax purposes under the "check-the-box" rules.
4. In community property states, a husband and wife may exchange relinquished property held by them individually as community property, for replacement property titled in a two-member LLC in which the husband and wife own 100% of the membership as community property, but only if they treat the business entity as a disregarded entity.
5. A corporation that merges out of existence in a tax-free reorganization after the disposition of the relinquished property may complete the exchange and acquire the replacement property as the new corporate entity.
6. An Illinois land trust is a disregarded entity for IRC §1031 purposes, so an Illinois land trust beneficiary may exchange his beneficial interest in relinquished property held by the trust for replacement property titled in the name of the beneficiary, individually, or in a different Illinois land trust, as long as the Exchanger is the beneficiary. The same is true for Florida Land Trusts.

C. Exchange Funds/Termination of Exchange – The central purpose of using a QI is to avoid actual or constructive receipt of the exchange funds during the exchange period. Despite disclosures prior to entering the exchange, exchangers frequently request the release of a portion or all exchange funds at times which could destroy the integrity of the exchange. The Exchanger can receive funds either before the exchange or after termination of the exchange, but never during an exchange. Exchangers who want money for non-exchange purposes may receive funds directly from the relinquished property escrow (closing). These funds are always taxable, but receipt in this way should not jeopardize the rest of the exchange. Once the Accommodator receives the proceeds, those funds may only be used for purchase of replacement property and

customary closing costs. If there are “excess” funds in the account, those funds can only be released after termination of the exchange.

Treas. Reg. §1.1031(k)-1(g)(6) (i.e. the “g6 restrictions”) states the four termination events:

1. The Exchanger does not identify replacement property within the 45-day deadline;
2. After the identification period, receipt by the Exchanger of all the identified property to which they are entitled;
3. After the identification period, upon the occurrence of a material and substantial contingency provided for in writing, related to the exchange and beyond the control of the Exchanger;
4. Upon the expiration of the 180-day exchange period.

Priv. Ltr. Rul. 103841 (April 10, 2000) emphasized the Service’s position on releasing exchange funds to Exchangers. Two scenarios were posed in that letter.

Scenario One – An Exchanger identifies three replacement properties intending to purchase all three. The Exchanger purchases two properties but after “good faith” negotiation with the seller of the third is unable to come to terms with that seller. The Exchanger requests that the remaining exchange funds be delivered to them after the 45th day and prior to the 180th day. Is the Accommodator permitted to deliver the funds?

Scenario Two – An exchanger identifies a single replacement property but after “good faith” negotiation with the seller is unable to reach an agreement. The Exchanger then requests return of exchange funds after the 45th day and prior to the 180th day. Is the Accommodator permitted to deliver the funds?

The answer from the Service was the same in either scenario. The Exchanger’s inability to purchase the property after “good faith” negotiations does not constitute a termination event within the “g(6)” restrictions. The Accommodator must hold the funds until after the 180th day.

It is evident from a case decided in 1999 (Florida Industries Investment Corporation, TCM 1999-346) that mishandling of the exchange funds can result in complete failure of the exchange. In that situation the Accommodator released funds to the Taxpayer on several occasions. Refunds from escrow were delivered to the Taxpayer instead of the Accommodator. The IRS disallowed the entire exchange, not even giving the Taxpayer credit for the one good purchase made before the bad behavior began. The Tax Court affirmed this treatment.

D. Related Parties - Exchanges may take place between related parties, but specific rules must be followed in order to qualify for tax deferral. Related parties are defined in I.R.C. § 267(b) and § 707(b)(1) as any person or entity bearing a relationship to the

exchanger, such as members of a family (brothers, sisters, spouse, ancestors and lineal descendants); a grantor or fiduciary of any trust; two corporations which are members of the same controlled group or individuals; corporations and partnerships with more than 50% direct or indirect ownership of stock, capital or profits in these entities.

The treatment of an exchange with a related party will depend upon whether the exchange involves a swap with, sale to, or purchase from a related party.

1. Swap with Related Party - Dad and Son, owning separate properties, may swap those properties with one another. The only requirement is that neither may dispose of their replacement properties within two (2) years of the exchange. I.R.C. §1031(f).

2. Sale to Related Party - It appears that Dad, using an accommodator, can “sell” to Son and “buy” from a third party. Son must hold the property he acquired from Dad for a two-year period. If Son disposes of the property within the two years Dad loses his tax deferral.

3. Purchase from Related Party - In what is referred to as the “Mommy” TAM (TAM 9748006) Son “sold” to a third party buyer and “bought” from Mother. The exchange was disallowed.

In 2002, Rev. Rul. 2002-83 was issued and again the Service disallowed a purchase from a related party. The scenario: Taxpayer, using an Accommodator, sold a low basis property to an unrelated party and purchased replacement property from a related party. The replacement property was a high basis property for the related party. The holding: no exchange for the Taxpayer.

However, in a private letter ruling 200440002 a Taxpayer was allowed exchange treatment where it acquired replacement property from a related party. The related party was also doing an exchange and both parties asserted that they would hold the subject properties for two years.

E. Identifying Issues - There are three identification rules and Exchangers must purchase from their list of identified properties:

1. 3-Property Rule - The Exchanger may identify three (3) properties of any value (The vast majority of Exchangers are required to use this rule.), or

2. 200% Rule - The Exchanger may identify more than three (3) properties if the total fair market value of what is identified does not exceed 200% of the sale price of the relinquished property(ies), or

3. 95% Rule - If the Exchanger exceeds the 3-Property Rule and the 200% Rule, the exchange will not fail if they purchase 95% of the aggregate fair market value of all identified properties.

The identification must be:

- A. Delivered to a party to the exchange (i.e., the Accommodator).
- B. In writing.
- C. “Unambiguous,” (specific street address, legal description, etc.
- D. Signed by the Exchanger.
- E. Delivered, mailed, telecopied, or “otherwise sent” within the 45 days.

F. Improvements to Taxpayer’s Property - A common scenario has the Taxpayer selling an investment property and wanting to use the sale proceeds to make improvements on another investment property they already own. For example, selling a rental house and building on a lot at the coast.

Any improvement work on property to which the Exchanger holds title will be “goods and services” and not like-kind real property. Treas. Reg. §1.1031(k)-1(e)(4). In order for the construction to qualify for the tax deferral, the regulations require that the work be done before the Exchanger takes title. Some Private Letter Rulings provided hope for Exchangers who must build on such properties. Priv. Ltr. Rul. 7823035 (March 9, 1978). Priv. Ltr. Rul. 8304022 (October 22, 1982). Priv. Ltr. Rul. 9243038, (July 27, 1992). Frequently these exchanges are structured with a series of steps to move ownership of the replacement property to another party (builder/Accommodator) during the construction period and return ownership to the Exchanger once the work is done.

However, Revenue Procedure 2004-51 dealt a blow to the validity of this structure. This Rev. Proc. modifies Rev. Proc. 2000-37. The substantive change is that the safe harbor for reverse exchanges will not apply to replacement property held in a Qualified Exchange Accommodation Agreement (“QEAA”), if the property is owned by the taxpayer within the 180 day period ending on the date of transfer of qualified indicia of ownership of the property to an Exchange Accommodation Titleholder (“EAT”). This prevents a taxpayer from parking their property with an EAT while improvements are constructed and then reacquiring the improved property as replacement property.

G. Reverse Exchanges - Revenue Procedure 2000-37, effective September 15, 2000, established rules for reverse exchanges.

1. What the Exchanger Needs to Know about Reverse Exchanges

- a. They are **expensive**.
- b. They are a **hassle**.
- c. The Exchanger only gets **180 days** to complete the reverse exchange.
- d. The Exchanger must have the **financial** ability to purchase a replacement property before they have “pulled” the cash out of the relinquished property.
- e. It takes more **time** to set up a reverse exchange than a forward exchange.

2. Requirements of Rev. Proc. 2000-37 - A “safe-harbor” reverse exchange must meet the following requirements:

- a. **Legal title** (indicia of ownership) held by the Accommodator.

- b. Taxpayer has **bonafide intent** to exchange.
- c. Accommodator and Taxpayer enter into a **qualified exchange accommodation arrangement** no later than five (5) business days after the Accommodator takes title to the property.
- d. Taxpayer must **identify** the relinquished property within **45 days**.
- e. Taxpayer must **complete** the exchange in **180 days**.

3. Permissible Agreements

It is permissible for the Accommodator and Taxpayer to enter into the following agreements:

- a. **Exchange agreement.**
- b. Taxpayer may **guarantee** Accommodator obligations and indemnify Accommodator.
- c. Taxpayer may **loan** funds to Accommodator.
- d. Accommodator may **lease** property to Taxpayer.
- e. Taxpayer may **manage** the property, **supervise improvements**, serve as the **contractor**, or otherwise provide services with respect to the property.
- f. May have **puts** and **calls** between Accommodator and Taxpayer.
- g. May have arrangements regarding **variation of** value in relinquished property.

4. Practical Issues - While much of the legal uncertainty was removed with the issuance of “safe-harbor” rules, practical issues still motivate Exchangers to structure forward exchanges whenever possible. The following issues must be addressed before parking title with an Accommodator:

- a. **Lender Issues** - Is there a due on sale clause on the relinquished property being parked with the Accommodator? Or, if the replacement property is being parked, the lender must be informed that the Accommodator will be the borrower.
- b. **Environmental Issues** - Accommodators will not take title to most properties without a current, clean Phase I.
- c. **Additional Expenses.**
 - 1. Accommodator fee
 - 2. Loan fees
 - 3. Environmental assessment fees
 - 4. Title insurance premium
 - 5. Closing fees
 - 6. Recording fees
 - 7. Transfer taxes/excise taxes
 - 8. Legal and accounting fees

5. The best alternative is to negotiate with the seller to hold off closing on the replacement property until the relinquished property can be sold. The Exchanger may offer:

- a. Additional earnest money

- b. Non-refundable earnest money
- c. Option Agreement
- d. Rental Agreement
- e. Lease/Option Agreement

H. Tenancy-in-Common - In the last few years a new industry has developed. Promoters have packaged and sold unit interests in shopping centers in California, office buildings in Texas, a Walmart in Kansas, etc. These interests have been promoted as “exchange solutions;” often designated as a back-up if the original target property cannot be secured. Other taxpayers have used these as an “exit” strategy from real estate. The investor gets a deferral of capital gain tax but no longer has the management headache of real estate.

The purchase of these interests falls within SEC regulation and as such must be purchased through a securities broker. The question arises, if the interest is subject to securities law, does it qualify as an interest in “real property” for purposes of §1031?

On May 19, 2002 the IRS issued Rev. Proc. 2002-22 establishing some guidelines for tenancy-in-common (TIC) interests in real property. If the TIC meets the guidelines the promoter can obtain a ruling that the TIC units are “real property.”

Requirements:

1. Tenants-In-Common Ownership. Each of the co-owners must hold title to the property, either directly or through a disregarded entity, as a tenant in common under local law.
2. Number of Co-Owners. Must be limited to no more than 35 persons (and husband and wife are treated as a single person for this purpose).
3. No Treatment of Co-Owners as an Entity. The co-owners may not file a partnership tax return or otherwise hold themselves out as a partnership or other form of entity.
4. Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that may run with the land. This agreement may provide that a co-owner must offer the interest for sale to the other co-owners or the sponsor at fair market value before exercising any right of partition. In addition, the agreement may provide for majority voting on certain issues.
5. Voting. The co-owners must retain their voting rights as described below. Unanimous approval is required for any sale, lease or re-lease of a portion or all of the property, any negotiations or re-negotiations of indebtedness secured by the property, the hiring of any manager, or the negotiation of any management contract (or extension or renewal of such contract). However, for all other actions, the co-owners may agree to be bound by a vote of more than 50% of the co-owners. A co-owner who has consented to an action in this matter may provide the manager with a power of attorney to execute specific documents with respect to that action.
6. Restrictions on Alienation. In general, each co-owner must have the right to transfer, partition, and encumber their interest in the property without the agreement or approval of any person. However, restrictions that are required by a lender and that are consistent with customary commercial lending practice are not prohibited.

Moreover, the co-owners or the sponsor may have a right of first refusal and a co-owner may agree to offer an interest for sale to the other co-owners or the sponsor at fair market value.

7. Sharing Proceeds and Liabilities Upon Sale of Property. If the property is sold, any debt secured by the property must be satisfied and the remaining proceeds distributed to the co-owners.
8. Proportionate Sharing of Profits and Losses. The co-owners must share in all revenue generated by the property and all costs associated with the property in proportion to their interests in the property. Neither the other co-owners, the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the property, unless the advance is recourse and is not for a period exceeding 31 days.
9. Proportionate Sharing of Debt. The co-owners must share in any indebtedness secured by the property in proportion to their undivided interests in the property.
10. Options. A co-owner may issue an option to purchase his interest, provided the exercised price reflects fair market value of the property determined as of the time the option is exercised. A co-owner may not acquire an option to sell the interest (a put option) to the sponsor, the lessee, another co-owner or the lender or any person related to such parties.
11. No Business Activities. The activities of the co-owners must be limited to those customarily performed in connection with the maintenance and repair of rental real estate. See Rev. Rul. 75-374, 1975-2 CB 261.
12. Management and Brokerage Agreements. The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually. The manager or broker may be a sponsor or co-owner (or a related party), but may not be a lessee. The management agreement may authorize the manager to maintain common bank accounts for the collection and deposit of rents and to offset expenses associated with the property against any revenues before disbursing each co-owners' share of net revenues. In addition, the management agreement may authorize the manager to take certain actions on behalf of the owners (subject to the voting restrictions above). The manager may not be paid a fee based in whole or in part on the income or profits derived from the property and the fees may not exceed the fair market value of the manager's service based on comparable fees paid to unrelated parties for similar services.
13. Leasing Agreements. All leasing agreements must be bona fide leases for federal tax purposes.
14. Loan Agreements. The lender may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the property.
15. Payments to Sponsor. The amount of any payment to the sponsor for the acquisition of the co-ownership interest and services must reflect the fair market value of the interest acquired and the services rendered. Thus, payments may not depend in whole or in part, on the income or profits derived from the property.

I. Combining § 121 and § 1031 Treatment – On October 22, 2004 H.R. 4520 was enacted. This is a large tax bill which amended I.R.C. § 121. Under the amendment taxpayers who convert replacement property to a principal residence may not exclude gain under § 121 unless the sale occurs at least five years after the date of acquisition.

Rev. Proc. 2005-14 published on January 27, 2005 addressed coordination of § 121 and § 1031 for mixed use properties. This Rev. Proc. provided guidance in the following scenarios:

1. Home-office qualifies for § 121 treatment, with the exception of depreciation taken after May 6, 1997.
2. Separate business/rental structure on the same property qualifies for § 1031 treatment.
3. A principal residence converted to rental can qualify for both § 121 and § 1031 treatment.

III. Recent Rulings/Decisions/Issues

A. Like-Kind Rulings

1. Water rights for farm land. Priv Ltr Rul 200404044 (January 28, 2004) Taxpayer held a perpetual right to pump water. The amount was limited to a maximum diversion rate and quantity per calendar year. Taxpayer proposed to exchange the water rights for farm land. The Service ruled that perpetual water rights are like-kind with farm land provided that both are held for productive use in a trade or business or for investment.
2. Laid railroad track for unassembled track. Tech Adv Mem 200424001 (June 11, 2004) Laid track, attached to the land, is not like-kind with unassembled track. The laid track is real property. The unassembled track is personal property.
3. Vacation homes. TC Summ Op 2004-81 (June 23, 2004) Taxpayers originally rented their Truckee property. Then, due to damage caused by tenants, they restricted use of the property to friends and family and some limited personal use. The court determined that when Taxpayers restricted the use they “abandoned holding the property for profit.” However, the court recognized that Taxpayers’ expectation of appreciation did qualify the property as being held primarily for investment and therefore eligible to deduct expenses under IRC §212(2).
4. NAICS Product Codes replace SIC Product Codes. TD 9151 (August 12, 2004) The NAICS six-digit product codes apply to all transfers of personal property made after August 12, 2004 taxpayer. There is no substantive difference between the SIC and NAICS product codes.
5. Radio station licenses for television station licenses. In a Coordinated Issue Paper (May 27, 2005) the IRS confirms that an FCC license for a radio station is like-kind with an FCC license for a television station. Further, the network affiliation agreement and goodwill should be valued separately from the FCC license.

6. Old-growth timberland for reproduction timberland. Priv Ltr Rul 200541037 (October 17, 2005) Taxpayer swaps her interest in old-growth timberland to a related party (corporation owned by Taxpayer and her son) in return for reproduction timberland. The Service ruled this to be like-kind even where there was a plan to cut the old-growth timber within two years of the exchange.
7. Exchange of a business must be analyzed on an asset-by-asset basis; identification requirements. Tech Adv Mem 200602034 (January 13, 2006) Taxpayer transferred a number of intangibles. The IRS required that the assets transferred must be analyzed item-by-item, confirming that the standard for determining what is like-kind for personal property is more rigorous than the standard for real property. Determining whether an intangible is foreign depends on where the intangible is used, not where it is owned or managed. In the exchange of patents the underlying property must be in the same Product Class. Trademarks and tradenames are not like-kind.

Further, the IRS found deficiencies in the identification. The Taxpayer exceeded the 200% limitation (due to negotiations between the parties after the 45-day deadline) and did not meet the 95% criteria. Also, the identification of the intangible was not sufficiently detailed. The Taxpayer provided the name of the Seller, a very broad description of the property and the estimated value.
8. Coal supply contract is like-kind with a gold mine. *Peabody Natural Resources Company, et al. v. CIR*, 126 TC 14 (May 8, 2006) Taxpayer exchanged coal mines for gold mines. The coal mines were subject to two coal supply contracts. The Service determined the coal supply contracts were not like-kind with the gold mines and taxable boot. The court held the contracts were covenants running with and appurtenant to the real property under state law and therefore, like-kind to the gold mines.
9. New York coops. Priv Ltr Rul 200631012 (August 4, 2006) The IRS ruled that shares of stock in a New York coop is real estate under state law and eligible for §1031 treatment.

B. Related Parties

1. Buying replacement property from a related party where both are exchanging. Priv Ltr Rul 200440002 (June 14, 2004) Taxpayer A transfers relinquished property to an unrelated party and acquires replacement property from Taxpayer B, a related party to Taxpayer A. Taxpayer B, doing its own exchange, purchases replacement property from a third party. Taxpayer A and Taxpayer B assert that they will not transfer their respective replacement properties within two years of acquisition. The Service approved exchange treatment for both.
2. Buying replacement property from a related party where only one is exchanging. *Teruya Brothers, Ltd. & Subsidiaries v. CIR*, 124 TC 4 (February 9, 2005) Taxpayer A transfers relinquished property to an unrelated party and acquires replacement

property from Taxpayer B, a related party. Taxpayer B recognizes gain but does not pay tax due to net operating loss carryovers. The court disallows the exchange. The court rejected the assertion by the Taxpayers that the “no tax avoidance” exception under IRC §1031(f)(4) should apply.

3. Related parties swap followed by cutting the timber. See Priv Ltr Rul 200541037, above. Allowed.
4. Buying replacement property from a related party where both are exchanging. Priv Ltr Rul 200616005 (April 26, 2006) Similar facts as Priv Ltr Rul 200440002, above, with the only variation being that one of the related Taxpayers receives some cash boot in addition to like-kind real property. Exchange treatment for both.

C. Combining §121 and §1031 Treatment

1. Converting replacement property to a principal residence. IRC §121(d) was amended (October 22, 2004). Taxpayers who convert replacement property to a principal residence may not exclude gain under §121 unless the sale occurs at least five years after the date of acquisition.
2. Coordination of §121 and §1031 treatment for mixed used properties. Rev Proc 2005-14 (February 4, 2005) provides favorable guidance in a number of scenarios.
 - a. Home-office qualifies for §121 treatment, with the exception of depreciation taken after May 6, 1997.
 - b. Separate business/rental structure on the same property qualifies for §1031 treatment.
 - c. A principal residence converted to rental can qualify for both §121 and §1031 treatment.

D. Reverse Exchanges

1. Failed reverse exchange. FAA 20050203F (November 30, 2004) This transaction started before the effective dated of Rev Proc 2000-37. The property was parked for 24 months. The relinquished property was not identified. The Service ruled that the Taxpayer had the benefits and burdens of ownership and therefore no exchange.
2. Impact of assignment to QI on Taxpayer’s cause of action against Seller. *Roy L. Hall v. Glenn’s Ferry Grazing Assoc.* (USDC Idaho, March 9, 2006) Really a question of whether Taxpayer had standing to sue the Seller of replacement property after assigning the contract to the Qualified Intermediary. The court held that there were questions of fact as to whether the Taxpayer had a beneficial or equitable interest under the wording of the Qualified Exchange Accommodation Agreement (QEAA).

E. Improvements to Taxpayer-owned Property

1. Exchange of relinquished property for improvements on long term leasehold property of related party. Priv Ltr Rul 200329021 (April 7, 2003) Taxpayer sells relinquished property to an unrelated party. Using an Exchange Accommodation Titleholder (EAT) to acquire the leasehold interest of Taxpayer's Parent, improvements are constructed and then the EAT assigns the lease to Taxpayer within the 180-day exchange period. The Service ruled in favor of the Taxpayer saying that the arrangement conformed to the requirements of a qualified intermediary and the QEAA safe harbors. Even though Taxpayer and Parent report on a consolidated return the related party issue was disposed of in saying that the "Taxpayer and Parent continue to be invested in exchange properties, both will remain so invested for a period of not less than two years following the exchange."
2. Cannot use parking arrangement to construct improvements on Taxpayer-owned property. Rev Proc 2004-51 (July 20, 2004). This amends Rev Proc 2000-37 (reverse parking rules) to prohibit its application to parking a property owned by the Taxpayer within the prior 180 days.

F. Partnership

1. Special allocation of boot. *Appeal of Ahlers*, Cal St Bd Eq No 257852 (December 13, 2005) A partnership sold property, recognized boot and through special allocation attempted to shift the gain to one of the partners. Saying there was no substantial economic effect under §704(b) the California State Board of Equalization rejected the special allocation and required recognition by all partners in accord with their percentage interest.
2. Sell as individuals, buy ranch as tenants-in-common. There is a case currently before the Oregon Tax Court, Magistrate Division, wherein various family members doing separate exchanges sold as individuals, pooled funds and purchased a ranch as tenants-in-common. The Oregon Department of Revenue audited and disallowed the exchange on the basis that the parties exchanged real property for partnership interests.

G. Tenancy-in-Common Property

1. Exchange real property for interest in a Delaware statutory trust. Rev Rul 2004-86 (July 20, 2004) Approved the use of Delaware Statutory Trusts, instead of directly deeded interests in real estate, as a mechanism for structuring tenancy-in-common arrangements. The DST can be used where the sponsor acquires a property, creates a triple-net lease, puts on financing, creates a DST where the trustee has no discretion to sell, finance, lease or make material improvements to the property.
2. Favorable TIC ruling. Priv Ltr Rul 200513010 (April 1, 2005) The second ruling to be issued under Rev Proc 2002-22.

3. TIC property fails to perform as promised. *Dean Campbell v. Bank of America* (404 F Supp 2d 1292, D Kan, December 22, 2005) Taxpayer acquires a TIC interest with a put option based on the recommendation of its Bank. A year into the investment the TIC sponsor fails to reacquire the interest from Taxpayer pursuant to the put. Taxpayer goes after the Bank. While the specific issue here was jurisdiction it is evidence that some of the TIC product is not what it purports to be.
4. Effect of a foreclosure when co-owners hold as individuals. *United States v. Padilla* (USDC ED Cal, April 11, 2006) The US held and foreclosed a lien against the real estate for the debts of one of two co-owners. Makes a case for co-owners holding their interest in a TIC property as a special purpose entity in order to protect themselves against the debts and obligations of the other co-owners.
5. Two more favorable rulings. Priv Ltr Rul 200625009 (March 1, 2006) and affiliated Priv Ltr Rul 200625010 (March 1, 2006).

H. State Issues

1. California “clawback.” FTB Publication 1100 (Rev 04-2005). Taxpayer exchanges California property with gain of \$100 for property located in another state. Taxpayer later sells the property without doing another exchange. Taxpayer owes California tax on the \$100 gain that was in the property at the time of the original exchange.
2. Montana “clawback.” ARM 42.2.304, 42.2.308, 42.2.309 clarify that Montana sourced income must be reported to Montana if and when it is recognized for federal income tax purposes. There is an amnesty program ending August 31, 2006 for 2002 – 2005 exchanges.

I. §1031 or §1033 Followed by Termination of Trust

1. Exchange followed by termination of the Trust. Priv Ltr Rul 200521002 (February 24, 2005) A trust exchanged then terminated in accordance with pre-arranged terms. The Service approved the exchange stating that the exchange and subsequent distribution were wholly independent. The ruling may indicate some softening of the IRS position regarding “swap and drop.”
2. Involuntary conversion followed by termination of the Trust. Priv Ltr Rul 200528011 (April 13, 2005) A Trust obtains like-kind replacement property pursuant to IRC §1033 and requests a ruling that the subsequent distribution of the property to the beneficiary will not preclude the replacement property from qualifying as like-kind. The IRS issued a favorable ruling.

J. Extensions due to Disaster, Terrorist or Military Action

1. Rev Proc 2004-13 (January 26, 2004) provides an updated list of time-sensitive acts that qualify for extensions of the 45 and 180-day deadlines.

2. Notice 2005-3 retroactively granted additional relief.
3. Rev Proc 2005-27 (May 16, 2005) provides an updated list of time-sensitive acts that qualify for extensions of the 45 and 180-day deadlines.
4. Notice 2006-20 granted an additional extension to August 28, 2006.

K. Qualified Intermediary Issues

With the exception of some minimal bonding and banking requirements for Qualified Intermediaries in Nevada, the industry is unregulated. There are a few proposals to change this.

1. §468B Proposal. REG-113365-04, February 3, 2006. A hearing was held June 6, 2006 about a proposed change in §468B. If adopted the general rule would be that exchange funds would be treated as a below-market loan from the Taxpayer to the Qualified Intermediary. The loan would be deemed to have an interest rate no less than the “182 day rate” and would be taxable to the Taxpayer. This general rule would not apply if *all* the earnings attributable to the funds are paid to the Taxpayer. If adopted this would likely change Qualified Intermediary pricing.
2. Registration of Qualified Intermediaries. The IRS, with the support of the Federal of Exchange Accommodators (FEA), proposes requiring Qualified Intermediaries to register. This registration requirement is proposed, not out of a concern for the integrity of Qualified Intermediaries, but out of a concern for Taxpayers diligent conformity to the Identification rules. If adopted Taxpayers would have to include the Qualified Intermediary’s registration number on their tax return thus facilitating an auditor’s ability to compare the tax return with the Qualified Intermediary’s file.
3. Providing routine financial services. Priv Ltr Rul 200630005 (July 28, 2006). A finance company which makes loans and sometimes sells its own properties to Exchangers is not a “disqualified party.” The finance company falls within the exception permitting provision of routine financial services. The Service did state that if the finance company acted as a real estate broker then it would be an agent of the Exchanger and therefore would be a disqualified party.

*** Note – This manuscript is a compilation of manuscripts and products prepared by Investment Property Services, Inc. (IPX1031).**