ADVANCED LIKE KIND REAL ESTATE EXCHANGES

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I. EXCHANGE BASICS

A. PROS AND CONS OF EXCHANGING

1. IRC Definition of an Exchange

IRC Section 1031(a) states that, in general, "no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment."

Section 1031 constitutes an exception to IRC Section 1001(c), which states that "except as otherwise provided in this subtitle, the entire amount of the gain or loss. . . on the sale or exchange of property shall be recognized."

A properly structured exchange allows the taxpayer to dispose of property, replace it with like kind property, and roll any gain on the disposition into the new property.

2. Benefits Of Exchanging

EXAMPLE 1: Two individuals, Sarah and Don, each own land held for investment with a fair market value of $100,000, a basis of $20,000, and no debt. Sarah exchanges her property for another piece of investment real estate worth $100,000. Don sells his property for $100,000 and reinvests the after-tax proceeds.

(a) Income tax deferral. By exchanging, the taxpayer can defer current income taxes. Any gains realized on the disposition of the exchanged property will not be recognized until the new property is disposed of in a taxable transaction. In Example 1, Sarah pays no current income tax and Don pays $16,000 in income taxes on his $80,000 gain (assuming 15% federal capital gain rate and 5% state).

(b) More equity to reinvest. By not having to pay income taxes currently, the taxpayer has more equity to reinvest in replacement property. In example 1, Sarah now owns real property worth $100,000, whereas Don only has $84,000 to reinvest, after taxes.

(c) Time value of money. Through the use of leverage and the time value of money, the taxpayer can invest the larger equity and accumulate greater wealth. Let us assume that Sarah and Don each hold their new property for 10 years at which time they sell it in a taxable transaction and that the property appreciates at a rate of 3% per year during the time they hold it. After selling the property and paying income taxes, Sarah will have about $111,500 cash, while Don will only net about $107,100 (a $4,400 difference). This example assumes, of course, that

federal and state tax rates do not change during the 10 year period.

(d) Leverage. If Sarah and Don each leverage the replacement property with an 80% loan-to-value, and we assume that the interest costs are offset by rental income, Sarah will net $221,566, while Don will have $199,556 (a $22,010 difference). Leveraging allows the investor to take advantage of the appreciation on a larger piece of property while only having to invest the required equity. Since Sarah had more equity to reinvest, she was able to acquire a $500,000 piece of property (leveraged) as compared to Don's $420,000.

(e) Continuity of depreciation. The taxpayer can dispose of one property and replace it with another one, but continue with the same depreciation life and method. The Treasury Department issued Temporary Regulations in 2004 (TD9115, 2/27/04) providing detailed instructions for depreciation calculations with respect to replacement property received in an exchange. (See Part V of these materials for additional information).

(f) Income tax avoidance. If taxpayer continues exchanging until death, he can avoid income taxes completely because the basis in the exchange property is stepped-up to fair market value at death (IRC Section 1014). If we return to our EXAMPLE 1 above (no leverage), but assume that Sarah and Don both die after holding their property for ten years (but not in 2010*), Sarah will avoid $28,878 of income taxes while passing property on to her heirs worth $134,392. Don, on the other hand, will only avoid $5,778 of income taxes and will pass property worth $112,889 to his heirs. * Note that the Tax Relief Reconciliation Act of 2001 repeals the estate tax for individuals who die in 2010, and also ties basis in inherited property to the decedent's basis rather than the property's fair market value at death.

3. When Not To Exchange

(a) When the taxpayer desires cash. (although there may be some ways to get cash out of a valid exchange - See Part III of these materials), or does not wish to reinvest in like kind property.

(b) When the taxpayer has net operating loss (NOL) carryovers that may expire unused. Because exchanges are generally only a tax deferral mechanism, the taxpayer would be wise to recognize the gain when it could be offset by the NOL carryovers. If the carryovers lapse unused, the taxpayer may eventually have to pay income taxes on the exchange gain.

(c) When the property would be disposed at a loss. If IRC Section 1031 applies to a transaction, it must be applied. It is not an election. Therefore, if a taxpayer enters into an exchange that has an inherent loss, he will be unable to recognize the loss until the subsequent taxable disposition of the replacement property. As a general tax planning rule, it is best to defer recognizing gains and

currently deduct losses. Therefore if the disposition of property would result in a loss, the taxpayer may want to structure the transaction as a sale followed by a purchase, rather than as an exchange.

(d) When the taxpayer does not plan to hold property of a like kind for a very long time period. The benefits of exchanging occur largely as a result of the time value of money. The longer exchanged property is held, the longer the taxes will be deferred. The longer taxes are deferred, the longer the taxpayer may use the savings to reinvest. The benefits of exchanging for only a short time period may not outweigh the transactional costs of completing an exchange.

4. Alternatives To Exchanging

(a) Continue to hold the property. No gain is recognized until the property is sold.

(b) Refinance the property and reinvest the loan proceeds. Refinancing provides cash now without a current tax liability; however, because of the increased debt on the property, less cash will be available upon sale to pay income taxes. For this option to be beneficial, the expected return on the investment of loan proceeds should exceed the cost to borrow.

(c) Sell the property under the installment method. Under the installment method, income tax is paid on the gain as principal is collected.

(d) Sell the property and pay income tax, reinvest the sale proceeds. Under this option, the taxpayer has less proceeds to reinvest; however, his reinvestment options are not dictated by the tax law, as they would be in an exchange. In addition, the taxpayer has a higher basis in the property, and therefore may have higher ordinary depreciation deductions than he would have under an exchange.

(e) Ground Lease of property - with or without granting the ground lessee an option to purchase. The taxpayer should be cognizant of tax authority distinguishing "true" leases from property sales.

(f) Contribute the property to a joint venture with or without a preferential distributive right. The taxpayer must consider the possible application of the partnership "disguised sale" rules under IRC Section 707(a)(2) and related Regulations, which establish a presumptive sale in connection with certain distributions to the "contributing" partner made within 2 years of the property contribution.

B. QUALIFYING PROPERTY

1. Exchanged Assets Must Constitute Property.

(a) Prepaid Rents. If the taxpayer receives from its tenant an ownership interest in other land, in consideration of granting a leasehold interest in property, the land received will be treated as prepaid rent. *Rev. Rul.* 66-209, 1966-2 C.B. 299; *Pembroke v. Helvering*, 70 F. 2d 850 (D.C. Cir. 1934). On the other hand, a taxpayer who transfers a leasehold in property in which the taxpayer does not hold the reversionary interest, will be considered to have transferred property. See Reg. § 1.103(a)-1(c), *Rev. Rul.* 66-209 and *Everett v. Commissioner*, 37 T.C.M. 274 (1978). A comparable result applies where the taxpayer transfers a life estate, retaining the remainder interest, in exchange for other property. *Rev. Rul.* 72-601, 1972-2 C.B. 467.

(b) Assignment of Income. Certain payment rights, if transferred, may be considered an assignment of income, rather than a transfer of property. This was the result in *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958), which involved the transfer of certain oil payment rights.

(c) Property for Services. The transfer of property by the taxpayer to a third party, in consideration of that party's construction of improvements on other property already owned by the taxpayer, can be considered a transfer of property in consideration of the receipt of building services and materials, which would not qualify for nonrecognition treatment. See *Bloomington Coca-Cola Bottling Co. v. Commissoner*, 189 F. 2d 14 (7th Cir. 1951). In the *Bloomington Coca-Cola* case, the third party never owned the real estate on which the improvements were constructed. This situation can be distinguished from the "build to suit" transactions covered in Part IV C of the materials.

2. Trade/Business/Investment Requirement. Property that is not held for productive use in a trade or business or for investment cannot be Relinquished Property or Replacement Property in an exchange. In *Starker*, for example, recognition was required with respect to one of the replacement properties because it was used as Mr. Starker's residence. *Starker v. United States*, 602 F.2d 1341, 1350 (9th Cir. 1979). Closer issues are raised where home offices, vacation homes and property adjoining a residence are involved. Subpart 7 below addresses second homes, vacation homes and home offices.

3. The "Holding" Requirements.

(a) **Statutory Requirement** - Under Code § 1031(a)(1), the Relinquished Property must be "held for" trade, business or investment purposes, and the Replacement Property must be property "to be held" for such purposes.

(b) **Application of Requirement** - The "holding" requirements become a concern when an exchange is preceded or followed by an acquisition, disposition or other transfer which is part of an integrated plan. See, for example, *Regals Realty Company v. Commissioner*, 43 B.T.A. 194 (1940), aff'd 127 F. 2d 931 (2nd Cir. 1942) (nonrecognition denied, where the taxpayer intended to resell

the replacement property at the time it was received), as well as Rev. Rul. 75-292 (corporate level exchange, followed by liquidating distributions of the replacement property) and Rev. Rul. 77-337 (corporation's liquidating distribution of the relinquished property to its shareholders, followed by shareholder level exchanges). These rulings are addressed again in Part V B of these materials, where application of the "holding" requirements is considered in connection with certain partnership transactions. Compare *124 Front Street, Inc. v. Commissioner*, 65 T.C. 6, (1975), where the taxpayer was obligated to resell the replacement property, at the time it was acquired, and borrowed the funds used to acquire the replacement property from its ultimate purchaser. The facts of *124 Front Street, Inc.*, are described in greater detail on page 49 below, and also mentioned in part 8 of this Section, which considers the possibility of optioned relinquished properties, which the tax payer/seller does not actually own.

(c) **Gift Cases** - In *Click v Commissioner*, 78 T.C. 225 (1982), Taxpayer's child moved in the Replacement Property on the date of closing, and received title seven months later. Nonrecognition treatment was not permitted. In *Wagensen v. Commissioner*, 74 T.C. 653 (1980), the Replacement Property was transferred by gift nine months after the exchange. While the Taxpayer admitted that he had a "general plan" to make future gifts to his children for estate planning purposes, he was successful in convincing the Tax Court that he had no "specific intent" to transfer the Replacement Property when it was acquired, and nonrecognition treatment was allowed.

(d) **How Long to Hold** - Tax practitioners are often asked how long the taxpayer must hold a relinquished or replacement property to meet the applicable "holding" requirement under Section 1031. The taxpayer's intent at the time a relinquished property is conveyed or replacement property acquired is controlling. Accordingly, there is no set 1031 holding period by law or under regulation. Because the original acquisition date of the relinquished property and the date of its transfer are both required to be disclosed on IRS Form 8824, clients should whenever possible acquire the replacement property after the tax year in which the relinquished property is given up. (Although the same year disposition would not necessarily dictate that the relinquished property was not originally acquired and held for investment, however briefly.)

(e) **Practical Analogies** - Prior legislative proposals have at times suggested the addition of an explicit requirement in Code Section 1031 that relinquished property be held for at least one year prior to a qualifying exchange, indicating congressional recognition that such period would be considered significant for these purposes. However, such proposals have not been enacted. IRC Section 1031(f), concerning related party exchanges, and discussed in detail under Part III F of these materials, disallows non-recognition treatment when properties in a related party exchange are disposed of within 2 years thereafter. In the absence of aggravating factors, most tax practitioners will consider a 2 year hold to be sufficient, and would find the analogy to Section 1031 (f) to add

comfort to this approach. A similar 2 year period is incorporated in the Section 707 Regulations, concerning the "disguised sale" rules for transactions between partners and partnerships.

As discussed in more detail in Section IV of these materials dealing with partnership issues, the holding requirements have been the subject of significant debate in connection with the split-up of a partnership prior to an exchange, or the formation of a partnership following an exchange.

4. Express Statutory Exclusions. Section 1031(a)(2) expressly excludes the following items from the nonrecognition treatment otherwise available under Code § 1031(a):

a. Stock and trade or other property held primarily for sale.
b. Stocks, bonds or notes.
c. Other securities or evidences of indebtedness or interest.
d. Interests in a partnership.
e. Certificates of trust or beneficial interests.
f. Choices in action.

Section 1031(a)(ii)(D) was added in 1984. This legislative change may be relevant in the current application of partnership exchange cases which were decided prior to that time. Code § 1031(a)(2) expressly provides that an interest in a partnership which has in effect a valid election to be excluded from Subchapter K will be treated as an interest in each of the assets of the partnership, and not as an interest in a partnership. (These topics are discussed in greater detail under Section IV below).

5. Multi-Asset and Personal Property Exchanges.

Some real estate transactions also include the sale of a certain amount of personal property (also referred to as §1245 property or furniture and fixtures.) Common examples include hotels, restaurants, hospitals and nursing homes. Although personal property is not considered like-kind with real property, in many instances, it also qualifies for tax deferral treatment. Intangible property, such as goodwill, may also be a part of the transaction. One transaction may include the following types of property:

1. Real property, such as land and building
2. Personal property, such as equipment, furniture and fixtures
3. Intangible property, such as goodwill

(a) Like-Kind Issues. All real property is like-kind with any other kind of real property held for investment. However, in the case of personal property, the definition of like-kind is much stricter. For example, a commercial dishwashing machine is not considered like-kind with a cash register, even though both items

are used in the same restaurant. Even though the North American Classification System Manual ("NACS Manual") has been recently issued, the older, Standard Industrial Code Manual is still the operative guide. It groups personal property into separate product classes. Regulation §1.1031(a)(2) outlines standards for depreciable tangible personal property (DTPP) and the like-kind General Asset Classes. Any DTPP within the same General Asset Class or Product Class is considered to be like-kind. *(For more details, see "Personal Property Exchanges.")*

Goodwill is a common component in sales that involve an ongoing business. However, it is not like-kind with any other intangible property and cannot qualify for exchange treatment. Consequently, any goodwill associated with the sale of relinquished property will be taxed and typically receives capital gains treatment. *(Note: Be careful about not allocating any value to goodwill. Field Service Advice 1999-51006 (September 10, 1999))*

(b) Exchange Strategy. There are more pre-planning needs to maximize the benefit of multi-asset exchanges. Here are the primary steps to follow:

1. First, assess if the property being sold by the taxpayer has multiple asset components that would qualify for exchange. Optimally, this should be done prior to placing the relinquished property under contract.

2. Based on the anticipated sales price of the property, it is important to place a fair market value on each of the different components.

3. Determine the current tax basis of each component.

4. Determine what type of replacement property the taxpayer would like to acquire. Determine the estimated price range for the property.

5. If the desired replacement property also has multiple asset components that qualify to be exchanged, allocate a value to each based on the total estimated acquisition price.

6. Based on the values assigned to each component of the replacement property, create a "wish list" of corresponding values for each asset category of the relinquished property.

7. Determine if the values match well enough to proceed.

8. If so, establish justifiable value ranges for each of the relinquished components. Decide the optimum defensible value for each.

9. The property can then be marketed by the taxpayer's representative using the optimal values as a guide for negotiations.

10. When an offer is accepted, it may be best to allocate values in the sales contract. Many tax professionals fill out form 8594 which requires both the purchaser and seller to use the same allocation of values for acquisition and disposition. (If this form is not going to be submitted, it would potentially allow for the taxpayer to associate whatever values they think are most important to the separate assets and for the purchaser to do the same.) Often, what the taxpayer wants to associate to a given component may be at odds with the purchaser's preference. As such, this negotiation can be a critical part of the exchange transaction. If the parties (i) mutually establish values, (ii) commit to consistent tax reporting with respect thereto, and (iii) have materially adverse tax interests, these circumstances will help substantiate the validity of the assigned values.

Example:
A taxpayer is selling a restaurant for $1 million and wants to execute an exchange. He wants to buy raw land worth $1 million for the site of a new restaurant. He is negotiating the terms of the sales contract on his existing property. The buyer suggests some preliminary values, and the taxpayer does a quick analysis:
(Note: Tax rate is blended Federal and state)

Property Type	Allocation	Seller's Tax Basis	Gain Realized	Tax Rate	Potential Tax Due	Taxes Not Deferred
Building and Land	600,000	200,000	400,000	25%	100,000	0
Equip.	200,000	50,000	150,000	45%	67,500	67,500
Good Will	200,000	0	200,000	25%	50,000	50,000

Total price: $1,000,000 **Total taxes due: $117,500**

The taxpayer wants to allocate as much value to the real estate portion of the relinquished property sale as he can negotiate. With this goal in mind, he establishes that there have been several comparable sales within the last year that substantiate an $800,000 value for his land and building. Because the buyer is highly motivated to purchase the property, he agrees to the following adjustments:

Property Type	Allocation	Taxpayer Basis	Gain Realized	Tax Rate	Potential Tax Due	Taxes Not Deferred
Building and Land	800,000	200,000	600,000	25%	200,000	0

Equip.	50,000	50,000	0	45%	0	0
Good Will	150,000	0	150,000	25%	37,500	37,500

Total price: $1,000,000 Total taxes due: $ 37,500

By changing the value allocation on the relinquished property, the taxpayer will save $80,000 in taxes. If the buyer is not concerned about allocating values, the taxpayer can be in the driver's seat when negotiating. When the buyer is well-informed, the negotiations can get very interesting. These types of transactions require a great deal of pre-planning if the taxpayer wants to maximize tax deferral.

(c) Personal Property Exchanges. The steps involved in completing an exchange of real property are very clear and the definition of like-kind is very broad. Unfortunately, the steps involved to complete an exchange of personal property are not as clear and the identification process is more cumbersome. Personal property will usually fall into one of three categories: "depreciable tangible personal property" ("DTPP,") "non-depreciable personal property" or "intangible non-depreciable personal property."

For **depreciable tangible personal property**, Regulation §1.1031(a)(2) sets forth thirteen General Asset Classes. Personal property will be considered like-kind with any other asset in the same specific asset class. Also, any personal property listed in the same Product Class found in the North America Industrial Classification System Manual will be considered like-kind personal property. Some examples of depreciable tangible personal property include planes, construction equipment, business equipment, cash registers and computer equipment.

Due to the broad range of **non-depreciable personal property** and **intangible non-depreciable personal property**, there is no specific classification system or reference manual. In general, the taxpayer must look at the nature or character of the underlying property. *(See Revenue Procedure 92-91, 1992-2 CB 503.)* Common examples of non-depreciable personal property include art and other collectibles. Examples of intangible non-depreciable personal property include patents, copyrights, broadcast licenses and sports contracts.

Prior to the personal property regulations, taxpayers looked upon a business as a single asset and simply exchanged one for another without dividing the associated personal property into different asset classes. This is no longer the case. The taxpayer must stay within the asset or product classes for the safe harbor definition of like-kind to apply. Regulation §1.1031(a)(2) is clear: **to have**

a "safe harbor" for like-kind, the personal property must be broken into separate asset or product classes and the values credited against the same replacement property components. See Field Advisory memorandum 1999-41005 (June 10, 1999) for a good reference. (While this does not mean that a taxpayer cannot use an alternative approach in matching the personal property components in a transaction, he will not be afforded the automatic protection of the safe harbor and may have to defend his position.)

(d) Incidental Property. "Incidental" personal property most commonly appears in exchange transactions related to the sale of a business or in real estate transactions that have a small component of personal property. For example, the sale of an apartment complex may include commercial washers, dryers and vending machines. For identification purposes, if this "incidental property" represents 15% or less of the value assigned to the larger asset (i.e., the real estate,) then the incidental property does not have to be separately identified. See Regulation §1.1031(k)-1(c)(5)

While the deferred exchange safe harbor regulations do not require a separate identification of incidental personal property, under the 15% rule cited above, personal property, even if incidental for such purposes, will not be treated as "like kind" with real estate. See Rev. Rul. 72-151, 1972-1 C.B. 225, in which the aggregate assets comprising a single business or integrated economic investment were fragmented to apply Section 1031(a). See also PLR 8434015, May 16, 1984, which specifically concluded that non-recognition treatment would not be provided with respect to incidental personal property, where the replacement property consisted solely of real estate.

(e) Personal Property to be Produced. If the personal property is being produced, unlike real property, the production must be completed within the 180-day acquisition period. Personal property must be complete when transferred to the taxpayer. Otherwise, it will not be considered substantially the same as the property listed in the ID letter.

6. Property Held Primarily for Sale.

(a) Statutory Provisions. Code § 1031(a)(2)(A) specifically excludes from nonrecognition treatment "stock in trade or other property held primarily for sale". The language of Section 1031(a)(2)(A) may "taint" property for purposes of an exchange, even in some situations where the same property would be eligible for capital gains treatment under Code § 1221. The latter section includes the additional requirement that the property held primarily for sale be held for sale "to customers in the ordinary course of . . . trade or business", while this limitation on the exclusion is not found in the Section 1031 language.

(b) Investor vs. Dealer Status. In the real estate context, the § 1031(a)(2)(A) extension has sometimes led to the conclusion that a "dealer" cannot make tax

deferred exchanges. Literally, this is not the case, since a taxpayer may be "dealer" with respect to some parcels, and an investor with respect to others. See *Scheuber v. Commissioner*, 371 F.2d 996, and *Matthews v. Commissioner*, 317 F.2d 360 (6th Cir. 1963), and cases cited therein. Thus, the analysis must focus on the taxpayer's intent with respect to each specific property.

(c) Illustrative Case Studies.

1. Baker Enterprises. In *Baker Enterprises,* T.C. Mem. 1998-302, the taxpayer subdivided, improved and sold 14 lots, reporting ordinary income. The taxpayer sought exchange treatment, however, for an additional 48 lots. He sought to distinguish the initial 14 lots, which could be inexpensively subdivided and developed as entry-level houses, while the same method was not feasible for the remaining land. Although the taxpayer had held the 48 lots for 11 years, without placing any improvements on them, and sold these lots in a single closing, pursuant to an unsolicited purchase offer, without listing them for sale, the Tax Court found that the property was held primarily for sale, and was not eligible for exchange treatment. The taxpayer had the burden of proof on this issue, and its evidence was held insufficient to establish that it was "wearing the hat of an investor rather than that of a dealer" with respect to the lots. The court considered it significant that the property was characterized as "work in progress" on the taxpayer's books and records, and the taxpayer continued to describe its business as a "subdivider and developer" on the Form 1120s filed during the years in question, instead of changing the description to "real estate investor".

2. Paullus. In *Paullus v. Commissioner*, T.C. Memo 1996-419, taxpayer corporation's sale of real estate was eligible for nonrecognition, notwithstanding § 1031(a)(2)(A), since its real estate holdings were viewed as constituting an investment incidental to the taxpayer's primary business of operating a golf course.

3. Land Dynamics. In *Land Dynamics v. Commissioner*, T.C. Memo 1978-259, statements in a 1972 stock prospectus doomed taxpayer corporation's effort to treat a 1970 sale as part of an exchange.

4. Beeler. In *Beeler v. Commissioner*, T.C. Memo 1997-73, taxpayer held certain sand and related mining permits with respect to land originally acquired for a potential expansion of the adjoining mobile home park. Such permits were considered part of the land, and not a separate component of property which might otherwise be considered to be held primarily for sale. The opinion also cites *Asjes v. Commissioner*, 74 T.C. 1005 (1980) concerning unharvested crops and *Butler Consol. Coal Co. v. Commissioner*, 6 T.C. 183 (1946) concerning coal in an abandoned coal mine.

5. Mathews. In *Mathews v. Commissioner*, 315 F. 2d 101 (6th Cir. 1963) a Cincinnati physician was required to recognize ordinary income on his sale of

certain lands in California and Florida. He purchased 31 properties in 1955-1956 and sold 33 properties within that time frame, at average holding periods of approximately 22 months. Dr. Mathews' listing agreements and extensive correspondence with real estate brokers was damaging to his case.

6. Tibbals. In *Tibbals v. United States*, 362 F.2d 266 (Ct. Cl. 1966) taxpayer was required to recognize ordinary income on one 1952 sale (in part because he was a "moving force" in securing water, sewer and street improvements funded by the county) but was allowed to report capital gain on another 1952 sale (which was part of the same overall tract which the taxpayer and his brother acquired in 1950). In a separately reported case, *Tibbals v. Commissioner*, 17 T.C. 288 (1958) the brother realized long-term capital gain on both transactions.

7. Byram. In *Byram v. United States*, 705 F.2d 1418 (5th Cir. 1983) capital gains treatment was afforded a taxpayer who over a three year period sold 22 parcels for more than $9,000,000, netting approximately $3,400,000 in profit. The court described the ordinary income/capital gain issue as "one of the most uncertain in the entire field of litigation". Holding periods ranged from six to nine months. The court held that "substantial and frequent sales activity, standing alone, is not sufficient" to trigger ordinary income treatment where most of the other factors cited in *United States v. Winthrop*, 417 F.2d 905 (5th Cir. 1969) are absent.

8. Huey. In *Huey v. United States*, 4 F.2d 1388 (Ct. Cl. 1974), although taxpayer had real estate broker's license and owned and operated Huey Realty Company in Birmingham, the particular parcel in question was determined to have been held for investment.

9. Bramblett. In *Bramblett v. Commissioner*, 960 F.2d 526 (5th Cir. 1992), within a three week period in 1979, four individuals formed an investment joint venture and a "mirror image" development corporation. In 1982, the joint venture sold a portion of the land to the corporation, on the installment basis, at a price exceeding $9,800,000 (supported by appraisal), and at a profit of over $7,000,000. Although the joint venture had four previous sales (in 1981) that were reported as ordinary income, the 1982 transaction (which was structured after the parties consulted their attorneys and accountants) was reported as capital gain, and that treatment was upheld by the Court of Appeals.

10. Bradshaw. In *Bradshaw v. United States*, 683 F.2d 365 (Ct. Cl. 1982) taxpayer's transfer of real property to a controlled corporation was treated as a sale (giving the corporation a "stepped up" basis) and not as a capital contribution under Code § 351 (which would have resulted in a "carryover" basis). Taxpayer's adjusted basis was approximately $8,500. Although no independent appraisal was obtained, the court found that the "conservative" fair market value of the property on date of transfer was $250,000 (which equaled the price paid by the controlled corporation). A period of approximately 7 and one-half years transpired between

taxpayer's original acquisition of the land and the sale to his controlled corporation.

7. Personal Residential Properties.

(a) **Exchange Qualification.** In light of the trade/business/investment requirement under Section 1031, exchanges involving a principal residence, second home, vacation home or home office raise issues concerning the extent to which such properties qualify as a relinquished property or replacement property in a proposed tax deferred exchange. The IRS position is clear and self-evident - such properties qualify for non-recognition treatment only to the extent of portions or components held (in the case of relinquished property) or to be held (in the case of replacement property) for productive use in trade or business or for investment. See, for example, PLR 8508095, November 29, 1984, and *Dewey v. Commissioner*, T.C. Memo 1993-645. In Dewey, the relinquished property included both a commercial storage facility and the taxpayer's personal residence. Time share units, which constituted it real property under applicable law, were part of the consideration received by the taxpayer. Because there was no evidence that the Deweys ever attempted to rent or have ever rented the replacement property at fair rental value, and since the replacement properties were often used by friends and acquaintances, without payment of fair rent, including their son who used one property for his honeymoon, the Deweys were not entitled to exclude any of the gain under Section 1031.

(b) **Analogy to IRC Section 280A.** IRC Section 280A disallows deductions with respect to a dwelling unit used by the taxpayer during the taxable year as a residence. The limitation does not apply to portions exclusively used on a regular basis for business purposes. Under Section 280A(d) the taxpayer is deemed to use a dwelling unit "as a residence" if such unit is used for personal purposes for a number of days which exceeds the greater of (i) 14 days; or (ii) 10% of the number of days of such year for which such unit is rented at fair rental. Use by family members, use under reciprocal arrangements, or use without a fair rental is considered personal use.

By analogy, many tax practitioners conclude that a residential dwelling, or portion thereof, will qualify for non-recognition treatment under Section 1031 if the dwelling unit or a portion is not considered to have been used by the taxpayer as a residence under the Section 280A standards. For instance, PLR 8508095, November 29, 1984, dealt with the exchange of a home office, where it was stipulated that use of this area would meet the requirements of Section 280A(c). See also PLR 8103117, October 27, 1980, which concluded that a residential property qualified for an exchange, although the house had not been rented during the past six or seven years. (This house was occupied by the taxpayer approximately 10 days per year, for maintenance purposes). TAM 8732002, April 2, 1987, includes an extensive discussion of a "Bed and Breakfast" operation in a certified historical structure. The bed and breakfast and "museum"

portions of the home were not subject to the disallowance provisions in Section 280A(a). (This TAM does not address Section 1031).

(c) **Exchange Strategy - Conversion of Use.** If the taxpayer has significant gain associated with residential property which is or may be "personal use" property, it might be wise to consider "converting" use of the property to an investment in real estate for a sufficient period. Generally, this would involve actually renting the property, or making it available for rental, while complying with the Section 280A limitations. See *Bundren v. Commissioner*, TC Memo 2001 - 2 (2001) concerning the exchange of property which constituted the taxpayer's primary residence for approximately 12 years, was then converted to rental property in the spring of 1994, and was actually rented from September to December 1994.

(d) **Combining Sections 121 and 231.** Revenue Procedure 2005-14 explains how the primary residence gain exclusion under IRC Section 121 can be combined with the like kind exchange. There were three principal tax benefits under the transaction described in Rev. Proc. 2005-14 (i) up to $500,000 (for a married couple) of cash can be received tax free under the personal residential exclusion allowed by IRC Section 121, even though the property no longer constitutes a personal residence, since the exclusion is available as long as the property has been used as a principal residence for at least 2 years in the 5-year period ending on the date of disposition, (ii) the home described in Rev. Proc. 2005-14 was considered by the IRS to be business property, due to its "having been rented for less than 3 years", and thus could be part of the tax-free like kind exchange and (iii) Rev. Proc. 2005-14 permitted the taxpayer to apply the personal residence exclusion rules <u>before</u> applying the like kind exchange rules, so all cash due received is first applied to the available exclusion ($500,000 for married couples/$250,000 for an unmarried taxpayer), with only any excess being treated as a component of the like kind exchange.

If the "conversion of use" goes in the "opposite" direction, i.e., business or investment property is converted to a personal residence, IRC Section 121(d) maybe applicable. Under this provision, the personal residence gain exclusion is not available if a personal residence originally acquired in a like kind exchange is sold within 5 years of its acquisition.

8. **<u>Disposition of Optioned Property</u>.** Taxpayers sometimes inquire about the possibility of "exchanging" property which the taxpayer has under contract, but has not yet purchased. Particularly until the recent decline in the Gulf Coast condo market, taxpayers were interested in "flipping" their purchase contracts, for an assignment consideration, without ever taking title, and reinvesting the profit on a tax-deferred basis. Generally, such transactions should not work, since the taxpayer does not have a real property interest which might serve as the relinquished property in such an "exchange".

Under a "benefits and burdens" analysis, the party holding the "record title" for state law purposes is not necessarily the "tax owner" of the property under federal income tax principles. If the taxpayer has a non-refundable purchase deposit, which is substantial in comparison with the purchase price and fair market value of the optioned property, (or if his Seller has a right of specific performance) and if the improvements contemplated under the option or purchase contract have been completed to a sufficient degree, then the taxpayer/purchaser may be considered to be the owner of a real property interest for tax purposes. In such event, the transfer of the taxpayer's beneficial interest in the property, through an assignment of his contractual purchase or option rights, could constitute the "first leg" of a real property exchange.

If the "real property interest" issue with respect to optioned property can be favorably resolved, the taxpayer must still contend with the "holding" requirement. Can it can be said that the real property interest has been "held" for requisite trade/business/investment use, when the taxpayer is attempting to flip or resell that interest? A successful result could occur when the taxpayer's efforts to flip or resell the contract rights commence only <u>after</u> the contract becomes a real property interest for tax purposes under the analysis outlined above.

In many cases, the best result a taxpayer might reasonably anticipate is achievement of capital gains treatment for the "flip" consideration. If the contract right has been held for more than a year, the contract itself could be considered a capital asset, unless it is clear that the taxpayer fulfilled the contract right "primarily for sale in the ordinary course of business".

Taxpayers and their advisors should consider the facts and result in *124 Front Street, Inc. v. Commissioner*, 652.C.6 (1975). In that case, the exchange treatment was permitted, notwithstanding that the taxpayer was obligated to resell the replacement property, at the time it was acquired, and borrowed the funds used to acquire the replacement property from its ultimate purchaser.

C. DEFINITION OF "LIKE-KIND"

1. <u>Personal Property</u>. Personal Property is not of like-kind to real estate. *Rev. Rul.* 59-229, 1959-2 C.B. 180; *Rev. Rul.* 72-151, 1972-1 C.B. 225. Whether property is real or personal is generally determined by state law. See *Aquilino v. United States*, 363 U.S. 509 (1960). Under Regulation Section 1.1031(a)-2, Personal Property is subject to a "like-class" standard which is more restrictive than the "like-kind" standard applicable to real property. For example, under these provisions, a car may not be exchanged for a truck. Reg. §§ 1.1031(a)-2(b)(2)(v) and (vii).

In Rev. Proc. 2003-39, the IRS set forth three separate safe harbors applicable to tangible personal property exchange programs using a single intermediary. These so-called "LKE Programs" facilitate the goals of taxpayers,

including major car rental companies, involved in multiple exchanges of 100 or more properties.

2. Real Property Interests. Numerous and varied interests in real property may be considered like-kind to one another. Improved real estate may be exchanged for unimproved real estate. Reg. § 1.1031(a)-1(b) and -1(c); *Rev. Rul.* 72-515, 1972-2 C.B. 466. Tenancy in common interests may be exchanged for fee interests. *Rev. Rul.* 79-44, 1979-1 C.B. 265; *Rev. Rul.* 73-476, 1973-2 C.B. 300; *Rev. Rul.* 68-186, 1968-1 C.B. 354. An easement may be exchanged for a fee interest. *Rev. Rul.*72-549, 1972-2 C.B. 472. Water rights constituting real property under state law, may be exchanged for a fee interest. *Rev. Rul.* 55-749, 1955-2 C.B. 295. A fee interest, subject to a 99 year lease, may be exchanged for an unencumbered fee interest. *Koch v. Commissioner*, 71 T.C. 54 (1978), acq'd. 1979-1 C.B. 1. A condominium unit, if it is real property under state law, may be exchanged for a fee interest. *Rev. Rul.* 77-423, 1977-2 C.B. 352. Exchanges of mineral interests for other mineral interests, or for nonmineral real property interests can qualify for nonrecognition, so long as the interests involved are considered real property under applicable state law. *Rev. Rul.* 55-749, 1955-2 C.B. 95, *Commissioner v. Crichton*, 121 F.2d 181 (5th Cir. 1941); PLR 79-35126 (June 4, 1979) and Rev. Rul. 68-331 (lessee's interest in a producing oil lease, extending until exhaustion of the deposit, was like kind with an improved ranch). However, limited carved out "production payments", such as a payment right which terminates when a specified quantity of materials have been produced, or stated amount has been paid, may be considered payment rights, and not property rights. *Midfield Oil Co. v. Commissioner*, 267 F.2d 291 (9th Cir. 1959).

Under Code § 1031(h), added by the Omnibus Budget Reconciliation Act of 1989, real property located in the United States and real property located outside the United States are <u>not</u> property of a like-kind. Under Code § 7701(a)(9), the term "United States" when used in a geographical sense includes only the States and the District of Columbia.

The exchange of timber land for other real property, including bare land, satisfies the like-kind standard. *Rev. Rul.* 78-163, 1978-2 C.B. 257. The right to remove standing timber for a limited period, or the right to remove a certain quantity of timber from various tracts of land, is not of like-kind to a fee interest in land, even if the right is conveyed by timber deed and is otherwise treated as real property for state law purposes. Technical Advice Memorandum 9525002; *Oregon Lumber Co., Inc. v. Commissioner*, 20 T.C. 192 (1953).

A remainder interest is of like-kind with another remainder interest. *Rev. Rul.* 78-4 1978-1 C.B. 256. A fee interest is of like-kind with a life estate of at least 30 years duration, but not with a life estate of less than 30 years duration. *Rev. Rul.* 72-601, 1972-2 C.B. 467. A remainder interest appears to be of like-kind with a fee interest. *Rev. Rul.* 72-601.

If a purchase option constitutes real property under state law, then it may constitute property of like-kind with other real property under Section 1031(a)(1), at least to the extent of any "premium" value by which the current fair market value of the real estate exceeds the option price. See *Biggs v. Commissioner*, 69 T.C. 905 (1978) aff'd 632 F.2d 1171 (5th Cir. 1981); *Swaim v. United States*, 651 F.2d 1066 (5th Cir. 1981) (dicta); and *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979). See also discussion at pages 14-15.

The exchange of assembled railroad track components for unassembled railroad track components is not of like-kind and does not qualify for 1031 treatment, given that the former is considered real property under state law and the latter is considered personal property. *Technical Advice Memorandum 200424001*.

3. Leasehold Interests. The duration of the leasehold interest is the determining factor in the status of that interest under Section 1031(a)(1). A leasehold of at least 30 years duration is of like-kind to a fee interest. Reg. § 1.1031(a)-1(c)(2); *Rev. Rul.* 66-209, 1962-1 C.B. 299. Optional renewal periods are included in determining the leasehold's duration for this purpose. *Rev. Rul.* 78-72, 1978-1 C.B. 258. Leaseholds with the remaining duration of less than 30 years are of like-kind to one another. *Everett v. Commissioner*, 37 T.C.N. 274 (1978); *Rev. Rul.* 76-301, 1976-2 C.B. 241. Leaseholds with the remaining duration of less than 30 years are not of like-kind to a fee interest. *Capri, Inc. v. Commissioner*, 65 T.C. 162 (1975).

D. EXCHANGE REQUIREMENT

1. Overview. Tax deferral is available under Section 1031 only in the case of a reciprocal exchange. Generally, this would mean that the same taxpayer that conveyed the relinquished property should receive the replacement property. For example, in TAM 9818003, the Service indicated that direct deeding of replacement property to partners would not constitute a valid exchange where title to the relinquished property was conveyed by the partnership. However, in Private Letter Ruling 9850001, released December 11, 1998, a corporate taxpayer's holdings were consolidated and reorganized, during an exchange, with the effect that the replacement property was deeded to a party other than the transferor of the relinquished property, and nonrecognition treatment was allowed. (In the ruling, the ultimate recipient was, in effect, controlled by the same persons who controlled the original owner of the relinquished property).

2. Single Member LLCs. Since single member limited liability companies are "disregarded" entities for federal tax purposes, they may be used in exchange transactions without fear of violating the "same taxpayer" standard. In PLR 9807013, the taxpayer individually disposed of the relinquished property, and formed a single member LLC to take the replacement property. In PLR 9911033, a two-member entity was disregarded where one of the members held 100% of

the economic interests (the second member's interest was limited to certain management rights). In PLR 200118023, the taxpayer avoided certain transaction expenses by acquiring an interest in a single member LLC as replacement property. (The IRS concluded that such acquisition was the equivalent of acquiring the LLC's real property). In PLR 200131014, the taxpayer disposed of his relinquished properties individually, received replacement properties individually, and transferred those replacement properties to a disregarded single-member LLC.

II. DEFERRED EXCHANGES

A. IDENTIFICATION PERIOD AND REPLACEMENT PERIODS

1. What is a deferred exchange?

A deferred exchange, also known as a non-simultaneous exchange, is an exchange in which, "pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment and subsequently (emphasis added) receives property to be held either for productive use in a trade or business or for investment." (Regs. 1.1031(k)-1(a)). In other words, the taxpayer does not transfer his relinquished property at the same time that he receives his replacement property. IRC Section 1031(a)(3) sets forth certain timing requirements that must be met in order to have a valid deferred exchange:

> "Any property received by the taxpayer shall be treated as property which is not like kind (emphasis added) property if (A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (B) such property is received after the earlier of (i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange or (ii) the due date (determined with regard to extension) for the transferor's return. . . for the taxable year in which the transfer of the relinquished property occurs."

2. Identification Period: The 45-day period the taxpayer has to identify the replacement property in an exchange is known as the "identification period." It begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th day thereafter (Regs. 1.1031(k)-1(b)(2)). There are no exceptions or grace periods, even if the 45th day falls on a weekend or holiday, and no matter what circumstances cause the identification not to occur. In other words, the property must be identified by midnight on the 45th day or the exchange will be taxable.

EXAMPLE 1: If John enters into an exchange agreement and transfers property to an intermediary on November 16, 2000, he has until midnight on December 31, 2000 to identify his replacement property.

3. Replacement Period: The 180-day period the taxpayer has to acquire the replacement property in an exchange is known as the "replacement period" or the "exchange period." It also begins on the date the relinquished property is transferred and ends on the earlier of:

- 180 days or
- the due date (including extensions) of the taxpayer's income tax return for the year during which the relinquished property was transferred.

Because the replacement period is defined as it is, the taxpayer will know whether to report the gain realized on the exchange as a taxable or nontaxable transaction by the time he files his income tax return for the year covering the transfer.

If a calendar year corporate taxpayer transfers relinquished property in a deferred exchange prior to September 16 (September 17 in years immediately prior to a leap year), then the 180-day rule and not the tax return due date rule will apply. If a calendar year individual, partnership, estate or trust transfers relinquished property in a deferred exchange prior to October 17 (October 18 in years immediately prior to a leap year), then the 180-day rule and not the tax return due date rule will apply. Even for transfers occurring after the dates mentioned above, the tax returns can be extended to expand the replacement period to 180 days.

EXAMPLE 2: In Example 1 above, John has until April 17 (because April 15, 2000, the filing deadline for John's 1040, fell on a Saturday) to acquire his replacement property; however, if he extends his personal income tax return, his replacement period is extended to the 180th day, or May 15, 2001.

As with the identification period, there are no exceptions or grace periods; therefore, it is critical that the taxpayer and his advisors understand the replacement period is 180 days and not six months. An exchange completed six months after the relinquished property is transferred will be a few days too late and will be taxable.

4. Using Leases to Extend Periods. If the taxpayer leases the relinquished property to its prospective purchaser, prior to sale, or leases the prospective replacement property from its current owner, in anticipation of a future purchase, greater flexibility will be afforded in meeting the identification and replacement deadlines for a tax deferred exchange. However, care must be taken so that the transaction will qualify as a true "lease", instead of a sale, particularly when options to purchase are included in the package. The relationship between rent and fair market value of the property must be considered. Rev. Rul. 68-590, 1968-2 C.B. 66. Recharacterization is likely when a purchase option is included with an option price which is nominal in relation to the property's value. *Frito-Lay, Inc. v Commissioner* 209 F. Supp. 886 (D.C. Ga. 1962). See also Rev. Rul. 55-540, 1955-2 C.B. 39 and *M&W Gear Co. v. Commissioner*, 446 F. 2nd 841 (7th Cir. 1971) and Rev. Proc. 75-21, 1975-1 C.B. 715. In General Counsel Memo 20050203F (January 14, 2005), an exchange was disallowed in part because facts indicated that the taxpayer bore the benefits and burdens of ownership with respect to the replacement property prior to disposition of its relinquished property. (The transaction was not structured to meet the "reverse exchange" safe harbor elsewhere discussed in these materials).

5. Identification issues:

(a) What form should an identification take? Under Regs. 1.1031(k)-1(c)(2), identification of replacement property must be written and signed by the taxpayer, and hand delivered, mailed, faxed or otherwise sent before the identification period expires to either (i) the party obligated to transfer the replacement property to the taxpayer (often times this will be the qualified intermediary) or (ii) any other person involved in the exchange who is not the taxpayer or a "disqualified person." A disqualified person is defined as an agent of the taxpayer or a person related to the taxpayer or to the taxpayer's agent under IRC Section 267(b) or 707(b), substituting 10% for 50% where it appears in those sections. Further discussion of disqualified persons appears later in this section.

(b) Acquisition within Identification Period. If replacement property is actually acquired within 45 days, the acquisition is considered to be timely identified and there is no need for written identification.

(c) How should the replacement property be described? The identification must include an unambiguous description of the property (Regs. 1.031(k)-1(c)(3)). For real property, this means a legal description, street address, or distinguishable name. "Unimproved real property in St. Clair County, Alabama" would not be an unambiguous description unless it also included a street address or legal description. The AmSouth-Harbert Plaza would be unambiguously described since it is property with a distinguishable name. For personal property, an unambiguous description means a specific description such as the make, model and year of a vehicle or piece of equipment.

(d) Identifying Fractional Interests. When undivided fractional interests (also referred to as tenancy-in-common interests) will constitute the replacement property, the identification may involve "an undivided x% interest in and unto…" followed by a sufficiently detailed description of the corresponding fee interest. If the actual undivided interest cannot be ascertained during the identification period, it may be necessary to identify "the undivided interest represented by the quotient having (i) as its numerator, $_________ [the exchange proceeds held by the qualified intermediary, or allocable portion devoted to this particular replacement property] and (ii) as its denominator, the net amount due in connection with the purchase of …" followed again by a sufficient description of the fee interest. (Neither the deferred exchange safe harbor regulations, or Rev. Proc. 2002-22, concerning undivided fractional interests in real property, specifically addressed the preferred method for making an identification under such circumstances).

(e) Can identifications be revoked or amended? Identifications can be revoked at any time before the identification period expires. The revocation must be in writing and signed by the taxpayer, then hand delivered, mailed, faxed or otherwise sent to the same person who received the original identification. A revocation or change to the identification cannot be made after the 45-day period (Regs 1.031(k)-1(c)(6)). Only the properties identified by the end of the identification period will qualify as like kind property upon receipt.

One husband and wife team attempted to avoid the identification period. They did not close on the properties they had timely identified. Instead, they acquired property that they found after the 45-day period had expired. They backdated documents to fraudulently support the late identification of the replacement property. The exchange was declared to be taxable, and the taxpayers were subject to Section 6663 fraud penalties (Dobrich v. Commissioner, TC Memo 1997-477, 74 TCM 985).

(f) Will the exchange of multiple relinquished properties be treated as a single exchange or multiple exchanges? The answer to this question depends on numerous factors. The Internal Revenue Code and Regulations do not provide specific authority on this issue; however the American Bar Association identifies what it believes are some relevant factors in its *Comments Concerning Open Issues in Like Kind Exchanges*. These include

- the identity of the buyer - is one buyer acquiring all of the relinquished properties, or are there multiple buyers?
- the taxpayer's intent - did the taxpayer intend for the transaction to be a single exchange or multiple exchanges?
- the structure of the transaction(s) - single or separate exchange agreements, contracts, intermediaries, or escrow accounts
- The geographical proximity of the relinquished properties – adjacent properties are more apt to be considered part of a single exchange

- Chronological proximity of the dispositions – dispositions occurring simultaneously or within a short time period of each other may be more likely to result in a single exchange, especially when other factors exist.

Other factors that may be considered relevant in determining whether the disposition of multiple properties is a single transaction may include the use of a single listing agreement, mutual contingencies on the transfer of the properties, whether the properties are used in a "functionally integrated business," and possibly whether the replacement property is a single property (*Real Estate and the Deferred Exchange Regulations,* Cuff, 1997).

If the disposition of multiple relinquished properties is deemed to be a single exchange, the identification period and the replacement period begin on the earliest date on which any of the properties are transferred. For example, if relinquished property A is transferred on October 31, relinquished property B is transferred on November 10, and the transaction is deemed to be a single exchange, identification of replacement properties for both A and B must occur by December 15. If the disposition is treated as multiple exchanges, each exchange will have its own identification and replacement period based on the date that the relinquished property was transferred. In the above example, the replacement property for property B could be identified as late as December 25. In order to timely identify and acquire replacement property, it is critical for the taxpayer to consider these factors and take action to structure the transaction(s) to increase the likelihood of achieving the desired result. In addition, the limitations on identifying multiple replacement properties may be affected by the single v. multiple exchange issue. These limitations are discussed below.

5. Identification of alternative and multiple replacement properties: In a single exchange, a taxpayer may identify more than one replacement property, but there are some limitations involving the number and value of identified replacement properties. Regs. 1.1031(k)-1(c)(4).

(a) Three-property rule: Up to three replacement properties can be identified without regard to their fair market values. EXAMPLE: Jane disposes of investment real property with a fair market value of $100,000. She timely identifies three properties with fair market values of $75,000, $100,000, and $175,000. Her identification is valid because the three-property rule has no fair market value limitations.

(b) 200-percent rule: Any number of replacement properties may be identified as long as their aggregate fair market value at the end of the identification period does not exceed 200 percent of the aggregate fair market value of all of the relinquished properties at the time they were transferred by the taxpayer. EXAMPLE: Assume the same facts as the above example except that Jane also timely identifies a fourth property with a fair market value of $50,000. She will be treated as not having identified any replacement property because the

aggregate fair market value of the replacement properties ($400,000) exceeds 200 percent of the relinquished property fair market value. Jane could cure this situation by revoking properties (within the identification period) with fair market values that would drop the aggregate below $200,000. In addition, any identified properties acquired within the 45-day period are treated as being properly identified, even if the three-property rule and the 200-percent rule are exceeded at the end of the identification period.

(c) 95-percent rule: If the taxpayer exceeds the three-property rule and the 200-percent rule, the taxpayer will be treated as having identified no replacement property unless he acquires properties by the end of the replacement period that have combined fair market values at least 95 percent of the aggregate fair market value of all of the identified replacement properties. EXAMPLE: Assume the same facts as above. If Jane acquires all of the identified properties, she will meet the 95-percent rule, and will be treated as having timely identified the replacement property. If she fails to acquire just one of the properties, her exchange will fail because she has not met the 95-percent rule.

(d) Incidental property: Property that is "incidental" to a larger item of property is not treated as a separate property for identification purposes if the property is typically transferred with the larger item of property in standard commercial transactions and the aggregate fair market value of all incidental property does not exceed 15 percent of the aggregate fair market value of the larger property item.

(Regs. 1.1031(k)-1(c)(5)). For example, appliances worth $120,000 as part of a transfer of an apartment building with a value of $1,000,000 would not be considered as a separate property for identification purposes since the value of the appliances does not exceed 15 percent of the total apartment building value.

These rules underscore the importance of revoking the identification of property the taxpayer knows he will not acquire when he identifies additional replacement property that puts the total number of identified properties above three. Revocation may not be necessary, but the taxpayer and his advisors must consider the effects of the three-property rule, the 200-percent rule, and the 95-percent rule when making original and additional identifications.

6. Replacement Issues: The replacement property acquired by the taxpayer must meet two requirements to be considered a valid replacement for exchange purposes. The taxpayer must receive the replacement property within the exchange (replacement) period and the replacement property must be "substantially the same" as the identified property (Regs. 1.031(k)-1(d)). Exactly what "substantially the same" means is not clear. The examples in the Regulations imply that the "basic nature or character of the property" must be the same for the actual replacement property acquired as it is for the identified replacement property. Building a fence on previously identified unimproved land

would not change the property's basic nature or character, nor would acquiring 1.5 acres of an identified two-acre tract. There is no bright-line test regarding what percentage of identified property would still be considered substantially the same, although the example in the Regulations allows the replacement property to be 75% of the area of the identified property. Because no solid guidance exists, the taxpayer would be wise to identify the replacement property as specifically as possible; and if he intends to acquire an undivided interest in property, he should quantify that undivided interest in his identification.

Another area where the "substantially the same" issue arises is in the case of replacement property to be constructed. The Regulations do allow for property to be identified that is not in existence or is being produced at the time of identification. These "build-to-suit" exchanges will be covered in further detail in Part 4 - Current Issues.

B. SAFE HARBORS UNDER THE DEFERRED EXCHANGE REGULATIONS

The safe harbors for qualified intermediaries and security arrangements, which become effective in 1991, have been described as the heart of the deferred exchange regulations. Use of a qualified intermediary, subject to the conditions of the safe harbors, will insulate the taxpayer from constructive receipt concerns. The taxpayer may use more than one of the safe harbors under the regulations in the same deferred exchange, provided that the terms of each are satisfied.

1. Qualified Intermediaries. A qualified intermediary is not considered an agent of the taxpayer for purposes of Section 1031. To enjoy the "QI" safe harbor, there must be a written exchange agreement, between the taxpayer and the intermediary, which includes an affirmative statement expressly limiting the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by the intermediary until the occurrence of a "cash-out" event specified in Paragraph (g)(6) of the Regulations.

In Private Letter Ruling 200338001, the IRS approved certain structures wherein professionals may act as qualified intermediaries for their own clients. Most such professionals were traditionally prohibited from acting in this role as "disqualified persons" under Treas. Reg. 1.1031(k)-1(k)(2). For more information on this new PLR, see E. John Wagner, II, Ruling Paves the Way for Professionals to Operate Section 1031 Exchange Intermediaries, Journal of Taxation, December 2003.

2. Disqualified Persons. Reg. § 1.1031(k)-1(k) describes the categories of disqualified persons who may not serve as qualified intermediaries for the taxpayer under the deferred exchange safe harbor rules. Certain related parties are considered to be disqualified persons. In addition, anyone who has acted as the Taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker, within the two year period ending on the date of the

transfer of the first of the relinquished properties is treated as an agent of the taxpayer, and will be a disqualified person. Under Reg. §§ 1.1031(k)-1(k)(2)(i) and (ii) services "with respect to exchanges of property intended to qualify for nonrecognition" and "routine" financial, title, escrow or trust services, by a financial institution, title company or escrow company, will not result in disqualification.

The "exchange services" provision literally applies to actual exchanges (intended to qualify) so that an intermediary who participated in an attempted exchange, which resulted in a taxable transaction because replacement properties could not be identified, would not be within the literal scope of the exemption. The regulation does not attempt to define "routine" services, as described in the second leg of this exemption. PLR 20063005, May 24, 2005, incorporated the definition of "financial institution" under Regulation Section 1.165-12 (c)(1)(iv)(G) and Reg. Section 1.1441-1(c)(5) in finding that a disregarded entity, whose sole owner was a privately held, specialty finance company, could act as a qualified intermediary for the parent's loan customers.

The deferred exchange regulations incorporate the "attribution" rules in Internal Revenue Code § 267(b) (which applies to corporations) and § 707(b) (which applies to partnerships) in defining the universe of "disqualified" persons. Under these provisions, certain family members, and parties who participate in controlled corporations or partnerships, are considered to bear a relationship which would make them "disqualified" to act as an intermediary for other persons. § 707(b)(3) has a reference which effectively avoids "double" attribution. For example, if an individual owns more than a 10% interest in the taxpayer, and also owns more than a 10% interest in a title agency which is otherwise unrelated to the taxpayer, then the taxpayer and the title agency would not be considered related under the attribution rules. (The taxpayer is related to the individual, and the individual is related to the title agency, but this does not cause the taxpayer to be related to the title agency).

3. <u>Direct Deeding</u>. The Regulations provide that an intermediary will be considered to have acquired and transferred property, regardless of general tax principals, if the intermediary enters into an agreement for the transfer of the property, and pursuant to that agreement, the property is transferred. Reg. § 1.1031(k)-1(g)(4)(iv). For such purposes, an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to the agreement are notified in writing of the assignment on or before the date of the relevant property transfer. Reg. § 1031(k)-1(g)(4)(v). Since the regulation refers to an assignment of rights, there does not appear to be any requirement of a novation, so that the Taxpayer may remain liable on its obligations under the assigned agreement, and it will not be necessary for the intermediary to assume any such obligations. These provisions provide the mechanics to permit direct deeding under the situation where the intermediary acts as a mere "stakeholder" during the Exchange Period. To utilize

this approach, it would be important that the underlying agreements permit assignment, at least to a Qualified Intermediary for purposes of effecting an Exchange.

4. Transactional Expenses. Under Reg. § 1.1031(k)-1(g)(7) transactional items that relate to the disposition of the Relinquished Property or to the acquisition of the Replacement Property and appear under local standards in the typical closing statement may be paid from a qualified escrow. Technically, it appears that transactional items paid in connection with an attempted but failed acquisition of Replacement Property are not covered by this provision. Legal fees, accounting fees, or other professional expenses may or may not satisfy the requirement that such items "appear under local standards in the typical closing statement".

5. Security Arrangements. The regulations allow a wide variety of security arrangements, including mortgage, pledges of property, standby letters of credit and qualified escrow accounts, which may serve as security for another party's obligation to complete the Exchange. The letter of credit provision, in the regulation, however, would permit the letter of credit to be drawn only upon a default in the transferee's obligation to transfer like-kind Replacement Property to the Taxpayer. The Taxpayer's concerns would not be addressed if the intermediary refused to pay the excess balance in an exchange account, or to release funds to the Taxpayer where a Replacement Property has been designated but the Taxpayer cannot negotiate an agreement to acquire it.

6. Overview of Section 1.1031(g)(6)

(a) Specific Limitations. Section 1.1031(g)(6) outlines the specific limitations of a taxpayer's right to receive, pledge borrow or otherwise obtain the benefits of the cash or cash equivalents from an exchange. It lists certain requirements that must be met in this area:

1. There must be proper language in the exchange agreement regarding the taxpayer's rights to the funds. Specifically, the agreement must not allow the taxpayer to receive, pledge, borrow or otherwise obtain benefits from the funds.

2. The agreement may allow this restriction to be lifted and give the exchanger the right to receive, pledge, borrow or otherwise obtain the benefits of the funds upon the occurrence of certain events. Specifically:

a. If the taxpayer has not identified property within 45 days from the sale of the relinquished property and the 45-day identification period has expired. *(i.e. The exchange has failed because the exchanger has not identified property within the time allowed.)*

b. If the taxpayer has received all the replacement property to which he is entitled and there are funds remaining. *(i.e. If the exchange has been totally completed prior to the end of the 180-day exchange period.)*

c. If after the identification period, a material, substantial contingency occurs that does not practically allow for acquisition of the replacement property. The contingency must:

i. Relate to the exchange
ii. Be provided for in writing
iii. Be beyond the taxpayer's control or the control of a disqualified party other than the qualified intermediary (see example #2 under §1.1031(g)(8).)

(b) Pertinent Examples.

1. A client decides not to complete an exchange once it has begun and seeks immediate release of exchange funds.

Situation: A taxpayer, initially committed to doing a tax-deferred exchange, sells his relinquished property. Prior to the end of his identification period, however, he decides not to proceed with his exchange. He requests that the qualified intermediary release his proceeds to him before the end of the 45-day identification period.

Problem: The IRS Regulations do not provide for the early release of exchange proceeds. Neither does the exchange agreement executed by both parties. But the client and the CPA who referred him are unhappy and threatening to sue if the money isn't released immediately.

The qualified intermediary must address the ramifications of not consistently enforcing §1.1031(g)(6) limitations. Is it possible that allowing one client to have early receipt of funds could deem all of the intermediary's clients to have constructive receipt of exchange funds?

Possible Solutions: The IRS has not issued specific rulings and there are no court cases addressing the early release of exchange funds prior to the expiration of the 45-day identification period. However, there appear to be two schools of thought among exchange professionals. The first group believes that the intermediary should strictly enforce the client's compliance with the prescribed steps in order to preserve the integrity of the process and to demonstrate consistency in dealing with all clients. If a client fails or is unwilling to comply, the intermediary would be justified in his refusal to complete certain steps that he feels may violate the safe harbor rules. Other exchange professionals believe that the intermediary is not responsible for enforcing strict compliance in what is

essentially a voluntary transaction entered into by the taxpayer. This group discourages the intermediary from taking on the role of the “exchange police”.

Given this disparity of views and lack of concrete direction in the Regulations, there are a number of actions that might be taken:

* Release the funds.
* Release the funds after written demand by the client.
* Release the funds after written demand, indemnification and acknowledgement of potential consequences by the client.
* Release the funds after a court order only.
* Do not release the funds until the end of the 45-day identification period.

2. A client seeks the immediate return of exchange proceeds after she acquires only one of her targeted replacement properties.

<u>Situation:</u> A client identifies two potential replacement properties, is beyond the 45-day identification period and uses a portion of the proceeds to acquire only one property. Prior to the end of her exchange period, she seeks the return of her remaining funds.

<u>Problem:</u> Most exchange agreements contain the standard G-6 language that does not allow for the early release of funds. In Letter Ruling 200027028, the service indicates that the early release of exchange funds <u>does not</u> fall within the regulations even if the exchange agreement stipulates that the funds can be released if the taxpayer fails, after negotiating in good faith, to enter into a contract on identified property.

<u>Possible Solutions</u>: Unlike example #1, the service has given some direction on this issue. As such, potential actions that might be taken include:

- Release of funds.
- Release of funds after client has submitted a letter that includes material and substantial contingency language.
- Release of funds after a court order only.
- Do not release the additional funds until the end of the 180-day identification period.

3. A client uses all of his proceeds to acquire one of three replacement properties identified and seeks the payment of his interest earned.

<u>Situation:</u> A client identifies three potential replacement properties, but uses all of his exchange proceeds to acquire just one. Prior to the end of his exchange period, he seeks the interest earned on his funds.

Problem: It may be appropriate to argue that the exchanger received all the property to which he was entitled given the adequacy of his funds. However, a strict interpretation might beg the question of whether debt could have been used to acquire one of the remaining properties identified. If the exchanger receives the interest prior to the end of the exchange period, could he be deemed to have received the benefits of the cash strictly prohibited under the Regulations?

Once again, the qualified intermediary must address the ramifications of not consistently enforcing §1.1031(g)(6) limitations.

Possible Solutions: The potential solutions in addressing the release of interest to the exchanger prior to the end of 180 days include:

- Release interest at QI's discretion.
- Release interest after written request by client.
- Release interest after a court order only.
- Do not release the interest until the end of the 180-day exchange period.

III. CALCULATING THE EFFECTS OF AN EXCHANGE

A. CLOSING STATEMENTS AND TAX REPORTING

1. Closing Statement Format.

In an exchange transaction, there are certain settlement statement items that need to be handled differently. Generally, these fall under the headings of prepaid items, prorations and transfers of security deposits and escrow accounts. These items should be debited and credited against each other on a separate part of the settlement statement or addressed outside of the closing.

(a) Relinquished Property Settlement Statement. Here are some suggested adjustments to the settlement statement when the taxpayer, who is exchanging, is selling the relinquished property:

- **Add a Section 2 to the statement to handle non-exchange expense items:**

Create a two-part settlement statement. Section 1 contains all of the regular statement items such as attorney's fees, transfer tax and commissions. Section 2 will contain non-exchange expense items. These expense items are then debited or credited against each other. The total will usually result in the taxpayer (as the seller) owing the buyer money. **This amount should be paid by the seller from funds outside the closing. It is very important not to subtract these non-exchange expense items from the proceeds that will be forwarded to the intermediary**.

- **Add a footnote identifying these items and the related funding.**

Outline these items in the footnote section of the settlement statement. Again, the seller will probably be writing a separate check for the net amount to the buyer.

- **Add an exhibit showing the non-exchange expense items.**

Create an exhibit to the settlement statement that lists the non-exchange items. This exhibit is usually referenced in a footnote contained in the main body of the settlement statement. (See chart on next page outlining various settlement statement items.)

Proper Treatment of Settlement Statement Items
At the Relinquished Property Closing

Debit	**Credit**	**Allowable Exchange Expense?**
Commission		Yes
Attorneys' Fees		Yes
Transfer Tax		Yes
Intermediary Fee		Yes
Security Deposits		No
	Escrow Account Transfer	Non-Exchange Credit
	Prepaid Service Contracts	Non-Exchange Credit
Prorated Rents		No
Prorated Property Tax		No, but can be liability
Prorated Interest		No, but can be liability

It is best to coordinate a thorough method of documenting these items within the settlement statement.

(b) Replacement Property Settlement Statement. Unless the taxpayer (as the exchanger) is required to pay more than the exchange proceeds held, then the settlement statement for this closing should follow basically the same structure as described earlier. In this instance, after the non-exchange items are netted, the taxpayer would probably receive a separate check from the seller.

If there are exchange proceeds remaining when funding the acquisition of the replacement property, it is important to reimburse the exchanger for any monies advanced. This would include earnest money, inspection fees and other costs in the acquisition that are not considered *non-exchange* items**. (The**

reimbursement should come from the closing agent and not the QI.) They should be handled as follows:

- If earnest money previously advanced by the exchanger is being reimbursed, then it should be shown as a refund to the buyer on the settlement statement. This will create the need for funding more exchange proceeds.

- If acquisition costs advanced by the exchanger are being reimbursed, then the total reimbursement should appear as a debit item in the purchaser's section of the settlement statement. It may be labeled "reimbursement for prepaid expenses". When the checks are disbursed by the closing agent, the exchanger will recoup the funds he advanced. *(See chart below outlining various settlement statement items.)*

Proper Treatment of Settlement Statement Items
At the Replacement Property Closing

Debit	**Credit**	**Allowable Exchange Expense?**
Lender Fees		No
Title Insurance		Yes (Exchangers)
Inspection Costs		Yes
	Earnest Money	May be Refunded
	Prorated Property Tax	No, but can be liability
	Prorated Rents	Non-Exchange Credit
	Security Deposits	Non-Exchange Credit

2. <u>Earnest Money</u>.

The method in which earnest money is documented and disbursed may require changes be made to both the relinquished and replacement property settlement statements.

(a) Relinquished Closing (when the exchanger is selling). If the taxpayer is holding the earnest money, he must reimburse it at the closing. This can be done several different ways:

- **The taxpayer can make the funds payable to the closing attorney.**

The closing attorney then adds the earnest money to any other funds forwarded on behalf of the purchaser. Ultimately, the earnest money refunded becomes part of the proceeds sent to the intermediary. (In this situation, the purchaser would still receive credit for the earnest money on the settlement statement, but there would be no debit on the seller's side of the settlement statement.)

- **The taxpayer could refund the earnest money to the purchaser at closing.**

The purchaser would then endorse or transfer the money to the closing attorney as part of the funds needed to close. (Although the earnest money would not be a line item on either the purchaser's or the seller's side of the settlement statement, it might be documented in a separate footnote.)

- **The taxpayer could forward the earnest money to the qualified intermediary as part of the proceeds from the sale.**

The settlement statement would show a credit to the purchaser and a debit to the seller for the earnest money. This is the least preferred method because it is better for the seller to forward the earnest money to the closing. Not only can this present a coordination problem, but a documentation problem as well. The settlement statement would not reflect that the earnest money has been forwarded to the intermediary. (At a minimum, it is best to add a footnote to the settlement statement stating this fact.)

Several of these options are still available if a separate escrow agent is holding the earnest money. (*Note: If the exchanger is still in possession of the earnest money after closing, he is considered to be in receipt of exchange proceeds and will be taxed on that amount*.)

(b) Replacement Closing (when the exchanger is buying). If the exchanger has advanced earnest money to the seller or seller's agent from his own funds, he may want to be reimbursed for this expense. The closing attorney is usually the only appropriate choice for this reimbursement. Here are two methods to resolve this situation:

- **On the settlement statement, show no earnest money credit on the purchaser's side.**

This would raise the amount of funds being forwarded by the QI by the amount of the earnest money. The earnest money refund is then released to the exchanger when the closing is disbursed. (This is not a risk to the closing attorney because she does not refund the earnest money to the purchaser until she has received the funds from the intermediary. However, some closing attorneys feel that using this method causes the settlement statement to inaccurately reflect the sales contract.)

- **Show a separate debit to the purchaser for the earnest money refund amount, effectively zeroing out the earnest money.**

This option requires the intermediary to fund more dollars to the closing.

(Note: If the taxpayer is buying a replacement property that requires more cash to close than the amount held by the QI, he will have to forward additional cash to the closing. In this case, there is no need to reimburse the earnest money.)

3. Tax Reporting Required for an Exchange Transaction.

Who is responsible for reporting exchange transactions to the IRS? When are they due? How are they sent?

(a) A Form 1099-S is submitted by the closing agent to indicate that a transfer of property has taken place. (It may be advisable to include a note on the 1099-S indicating that the transaction is intended to be part of an exchange under IRC §1031).

(b) A Form 8824[1] is attached as an exhibit to the taxpayer's return for the year in which the exchange took place. It asks for the following general information:

- The date the relinquished property was sold
- The date the replacement property was acquired
- The date of the identification letter
- The date that the relinquished property was originally acquired
- Information on a related party (if applicable)
- Calculation of any recognized gain
- Determination of the basis of the new replacement property

(c) A Form 4797 (Sale of Business Property) or Schedule D (Capital Gains and Losses for Non-Depreciable Property) may be used if the exchange includes business property.

4. State Withholding Procedures and Waivers.

(a) Withholding Procedures. Many states require that the closing agent withhold a certain percentage of the sales price in a real estate transaction if one of the parties is an out-of-state or foreign resident. *(*"Foreign resident" refers to someone filing a tax return in a state other than where the relinquished property is located.) In order to obtain a refund of the amount withheld, the individual must file a return that could obligate them to pay additional taxes if the calculation indicates a deficiency.

This withholding requirement creates complications in exchange transactions. If the taxpayer doing an exchange is forced to withhold taxes that would be due on a normal sale, then a portion of the exchange proceeds must be sent to the state. This withholding will not be refunded until the following year when the taxpayer files for a refund. When the refund is received, it will be considered cash boot to the taxpayer and be taxable.

In most states, the responsibility for complying with the withholding requirement is placed upon the closing agent. This is a statutory requirement. Even though

[1] Both Form 1099 and 8824 are commonly used, and are available from the IRS

closing agents are not direct parties to the transaction, there can be severe penalties if they do not comply with the withholding procedures.

(b) Procedures to Waive Withholding. A number of states do have a "waiver withholding form" that can be submitted by the taxpayer. The procedure varies from state to state. Procedures in two states are described below.

Georgia:
Georgia does not have a specific waiver that is submitted to a state agency for pre-approval, but does have an "affidavit of seller gain" form that can be filled out and signed by the taxpayer. If a taxpayer is completing an exchange, then the form can be filled out showing no gain on the sale and delivered to the closing attorney. (There is no requirement to withhold or to report that no withholding took place. Most attorneys just keep the affidavit in the post-closing file.) Although questions may arise if an exchange fails and tax is subsequently due, the State of Georgia allows the closing attorney to rely on the taxpayer's affidavit. Thus, there is no corresponding liability to the closing attorney.

California*:*
In this state, there is a specific mechanism used to obtain pre-approval to waive the withholding requirement. The taxpayer submits California State Form 597-A to the California Franchise Tax Board. This form requires the signature of not only the taxpayer, but also the qualified intermediary. If the taxpayer does not complete the exchange, the intermediary that signed the form is obligated to remit the withholding amount that would have been due to the State of California. The review time of these approvals is very fast and usually can be accomplished within 5 or 6 business days.

5. <u>FIRPTA Regulations</u>. In a real estate exchange transaction involving a relinquished sale by a non-resident alien or a foreign corporation, the requirements of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) must be considered. The purchaser of the property, commonly referred to as the transferee, is required to withhold 10% of the sales price to cover any tax that may be due on the transaction.[1] Transferee or transferor may apply for a withholding certificate to eliminate or reduce the amount withheld.[2] No withholding is required if 1) the relinquished property qualifies as a residence valued at $300,000[3] or less; or 2) the transferee provides a copy of the transferor's notice to the IRS within 20 days of the date of transfer.[4]

In an exchange, because the exchanger is assigning their rights to the property to the QI, the argument could easily be made that the QI is the purchaser. This

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1 See Regulation §1.1445-(1)(b)

2 IRS Form 8288 and Form 8288B

3 See Regulation §1.1445-(1)(b)(4)

4 See Regulation §1.1445-(2)(d)(2)(i)(B)

would put the primary responsibility on the QI for the withholding. This can be very important because the failure to withhold and submit the withholding amount to the IRS obligates the transferee (QI or purchaser) for the amount that was not withheld.

If the exchange fails, the transferee (QI) should forward the withholding amount to the IRS.

There are a number of issues that still are not clear:

1. Is the transferee the purchaser or the qualified intermediary?
2. Is it usually the transferee (QI or purchaser) that actually withholds this amount or, in practice, is it usually the closing agent?
3. What penalties could be levied on the party responsible to withhold if the money is not collected, taxes are never paid, or taxes are paid at a later date on a failed exchange?
4. Should the Qualified Intermediary automatically submit form 8288 when this type of transaction occurs?

Due to the potential liability, great care should be taken when executing exchange transactions involving a non-resident alien or a foreign corporation. Given this confusion, the American Bar Association has requested additional guidance on this issue.

B. REALIZED V. RECOGNIZED GAIN

There are three important calculations involved in determining the tax effects of like kind exchanges under IRC Section 1031. These are the amount of realized gain on the transfer of the relinquished property, the amount of recognized gain, and the basis of the replacement property. The realized gain is important as a starting point. The realized gain will be divided into two parts: the deferred gain (which will not be currently taxed) and the recognized gain (which will be taxable). The basis of the replacement property determines the amount of depreciation we may deduct as well as plays a role in the gain we will ultimately recognize when the replacement property is disposed in a taxable transaction

1. Realized gain: The realized gain is the amount of gain that would be taxable if the transaction did not qualify as a Section 1031 exchange. It is calculated by subtracting the consideration given from the consideration received:

TOTAL CONSIDERATION RECEIVED:

Fair market value of replacement property PLUS	$ xxx,xxx	
Cash received PLUS	x,xxx	
Fair market value of "other" property received PLUS	-0-	
Liabilities on relinquished property	xxx,xxx	
EQUALS total consideration received	$ xxx,xxx	A

TOTAL CONSIDERATION GIVEN:

Adjusted basis of relinquished property PLUS	$ xx,xxx	
Cash paid (including exchange expenses) PLUS	x,xxx	
Adjusted basis of "other" property given PLUS	-0-	
Liabilities on replacement property	xxx,xxx	
EQUALS total consideration given	$ xxx,xxx	B

REALIZED GAIN = A MINUS B

2. Recognized gain: The recognized gain is the amount of the realized gain that is currently taxable. IRC Section 1031(b) states that if cash or other non-like kind property is received in an otherwise valid exchange, gain shall be recognized, "but in an amount not in excess of the sum of such money and the fair market value of such other property." In other words, the taxpayer will pay tax on the realized gain to the extent that "boot" was received. The formula for calculating recognized gain is:
RECOGNIZED GAIN = lesser of realized gain or boot received

C. BOOT OFFSET RULES

Not only does "boot" include the receipt of cash and tangible non-like kind property, often referred to as "cash boot", but also the relief of liabilities associated with the relinquished property – "mortgage boot". Following are some guidelines for determining taxable "boot":

1. Offsetting Liabilities. Only the excess of liabilities transferred over liabilities assumed will be considered mortgage "boot" for gain recognition purposes. In other words, liabilities relieved on the relinquished property can be offset by the liabilities taken on the replacement property (Regs. 1.1031(b)-1(c); Regs. 1.031(d)-2, example 2; Rev. Rul. 79-44, 1979-1 CB 265).

In connection with 1031 exchanges involving partnerships, Rev. Rul. 2003-56 states that when property subject to a liability is transferred in one taxable year and property subject to a liability is received in the following taxable year, the liabilities are netted for purposes of Section 752. A net decrease in a partner's share of partnership liability is taken into account in the first taxable year of the

partnership, and any net increase in a partner's share of partnership liability is taken into account in the second taxable year of the partnership.

2. Cash Offsetting Debt Relief. This mortgage "boot" can be reduced by the amount of additional cash the taxpayer invests in the replacement property (Regs. 1031(d)-2, example 2; Rev. Rul. 79-44, 1979-1 CB 265).

3. Cash Offsetting Cash. Cash paid in an exchange may offset cash received. Rev. Rul. 72-456 allows cash boot to be reduced by commissions paid. It is probably safe to argue that cash boot can also be reduced by replacement property earnest money previously paid by the taxpayer. Regulation 1.1031(k)-1(j)(3), example 2 however, states that a taxpayer who receives cash upon disposition of the relinquished property in a deferred exchange, then later pays cash to acquire replacement property, cannot net the cash paid against the cash "boot." In essence, the taxpayer had constructive receipt of that portion of the exchange proceeds. Constructive receipt results in recognized gain.

4. Liabilities Do Not Offset Cash. Note, however, that cash received cannot be offset by additional liabilities assumed (Regs. 1.1031(d)-2, example (2)(c); Rev. Rul. 79-44, 1979-1 CB 265). Although the taxpayer may "trade up" in value, he will have to recognize a gain for the cash he receives as a result of increasing his replacement property debt. Normally borrowing funds is not a taxable transaction, but in the case of excess borrowings to provide cash proceeds to an exchangor, the IRS has taken the position that the cash received is taxable.

5. Determining Taxable Boot Received:

LIABILITIES ON RELINQUISHED PROPERTY	$ xx,xxx
LESS: LIABILITIES ON REPLACEMENT PROPERTY	(xx,xxx)
EQUALS MORTGAGE "BOOT" (If zero or less, enter zero)	x,xxx
LESS: CASH PAID OR "OTHER" PROPERTY GIVEN	(x,xxx)
ADD CASH OR "OTHER" PROPERTY RECEIVED	x,xxx
EQUALS "BOOT" RECEIVED	$ xx,xxx

A general rule of thumb for "boot" is if you wind up with cash in your pocket after an exchange, it is very likely taxable. We shall discuss below some possible methods for pulling cash out of exchanges through the use of refinancing before or after the exchange. These methods are not without risk, however.

D. REFINANCING BEFORE OR AFTER AN EXCHANGE

1. General Overview. One of the core principals of a tax-free exchange is the taxpayer **does not receive any cash**. Thus, there are some issues that may arise if a taxpayer receives cash by refinancing either (1) the relinquished property prior to the exchange or (2) the replacement property right after it is acquired. Unless there is an independent business reason for refinancing the relinquished property

in anticipation of an exchange, there can be a clear problem. This topic is further discussed in the article "Pre and Post Exchange Refinancing" discussed below under Section D.2.

There seems to be less of an issue if the replacement property is refinanced after an exchange. Once a taxpayer has taken title to the replacement property, he may refinance. There are some differing views on whether he should be able to refinance immediately or should wait for a certain time period. There is little guidance on this issue. However, once the exchange has been completed and the replacement property is owned by the taxpayer, it would seem to be less problematic. Most professionals recommend that the refinancing be distinctly separate from the exchange process, and serve an independent business purpose.

2. Pre and Post Exchange Refinancing. (With the original author's permission, the Section is based primarily on materials prepared by Jeff T. Nelson, Director of Taxation, PriceWaterhouseCoopers). In order to maximize tax deferred treatment on a like kind exchange, taxpayers need to maintain the level of their equity investment between relinquished property and replacement property. To the extent the taxpayer reduce its equity in replacement property by taking cash out of an exchange, the cash will be taxable boot. In order to cash out equity in relinquished or replacement property, taxpayers often place additional debt either on relinquished property before an exchange or replacement property after an exchange. Any time a taxpayer cashes out its equity in exchange property, there is a danger that the IRS might "step" the two transactions (refinancing transaction and the exchange transaction) together in order to conclude that the taxpayer has received taxable boot. Accordingly, there is a significant question regarding the taxpayer's ability to utilize value inherent in the taxpayer's equity in relinquished and replacement property for borrowing purposes.

(a) IRC § 1031 (b): If an exchange recipient receives other property or money in addition to like kind property then gain, if any, shall be recognized in the amount of the sum of money and fair market value of such other property.

(b) Reg. § 1.1031(b)-1(c), 1.1031(d)-2, example (1): Consideration received in the form of an assumption of the exchangor's liabilities (or a transfer to the exchangor's property subject to a liability) is treated as the receipt of money or other property in determining the exchangor's gain under IRC §1031 (b).

(c) Reg. § 1.1031(b)-1(c), 1.1031(d)-2, example (2): Consideration given in the form of an assumption of liabilities (or receipt of property subject to a liability) shall be offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability) for purposes of determining the amount of money or other property received by parties to an exchange.

(d) Reg. § 1.1031(d)-2, example 2(c),Rev. Rul 79-44, 1979-1 CB 265: Cash received by a taxpayer, as part of an exchange is not offset by consideration given in the form of an assumption of liabilities or receipt of property subject to a liability. However, cash given by a taxpayer as part of an exchange is offset by consideration received in the form of an assumption of liabilities or a transfer of property subject to a liability.

Stated another way, liabilities incurred by a taxpayer do not offset cash received by the taxpayer in determining net boot in an exchange and therefore the taxpayer's gain. Accordingly, the taxpayer can not take cash out of an exchange at closing by incurring a liability on replacement property greater than the liability on the relinquished property.

Based on the above, it is clear that a taxpayer is not allowed to receive cash as part of an IRC § 1031 exchange on a deferred tax basis. However, the statue and regulations do not address whether cash can be taken out as part of a refinancing either prior to or after the exchange in a separate and distinct transaction.

Note – With the exception of a statement made in dicta by the Tax Court in *Behrens* described below, there is literally no authority on post-exchange borrowing against exchange property. Accordingly, the authority analyzed below deals with pre-exchange borrowings and analogous authority in the installment sale area.

(e) Tem Reg § 15A.453-1(b)(2)(10); *Denco Lumber v. Commissioner*, 39 TC 8(1962): While regulations in the § 1031 exchange area do not contain a provision barring the placement of debt on a taxpayer's property in contemplation of an exchange, regulations in an analogous area, namely the installment sales rules, do. Under the installment sales rules, debt placed on property in contemplation of a disposition of property may trigger a taxable payment to the taxpayer at the time of the installment sale if the buyer assumes the debt. In general, the taxpayer must have a valid business reason for incurring pre-installment sale debt.

(f) Former Prop. Reg § 1.1031(b)-(c): Preamble to TD 8343, 56 Fed Reg. 14851 (April 12, 1991). The above-proposed regulation (issued prior to the Regulations under IRC § 1031) contained a provision that liabilities incurred by a taxpayer in anticipation of an exchange would not offset liabilities assumed by the taxpayer. Ultimately, this restriction was not adopted because the IRS felt it could create substantial uncertainty in the tax results of an exchange involving liabilities on both the relinquished and replacement property.

(g) *Garcia v. Commissioner*, 80 TC 4491 505 (1983), acqd. 1984-2CR: In Garcia, the seller increased its mortgage on the replacement property to be acquired by Garcia, in order to equalize the debt and equity of Garcia's

relinquished and replacement properties. The IRS argued that the seller's pre-exchange mortgage increase should result in taxable boot to Garcia, because it was an "artificial" reallocation of liabilities for the purpose of tax avoidance. Instead, the court found that the debt should be respected because it had independent economic significance.

Note – In the Garcia case, the taxpayer did not receive cash prior to or after the exchange. (It was the <u>other party</u> who increased debt, and received the loan proceeds). Indeed, if the seller had not increased the debt on the replacement property, Garcia, the taxpayer, would have had to pay additional cash to obtain it. This additional cash would have offset the mortgage boot received by Garcia in the form of mortgage assumed by the buyer of Garcia's relinquished property. Therefore, the Court's "independent economic significance" test in Garcia applies only by analogy to debt increased by the taxpayer prior to or after closing an exchange.

(h) Priv. Ltr. Rul. 8434015: The IRS ruled that cash proceeds received by the taxpayer from a refinancing immediately prior to an exchange constituted tax boot. The IRS stated that unlike Garcia, the debt in question did <u>not</u> have independent economic substance. The IRS reached this conclusion in spite of the similarity of facts in this case with the facts in Garcia and in spite of the IRS' acquiescence in the Garcia case.

(i) *Fredericks v. Commissioner*, TC Memo 1994-27: In Fredericks, the taxpayer received cash from a refinancing of his relinquished property which occurred one week after the taxpayer contracted to convey that property. The IRS argued that the refinancing cash was taxable as boot. The Tax Court disagreed, stating that the taxpayer did not receive the refinancing proceeds from the intermediary as part of the exchange, but received the cash from a third party lender as a result of the refinancing. Furthermore, the taxpayer had reasons for the refinancing separate and apart from the exchange,. The taxpayer had been attempting to refinance for sometime and the due date on the taxpayer's loan was fast approaching. Accordingly, the taxpayer would need to refinance the loan if the exchange failed to close.

(j) *Behrens v. Commissioner*, TC Memo 1985-195: In this case, the taxpayer traded-in equipment on the purchase of new equipment. Rather than apply the full value of traded-in equipment against the purchase price of new equipment, the taxpayer opted to receive part of the trade-in value in cash and thereby increase his debt on the replacement property. The taxpayer attempted to argue that he could have borrowed the same cash amount either before or after the exchange without tax consequences and therefore, the cash received in the trade-in actually represented a non-taxable loan, separate from the exchange. The Court disagreed saying the tax consequences were governed by what was actually done not by what might have been done, However, the Tax Court stated in dicta, that if the taxpayer had borrowed the money from a third-party lender (either before or

after the exchange) he would have received cash in a non-taxable event: (i.e the borrowing of money).

(k) *Commissioner v. Tufts*, (U.S.461 U.S. 300, 75 L.Ed 2d 863, 103 S. Ct. 1826 (1983)): This case distinguished debt from income and determined debt proceeds to be non-taxable. Therefore, it appears that if a deferred exchange causes a taxpayer to trade down in equity, the taxpayer could avoid taxable boot, by removing equity from relinquished property prior to the closing of a deferred exchange by placing additional debt on the relinquished property. The result in Tufts, and the US Supreme Court decision in Crane v. Commissioner, established a generally recognized and accepted tax treatment of "true debt" (as opposed to equity): (i) such debt is included in a taxpayer's basis, even if it is secured only by property with a fair market value which is less then the debt; (ii) debt paid or taken subject to on disposition of property is included in the amount realized, even if the debt exceeds the value of the property and is secured only by the property and (iii) a taxpayer's receipt of debt proceeds is non-taxable, irrespective of whether the debt exceeds the taxpayer's basis or the value of any property securing such debt.

The Service's position that pre-exchange or post-exchange borrowings should be taxed as boot may appear to be inconsistent with these general propositions. Nevertheless, taxpayers and their advisors should consider the IRS position on these matters, and take appropriate steps to avoid potential controversy whenever possible.

As the authority above indicates, the courts have looked favorably on the form of a pre-exchange refinancing where it is accomplished in a separate and distinct transaction apart from the exchange. This is especially true where the taxpayer has an independent business reason for increasing the debt and where the refinancing has independent economic significance. In contrast, the IRS has been loath to respect the form of pre-exchange refinancing where it believes the substance is to cash out the taxpayer's equity in property prior to an exchange.

(l) ABA Commentary: There is literally no authority (beyond the *Behren's* case cited above) regarding post-exchange financing. Recognizing the lack of authority, the American Bar Association commented on pre-exchange and post-exchange financing scenario where the taxpayer is relieved of the liability, the taxpayer in the post-exchange situation remains liable on the debt.

(m) Thoughts-Beyond a comment made in dicta that a taxpayer may finance property before or after an exchange without tax consequences, there is virtually no authority on post §1031 exchange borrowing. See Behrens. Equally important is the fact that nowhere in the Code, Regulations and Rulings is it suggested that a taxpayer is prevented from leveraging the full value of its relinquished or replacement property or that the leveraging must occur within any period certain either preceding or following an exchange.

Drawing from law derived from the pre-exchange borrowing setting, it is clear that courts are favorably disposed to respect the form of a taxpayer's refinancing where the borrowing is structured as a separate and distinct transaction with independent economic significance. This is especially true where there is a business need or purpose behind the borrowings.

In contrast, the IRS desires (except in the case of PLR 9826033) that the form and substance of an exchange maintain the taxpayer's equity in relinquished property as continuing equity in replacement property. In determining whether this has been accomplished, they look primarily at the timing of the refinancing in relation to the exchange.

E. REPLACEMENT PROPERTY BASIS

Once the "boot" received has been established and the recognized gain calculated, we are able to determine the basis of the replacement property. The basis can be calculated two ways. It is a good idea to calculate it both ways as a check for errors. Following are the two basis formulas:

FORMULA #1:

FAIR MARKET VALUE OF REPLACEMENT PROPERTY	$xxx,xxx
LESS: REALIZED GAIN	(xx,xxx)
PLUS RECOGNIZED GAIN	x,xxx
EQUALS REPLACEMENT PROPERTY BASIS	$xxx,xxx

FORMULA #2:

ADJUSTED BASIS OF RELINQUISHED PROPERTY	$xxx,xxx
ADD GAIN RECOGNIZED ON THE EXCHANGE	x,xxx
ADD CASH PAID OR "OTHER" PROPERTY GIVEN	xx,xxx
LESS: CASH OR "OTHER" PROPERTY RECEIVED	x,xxx
ADD LIABILITIES ON REPLACEMENT PROPERTY	xxx,xxx
LESS: LIABILITIES ON RELINQUISHED PROPERTY	(xxx,xxx)
EQUALS REPLACEMENT PROPERTY BASIS	$xxx,xxx

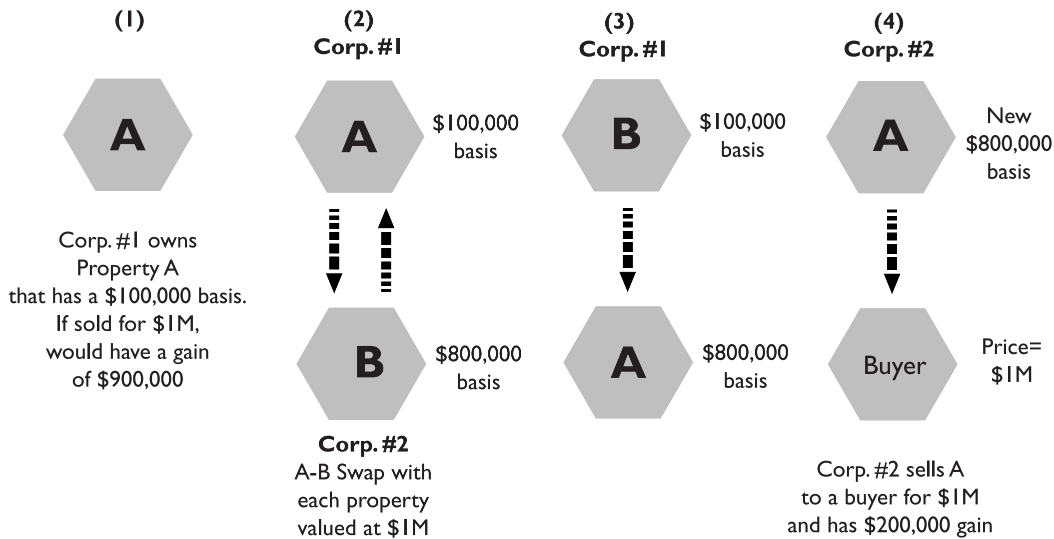
F. EXCHANGES INVOLVING RELATED PARTIES

1. Definition of Related Party. The term "related party" means anyone directly related by blood or who is related as defined under Sections 267(B) or 707(b)(1). For example, a taxpayer whose interest in an entity is greater than 50% (i.e., an interest that is 51% or greater) is considered a related party.

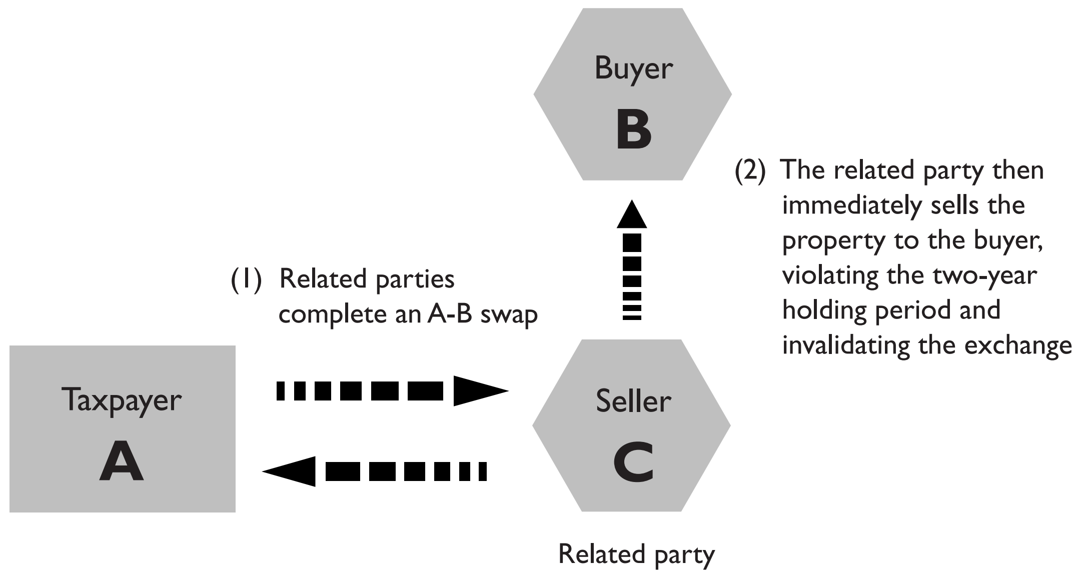
For a discussion of a recent Private Letter Ruling addressing related party issues in connection with reverse Section 1031 exchanges, see p.48 below.

2. Basis Shifting. In 1989, §1.1031(f) "Special Rules for Exchanges Between Related Parties" was added to the Code. This section was designed to be an "anti-abuse" provision that would address the basis shifting that had become prevalent between related parties. The following is a classic example:

> A taxpayer is the sole stockholder of two corporations that each own property. He wants to sell Property A that has a low basis, but potentially high tax consequences on a sale. Property B that he also owns has a very high basis and would have minimal tax consequences if sold. Utilizing both of his related entities, the taxpayer executes a direct "A-B" swap. Through the exchange, the low basis of Property A is transferred into Property B and the high basis of Property B transfers to Property A. This property is then sold after two years with minimum tax consequences. Field Service Advisory 200137003. (See diagram on next page outlining the transaction.)



3. Holding Periods for Related Parties. Under the rules, the taxpayer can sell relinquished property to a related party, but the related party must hold it for a minimum of 24 months. If the related party does dispose of the property prior to that time, then the gain from the original sale would be triggered. **Conversely, a taxpayer may not acquire his replacement party from a related party if there is a basis shift from the taxpayer's relinquished property to the related person's property and the related property receives cash.** (See diagram below.)



This diagram is supported by the Open Issues Report question # 21 submitted by the American Bar Association in 1993. Inserting the use of a qualified intermediary is considered an artificial step to circumvent this related party rule and will not meet the test of purposeful structure to avoid paying taxes under §1031(f)(4.) See also Rev. Ruling 2002-83. The actual text from the report appears below:

> "Q-21. May a taxpayer arrange for an unrelated party (including the qualified intermediary) to acquire replacement property owned by a related party and complete an exchange in which the taxpayer's relinquished property is transferred to an unrelated party or intermediary in exchange for the replacement property initially owned by the related party?"
>
> "A-21. No. The Senate Finance Committee Report states that non-recognition treatment will not be accorded to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of the related party rules. The Senate report further states that if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with the party related to the taxpayer within two years of the previous transfer in a transaction otherwise qualifying under Section 1031, the related party will not be entitled to non-recognition treatment under Section 1031. Here, the transaction is merely a rearrangement of the steps described in the Senate Finance Committee Report, and thus is covered by the anti-abuse language of Section 1031(f)(4)."

4. **Related Party Exchange with QI.** In *Teruya Brothers, Ltd. & Subsidiaries v. Commissioner*, 124 T.C. 45 (2005), a corporate taxpayer and its 62.5% owned affiliate structured a related party exchange, through (i) the transfer of the relinquished property by the taxpayer to a qualified intermediary, (ii) the QI's sale of that property to unrelated third parties, (iii) the QI's use of those proceeds to acquire replacement properties from the affiliate and (iv) the distribution of net proceeds to that affiliate. The Tax Court found the multi-party structure to be "economically equivalent to direct exchanges" between the related parties. The Court then determined that the taxpayer did not meet the burden of showing that the transaction did not have "the avoidance of Federal income tax" as one of its principal purposes. See IRC Section 1031(f)(2)(C). The taxpayer in Teruya Brothers was required to recognize more than $12M in gain as a result of the Tax Court holding.

IV. CURRENT ISSUES UNDER SECTION 1031

A. CURRENT STATUS OF "REVERSE" EXCHANGES.

1. <u>What is a "Reverse" Exchange</u>? A "Reverse" Exchange is said to occur when the Taxpayer, for whatever reason, acquires Replacement Property prior to his disposition of the corresponding Relinquished Property. There are a number of situations where this sequence may occur:

(i) Contingencies to the sale of the Relinquished Property remain in effect at the closing date for the Replacement Property;

(ii) A favorable financing commitment for the Replacement Property will expire before the Relinquished Property can close;

(iii) The Replacement Property is to include improvements which cannot be constructed within a 180-day period after conveyance of the Relinquished Property;

(iv) An advantageous opportunity exists to acquire a Replacement Property, but a Buyer has not been found for the Relinquished Property; or

(v) Fiscal year, regulatory approval conditions, or other approval conditions and timing factors dictate an acceleration in the purchase of the Replacement Property or a delay in disposing of the Relinquished Property.

2. <u>Reciprocal Reverse Exchanges</u>. Section 1031(a)(1) of the Code refers to the "exchange of property" without any distinction as to the order in which the exchange should occur. There is ample authority for <u>reciprocal</u> Reverse Exchanges, where one party receives his Replacement Property from a second party, and subsequently transfers his Relinquished Property to that <u>same</u> second party. (From the point of view of the second party in a reciprocal but nonsimultaneous transaction, this is a straight-forward deferred exchange).

(a) In *Rutherford*, the taxpayer acquired 12 half-blood heifers from Wardlaw with the agreement to have the heifers artificially inseminated and to deliver to

Wardlaw the first 12 3-quarter blood heifers. Rutherford received the half-blood heifers in November 1973 and delivered the 3-quarter blood heifers to Wardlaw in 1975 through 1977. The matter at issue involved the determination of Rutherford's basis, which was resolved by the Court's finding that the transaction contemplated an exchange, and not a purchase.

(b) PLR 9814019 and PLR 9823045 involved virtually identical facts. In each instance, an investor-owned public utility agreed to relinquish an easement for overhead transmission lines, in order to facilitate the revitalization of property owned by a "Company F" in exchange for receiving a new easement located on other land owned by Company F. Obviously, it was necessary that the taxpayer receive the new easement first, so that the new transmission lines could be constructed, energized and tested before the original transmission lines were taken out of service. In each private ruling, the Service concluded that the facts presented a "Reverse Exchange transaction between two parties" qualifying under Section 1031.

The deferred exchange regulations, Reg. § 1.1031(k)-1(a) et seq., promulgated on May 3, 1991 under T.D. 8346, by their express terms, apply only to deferred exchanges where the Taxpayer transfers the Relinquished Property and "<u>subsequently receives</u>" the Replacement Property. Reg. § 1.1031(k)-1(a).

3. <u>Multiple Party Reverse Exchanges</u>. For Reverse Exchanges which are not reciprocal, substantial issues remain which make these transactions somewhat "tax risky". The principal hurdle would appear to be the "Exchange" requirement itself, <u>particularly where the Taxpayer is not obligated to sell the "Relinquished Property" at the time that the "Replacement Property" is acquired</u>. It may be difficult to establish that transactions of this nature are mutually interdependent parts of a single transaction. See *Dilsby v. Commissioner*, T.C. memo 1995-477, *Lincoln v. Commissioner*, T.C. memo 1998-421, *Bezdjion v. Commissioner*, 845 F. 2d 217 (9th Cir. 1988), *Lee v. Commissioner*, T.C. memo 1986- 294, and *Anderson v. Commissioner*, T.C. memo 1985-205. (There is also an argument that nonrecognition treatment for such an "exchange" is not necessary to fulfill the policy objective of Section 1031, which is to defer tax on a transaction where the taxpayer has "continued" his investment in the Relinquished Property through the acquisition of a "Replacement Property".)

4. <u>Techniques to Avoid a Reverse Exchange</u>. A number of techniques have been suggested which may allow a Taxpayer to avoid a Reverse Exchange. For instance, if the Taxpayer needs to utilize the Replacement Property before the Relinquished Property can be disposed of, it may be possible for the owner of the Relinquished Property to lease it to the Taxpayer under an agreement which includes an option to purchase. If the terms of the lease, the terms of the option, or any consideration given with respect to the option are such that the Taxpayer is considered to have an equity in the Replacement Property, however, the lease may be considered an installment purchase, with the result that the transaction would

then constitute a Reverse Exchange. If the owner of the Replacement Property, at a date prior to which it is practicable to dispose of the Relinquished Property, needs substantial assurance that the Taxpayer will be acquiring the Replacement Property, a "hell or high water" purchase contract, with a substantial nonrefundable deposit, may be sufficient for the owner's purposes. Again, however, the contract may in substance be deemed to shift the benefits and burdens of ownership to the Taxpayer. If so, a Reverse Exchange may again be the deemed result of the transaction. From a tax perspective at least, the Taxpayer may be better served with a binding contract under which liquidated damages protection has been waived in the event of his breach.

5. <u>Safe Harbor Parking Arrangements</u>. The Service issued Rev. Proc. 2000-37 "in the best interest of sound tax administration" to provide a "workable means" of qualifying certain parking transactions under Section 1031. Rev. Proc. 2000-37, Section 2.02. If the safe harbor requirements are met, the Service will not challenge the qualification of property as either Replacement Property or Relinquished Property for purposes of Section 1031, and will not challenge the treatment of the "Exchange Accommodation Titleholder" as the beneficial owner of the property for federal tax purposes. Rev. Proc. 2000-37, Section 1. The Rev. Proc. is an "all or nothing" proposition, since it does not apply unless all of the requirements are satisfied. Rev. Proc. 2000-37, Section 3.04.

(a) Qualified Indicia of Ownership. The safe harbor requires that "qualified indicia of ownership" be held by the Accommodation Party. This requirement will be met only if the title holder is treated as the beneficial owner of the property under applicable stated law. Generally, record title would be required to meet the standard, but a "contract for deed" would also work if the terms resulted in the vendee being considered the beneficial owner under state law.

The safe harbor requirement that the accommodator actually hold legal title or have other indicia of ownership that are treated as beneficial ownership under applicable state law may make these transactions more cumbersome and costly in some situations. Concerns of the Accommodation Party about environmental conditions or other liabilities can be mitigated by having the Accommodation Party form a subsidiary single member limited liability company, having no independent assets, in which to warehouse the property. Concerns of the taxpayer about the Accommodation Party's solvency can be diminished if the Accommodation Party is a single asset LLC in which the taxpayer holds a non-economic interest which allows him to block bankruptcy filings and asset transfers. See PLR 199911033.

(b) Qualified Exchange Accommodation Agreement. Not later than five business days after the title holder acquires qualified indicia of ownership, the Accommodation Party and the taxpayer must enter into a Qualified Exchange Accommodation Agreement. The agreement must specify that the Accommodation Party is holding the part property to facilitate an exchange under

the revenue procedure and that the Accommodation Party will be treated as the beneficial owner of the part property for all federal income tax purposes.

(c) Identification Requirement. If the parked property is to serve as Replacement Property, the Taxpayer must identify Relinquished Property within 45 days after the Accommodation Party acquires qualified indicia of ownership, and the Accommodation Party must transfer the part Replacement Property to the taxpayer within 180 days after the Accommodation Party acquired qualified indicia of ownership. If the Relinquished Property is parked, there is no identification issue, but the Accommodation Party must transfer the Relinquished Property to a third party buyer within the 180-day period. The time limits of the safe harbor may pose a problem for a Taxpayer who wants to dispose of multiple Relinquished Properties and does not know which properties will be sold first. The time limitations prevent the safe harbor from serving as a solution where substantial construction is to be accomplished in connection with the exchange.

(d) Permissible Arrangements. Section 4.03 of the Revenue Procedure lists seven types of arrangements between the Taxpayer and the Accommodation Party which are permissible, regardless of whether the arrangements are at arm's length. The arrangements mentioned include the provision of services as a Qualified Intermediary under the deferred exchange regulations, taxpayer guarantees or indemnities, taxpayer loans, lease arrangements, management agreements, puts and calls at fixed or formula prices, or other agreements relating to the purchase or sale of the property, effective for a period not in excess of 185 days from the date the Accommodation Party acquires qualified indicia of ownership, and agreements under which the parties are made whole, by the Taxpayer's advance of funds to or receipt of funds from the Accommodation Party where there is a variation in the value of the Relinquished Property from its estimated value on the date that the Accommodation Party received it. Due to the "all or nothing" nature of the safe harbor, and the fact that Section 4.03 permits "any one or more of the following" arrangements, it would appear that any arrangement between the Taxpayer and the Accommodation Party not expressly permitted under Section 4.03 would cause the arrangement to fail to qualify for the safe harbor.

6. Agency Concerns Outside the "Safe Harbor".

(a) Inability to Meet Conditions. If the conditions of Revenue Procedure 2000-37 are not met, the Service will be free to challenge the treatment of the Accommodation Party as the beneficial owner of the parked property for federal income tax purposes. If the Accommodation Party is the Taxpayer's agent, then the parking arrangement should be treated as a "true" Reverse Exchange. In the "Exchange First" format, the Taxpayer will not be considered to have disposed of the Relinquished Property when it is conveyed to the Accommodation Party — only when the Accommodation Party actually conveys it to an independent buyer. In the "Exchange Last" approach, the Taxpayer will be considered to have received the Replacement Property when it is conveyed to the Accommodation

Party. In addition, if improvements are constructed on the Replacement Property while it is being warehoused by an Accommodation Party who is treated as the Taxpayer's agent, those improvements could not be considered to have been received by the Taxpayer in an Exchange, since in effect the improvements are being made to property which the Taxpayer already owns for federal tax purposes.

(b) Recent Authority. In Section 3.02 of Rev. Proc. 2000-37 the Service "recognizes that parking transactions can be accomplished outside of the safe harbor provided in this revenue procedure." However, in transactions outside Rev. Proc. 2000-37 a degree of "tension" will always be present between the necessity that the Accommodation Party bear enough of the benefits and burdens relating to the part property so that the Accommodation Party will be treated as the owner for federal tax purposes, while also minimizing the accommodator's incidents of ownership consistent with the Taxpayer's ultimate ownership. In PLR 200111025 the service approved a parking exchange outside the "safe harbor".

(c) Case Studies. A number of reported cases appear to be quite generous to the Taxpayer in their analysis of levels of involvement which are permitted without finding an agency relationship.

124 Front Street, Inc. v. Commissioner, 65 T.C. (1975) involved a tenant which leased a building with option to purchase the property. The tenant assigned this option to the Taxpayer, a corporation affiliated with the tenant. The taxpayer was approached by Fireman's Insurance Company with a purchase offer. Fireman's loaned the money to the taxpayer which was used to pay the lessor. The Taxpayer held title to the property for about six month's then conveyed the building to Fireman's (under an agreement which was in effect prior to the Taxpayer's acquisition of the property from the landlord.) The Tax Court allowed the exchange saying "although petitioner was to have the building for only a short period, we believe that during this time it was the actual owner of the option property" 65 T.C. 6, 16.

- In *JH Baird Publishing Co. v. Commissioner*, 39 T.C. 608 (1962) the taxpayer was approached on several occasions by the Baptist Sunday School Board, which had already acquired much of the remaining land within the same block. Baird had repeatedly refused to sell because it was satisfied with its location and did not want to incur tax on a sale. The Board's realtor, Murphree, agreed to acquire replacement land, construct a building to Baird's requirements, and then exchange the new building for Baird's property. The arrangement allowed Baird to approve the contractor, the plans and specifications, and any change orders. Murphree's profit in the transaction (apart from commissions) was only $1,615.20, but the court, without a great deal of analysis, made a factual finding that Murphree was not Baird's agent in the transaction.

• In *Fredericks v. Commissioner*, T.C. Memo 1994-27, Mr. Fredericks and four other tenants-in-common received an offer to sell the Wildridge Apartments for $9,180,000. Fredericks held a 90.83% undivided interest. In June 1983, the apartments were conveyed to a licensed building contractor which had Fredericks as its sole shareholder. The contractor then sold the apartments a few weeks later, paid the minority owners their 9.17% of the sales proceeds, and paid certain listing and sales commissions. In August 1983, the company purchased raw land for approximately $1,900,000, using $379,165 of the remaining sales proceeds, and delivering a purchase money note for the balance. From late 1983 through September 15, 1986, the company built a restaurant, theatre, ice cream parlor and hotel on the land, at a total cost of almost $17,500,000, using the remaining proceeds from the sale of the apartments, and incurring approximately $8,000,000 in additional debt. The contractor received a fee of $750,000 in all (or about 5% of the cost of the improvements) for a project which continued for almost three years. The Service sought to disallow the exchange on the basis that the contractor was "a mere conduit or agent" for the taxpayer. The court allowed the exchange, however, noting that the company "was an active corporation carrying on business as a licensed building contractor and real estate developer." There is no indication that the court considered whether or not the arrangement between Fredericks and his company was "arm's length" in reaching its conclusion.

• *Coupe v. Commissioner*, 52 T.C. 394 involved a four party exchange where the taxpayer's attorneys agreed to acquire and reconvey Replacement Property to facilitate the exchange. The transactions were held to qualify for nonrecognition treatment because the court was convinced that the attorneys were willing to retain the warehoused property if the exchange was not consummated. Apparently, the risk that one of the other parties in the transaction might default in the performance of its obligations was enough to give substance to the Accommodation Party's involvement.

• In Revenue Ruling 75-291, 1975-2 C.B. 332, Y desired to purchase X's land and factory. The parties agreed that Y would acquire another tract of land and construct a factory solely for the purpose of exchanging that land and new factory for X's land and existing factory. Y had the right to terminate the agreement if the cost of purchasing the land and building a new factory exceeded a specified amount. The ruling approves the exchange and includes the conclusory statement that Y was acting on its "own behalf" and "not as an agent of the taxpayer".

• In Private Letter Ruling 9413006 the taxpayer agreed to transfer rental property and consideration of the receipt of a separate parcel, together with a building to be constructed on it according to X's plans and specifications prior to the completion of the exchange. The contractor for the new building was one of the general partners of X. The letter ruling approves the transaction. The contractor's receipt of construction draws prior to the taxpayer's receipt of the Replacement Property was held not to effect the result, because those funds were

considered to represent bona fide construction payments, and not disguised proceeds of sale.

Outside the Section 1031 context, the Service has sometime taken a narrower view under its "benefits and burdens" analysis. For instance, in Rev. Rul. 82-144, the two significant factors of ownership were said to be which party has the right to dispose of the property and which party bears the risk of profit or loss with respect to the property. It is not clear that the taxpayers who have prevailed in the agency issue, in matters involving Section 1031 exchanges, could survive this analysis. One can only hope that liberal treatment will continue to be available in this area.

7. Related Party Issues with Reverse Exchanges

In Private Letter Ruling 200329021, the IRS approved a build to suit exchange involving related parties. Taxpayer was a wholly-owned subsidiary of another corporation, which ground leased a plant site from an independent third party. In exchange for the conveyance of relinquished property owned by the taxpayer to an independent third party, the parent corporation conveyed the ground leased site to an exchange accommodation titleholder. EAT, with proceeds from the sale of the relinquished property, proceeded to demolish the existing improvements and construct new improvements on the ground leased site. On or before the 180th day after the conveyance of the relinquished property, the EAT conveyed its leasehold interest in the replacement property to taxpayer. The PLR assumes that the related party rules under IRC Section 1031(f)(4) do not apply because taxpayer will own the replacement property for a period of at least two years following the exchange. For a result similar to that found in the above referenced PLR, see Private Letter Ruling 200251008.

Rev. Proc. 2004-51 provides that the above transaction would fail if the parent corporation, rather than taxpayer, obtained the improved property from EAT at the conclusion of the exchange. The result in this pronouncement reflects what most practitioners previously assumed would be the case under Revenue Procedure 2000-37.

B. PARTNERSHIP ISSUES IN LIKE-KIND EXCHANGES

1. <u>Choice of Entity</u>. For a variety of reasons, a limited partnership, limited liability company, or other entity treated as a "partnership" for federal tax purposes will typically constitute the entity of choice for the operation of real property. While an extensive discussion of such matters is beyond the scope of this program, inclusion of debt in a partner's base for purposes of recognizing losses, and the opportunity for tax deferred current and liquidating in kind property distributions are major factors which make the partnership preferable in most instances. In additional, tax partnerships can be structured with multiple

classes of equity rights, and may involve other entities as owners. These features are generally unavailable for Subchapter S corporations, for instance.

The Subchapter S structure may provide more favorable treatment with respect to potential self-employment tax liability, but since rental income is exempt for self-employment taxes, this advantage applies primarily to development and brokerage activities which are expected to produce ordinary income. A distinction in wording between IRC Section 707(b)(2) ("other than a capital asset") and IRC Section 1239(a) ("of a character which is subject to the allowance for depreciation") makes the Subchapter S corporation the appropriate vehicle to achieve capital gains in certain transaction where property is sold from an "investor" party to an affiliated "developer". (Transactions of this nature could involve the conversion of investment apartments to condominiums held for sale, or the conveyance and subdivision of raw land for residential development, for instance).

2. Partnership Level Exchange. Under Code § 703(a) the taxable income of a partnership is computed in the same manner as for an individual, subject to certain exceptions which are not pertinent to like-kind exchanges. Therefore, there should be no doubt that a partnership will be entitled to nonrecognition treatment under Code § 1031(a) when the partnership exchanges property held by it for investment for property of like-kind which is to be held by the partnership for investment. Just as the character of items of income taken into account by the respective partners is determined under Code § 702(b) at the partnership level, the "qualified use" requirement under Section 1031 should be analyzed at the partnership level. For example, even if a particular partner is a dealer in real property, neither the partnership nor such partner would be required to recognize income on a partnership level exchange if the partnership is not a dealer with respect to that property.

3. Partnership Exchange/Split Up. If the respective partners are to acquire separate individual replacement properties, two approaches can be considered: (i) a distribution of the partnership property to the partners, followed by partner level exchanges involving their respective interests (sometimes referred to as a "drop and swap") or (ii) exchange transactions at the partnership level, whereby the partnership property is disposed of by the partnership, in exchange for various Replacement Properties designated by the partners, and those Replacement Properties are then distributed to the appropriate partners, in liquidation of their respective partnership interests (the "swap and drop" approach).

4. Application of the "Held for Investment" Requirements. In *Rev. Rul.* 75-292, a taxpayer exchanged Relinquished Property for Replacement Property, and immediately afterwards transferred the Replacement Property to his newly formed, wholly owned corporation. The Service concluded that the exchange by the individual did not qualify under Section 1031, because the Replacement Property was immediately transferred to the corporation as part of a pre-arranged

plan. In the Service's view, this meant that the exchangor did not acquire the Replacement Property "for investment."

(a) ***Magneson v. Commissioner*****.** Magneson, 81 T.C. 767 (1983) aff'd 753 F. 2d 1490 (1985), represents the Commissioner's unsuccessful effort to extend *Rev. Rul.* 75-292 to the partnership context under the law in effect prior to the 1984 enactment of Code § 1031(a)(2)(D). In light of the specific circumstances found in the *Magneson* case, and because the 9th Circuit's affirmance was based on a different legal analysis from the tax court's original decision, and in recognition that the enactment of Section 1031(a)(2)(D) might compel a different result, there is legitimate uncertainty about the current implications of the taxpayer's victory in *Magneson*.

Magneson and wife sold an apartment building, received a 10% undivided interest in commercial property as Replacement Property and contributed cash and their 10% interest to a newly formed limited partnership in exchange for a 10% general partner's interest, all under a pre-arranged transaction. The tax court allowed nonrecognition treatment. The tax court was persuaded that joint ownership and partnership ownership are merely "formal" differences and not "substantial differences". Five tax court judges dissented from the majority opinion.

The 9th Circuit affirmed the result in *Magneson*, but on a rationale different from that of the tax court. The circuit court emphasized that the "critical attributes" of the taxpayer's relationship to the property were those "relevant to holding the property for investment" and concluded that the Magnesons' control of the property, as general partners, was of the same nature as their control as tenants-in-common, insofar as it related to holding the property for investment. The 9th Circuit distinguished *Rev. Rul.* 75-292, which concerned a corporate transaction, by observing that that transaction, viewed as a whole, resulted in the exchange of property for stock, which was expressly excluded under Section 1031(a), while no such prohibition then existed on the exchange of partnership interests.

(b) Bolker. In *Bolker v. Commissioner*, the tax court considered whether Bolker met the "held for investment" standard where he acquired the property from his corporation under a pre-arranged plan to dispose of it in the exchange. The tax court followed its decision in *Magneson* in concluding that Bolker met the test, since he did not hold the Relinquished Property for sale, personal use or for transfer as a gift. Since the tax court did not consider that Bolker had "cashed in" on theoretical gain or "closed out" a losing venture, it allowed nonrecognition treatment. The 9th Circuit affirmance of the Tax Court decision in *Bolker*, reported at 769 F. 2d 1039 (9th Cir. 1985) broke down the "held for . . . investment" standard into two component parts ". . . a taxpayer may satisfy the holding requirement by owning the property, and the for productive use in trade or business or for investment requirement by lack of intent either to liquidate the

investment or to use it for personal pursuits." 760 F. 2d 1039, at 1044-1045. The 9th Circuit held in *Bolker* that the intent to exchange property for like-kind property satisfies the holding requirement, since it is "not an intent to liquidate the investment or to use it for personal pursuits" (emphasis in original), and stated that the commissioner's position, in effect, would result in an additional requirement unexpressed in the statute "to keep the first piece of property indefinitely".

(c) Maloney. *Maloney v. Commissioner*, 93 T.C. 89 (1989) involved an exchange by a corporation, followed by a liquidating distribution to its shareholders under former Code § 333. The court concluded that the petitioners "did not intend to cash out their investment in the property received", noted that the taxpayer's "economic situation is in substance the same" before and after the transaction and followed *Bolker* and *Magneson* in allowing nonrecognition treatment since "petitioners continued to have an economic interest in essentially the same investment, although there was a change in the form of ownership."

(d) Mason. *Mason v. Commissioner*, T.C. Memo 1988-273 involved a partnership between a Georgia physician and a second individual who managed his investments. Various properties owned by two separate partnerships were exchanged by the men, so that each wound up with certain assets in his individual name as a result of the split-up. The Service argued that Mason and McClure exchanged partnership interests, and not assets. Because their agreement, however, referred to an exchange of "certain tracts of real property", the Tax Court concluded that the partnerships terminated prior to partner-level exchanges. While Mason allowed nonrecognition treatment, the "held for . . . investment" requirement was not discussed (and apparently was not raised by the Service).

5. Who Is the Seller? Whether the transaction is a "drop and swap" exchange or a "swap and drop" one, the Service may question who actually effected the exchange:

(a) Court Holding. In *Commissioner v. Court Holding Co.*, 65 S. Ct. 707 (1945), a corporation with husband and wife shareholders reached an oral agreement to sell its apartment property. After the shareholders were advised of the tax consequences, they attempted to "call off" the sale by the corporation, declared a liquidating dividend, entered into a sale contract individually, as sellers of the distributed property, on substantially the same terms and conditions as previously agreed upon, and attempted to treat the stockholder's sale as unrelated to the prior negotiations. The tax court made a finding that the whole transaction showed a sale by the corporation, rather than by the shareholders.

(b) Cumberland. In *United States v. Cumberland Public Service Co.*, 70 S. Ct. 280, the shareholders, concerned that their diesel generated power company would be forced out of business because of an inability to compete with TVA, offered to sell all of their corporate stock to a competing cooperative. The

cooperative declined to buy the stock, and countered with an offer to buy assets from the corporation. The corporation rejected the counter-offer based on tax consequences. The shareholders then made an offer to the cooperative to acquire the equipment, in a corporate liquidation, and sell it to the cooperative. This offer was accepted and consummated. The Supreme Court noted that the distinction between a corporate sale and a distribution followed by shareholder sales may be "particularly shadowy and artificial" when the corporation is closely held. Its opinion upheld the trial court's determination that the sale was effected by the stockholders, and that the corporation did not at any time plan to make the sale itself.

(c) Bolker. The tax court opinion in *Bolker v. Commissioner*, 81 T.C. 782 extensively analyzed the factual setting to determine whether the exchange in question was made by Crosby Estates, Inc., or its sole shareholder, Bolker, who received Crosby's assets in a liquidating distribution prior to the exchange. A part of the complex chronology is summarized below:

Date	**Event**
December 2, 1954	Crosby incorporated with Mr. and Mrs. Bolker as 50/50 shareholders
1960	Crosby acquires Relinquished Property
April 26, 1967	Bolkers are divorced
May 27, 1969	Crosby contracts to sell property to S&L
September 12, 1969	S&L breaches purchase contract
Late 1970	Bolker decides to build apartments on site, instead of subdividing and selling home sites; his attorney advises it would be advantageous to take the property out of Crosby since the apartment development would produce net losses in early years
October 13, 1971	Crosby files suit against S&L, for breach of 1969 contract
December 27, 1971	Rezoning to multifamily is completed
February 16, 1972	S&L agrees to purchase the property; it was agreed that Crosby's breach of contract suit would be dismissed and that S&L would be responsible for any liability to the broker who handled the 1969 contract

February 16, 1972	Memorandum to file by S&L attorney to the effect that Bolker individually will be the seller, for tax reasons
March 8, 1972	Crosby adopts plan of liquidation
March 13, 1972	Assets of Crosby distributed to Bolker, including real estate and other assets (including, by implication, but not express reference, the breach of contract action)
March 13, 1972	Crosby, Bolker and S&L enter into a settlement agreement for dismissal of the civil action, contingent on S&L's purchase of the property
June 30, 1972	Bolker conveys property to intermediary, who in turn conveys it to S&L

The tax court in *Bolker* held that in substance as well as form the exchange was made by Bolker. While the Service appealed portions of the tax court decision, it did not appeal this particular determination.

(d) Merkra Holding Co. In *Merkra Holding Co., Inc. v. Commissioner*, 27 T.C. 82 (1956) the tax court indicated that a negotiated sale will be attributed to the corporation, and not to its shareholders, in most cases, only if the negotiations through the corporation have "culminated" in an agreement or understanding such that the later transfer by the shareholders was actually "pursuant to the earlier bargain struck".

(e) Swap and Drop Scenario. While the cases which discuss the applicability of the form over substance analysis to exchange transactions generally deal with the "drop and swap" format, such an analysis can also be applied where an exchange at the partnership level results in Relinquished Properties selected by the respective partners which are then distributed to them. In this case, the issue would be whether the partnership in reality acquired the respective Replacement Properties if the ultimate partner distributees were the real parties actually involved in the negotiations to acquire those properties. If it could be considered that the partnership disposed of the Relinquished Property, but the individual partners in substance acquired the Replacement Properties, using the partnership as a "mere conduit" to effect those purchases, then the exchange could be attacked under the analysis of TAM 9818003.

(f) Disregarding the "Drop". *Chase v. Commissioner*, 92 T.C. 874 (1989) applied the "form over substance" doctrine in concluding that a purported "drop and swap" transaction was in effect a sale by the partnership, followed by one partner's reinvestment of his share of the proceeds, and not an exchange by the partner. After the partnership accepted an offer to sell its apartments, Chase caused the partnership to execute a deed covering an undivided interest in the

property to himself and to his wife, but did not record the deed until he was certain that the sale was going to close. The escrow instructions for the closing did not mention his individual interest, Chase did not bear any property expenses, or receive any rental income, in his individual capacity, during the period of his purported ownership, no approval or modification was sought or obtained from the other partners under applicable provisions of the partnership agreement and in general "petitioners' relationship with respect to the apartments, after they were deeded an undivided interest in such, was in all respects unchanged in relation to their relationship to the apartments as limited partners of JMI." 92 T.C. 874, at 879.

6. Exchange for Property Plus Installment Note. One suggested approach for the partnership exchange/split up involves the partnership's conveyance of relinquished property for replacement property plus the buyer's installment note. The "cash-out" partners then receive the installment note in liquidation of their partnership interests. The distribution of the installment note will not result in the recognition of income to the partnership or the exiting partners under IRC Section 453(b). See Reg. Section 1.453-9(c)(2). It would be permissible for the installment note to be secured by a standby letter of credit. See Reg. Section 15A.453-1(b)(3).

To avoid taxation of the note at the partnership level, under the "step transaction" doctrine, it would be best to wait some period of time after the sale, before the installment note is distributed to the exiting partners. To qualify for installment treatment, the note must provide for at least one payment in the following tax year.

7. Adding New Partners.

Under Reg. § 1.708-1(b)(2), the contribution of property to a partnership does not constitute a sale or exchange. Accordingly, a partnership will never be terminated under Code § 708, based on a sale or exchange within a 12-month period of 50% or more of the total interest in partnership capital or profits as a result of a partnership "expansion". Likewise, the liquidation of a partnership interest is not a sale or exchange, and would have no effect on a 1031 transaction whether occurring before or after a partnership level like-kind property exchange.

When two partnerships are merged, the resulting entity will be considered a continuation of the partnership which contributed more than 50% of the fair market value of the combined assets (net of liabilities). A merger transaction in which the resulting partnership is considered to be a continuation of the original owner of the relinquished property should not affect a partnership level exchange conducted by that entity.

In structuring partnership expansions, liquidations or merger transactions incident to a 1031 exchange, care must be taken to avoid the "disguised sales" rules in Reg. § 1.707-3.

8. <u>Fractional Interests</u>. In order to escape some of the confusion and pitfalls attendant to exchanges which involve transactions between a partnership and its partners, it may be appropriate to consider the co-tenancy form of ownership. If the co-tenants are treated as separate owners, for federal tax purposes, and not as a "defacto partnership", then each of them will be permitted to engage in their own separate exchange transactions.

Generally, the distinction between "mere co-ownership" and a defacto partnership will turn on the intent of the parties and on the extent to which they "actively" conduct a joint business. Reg. § 301.7701-1(a)(2) provides as follows:

> "A joint venture or other contractural arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants-in-common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes."

Revenue Ruling 75-374, 1975-2 C.B. 261, concluded that the ownership and operation of an apartment project does not constitute an active business so long as the owner furnishes only "customary" tenant services (which, in that case, were said to include the provision of heat, air conditioning, hot and cold water, unattended parking, normal repairs, trash removal and cleaning of public areas). In the ruling, it was also noted that the owner would not be considered to engage in an active business if additional services were to be furnished by an independent party, not acting as the agent of the owner. Private Letter Ruling 8117040, issued on January 27, 1981, indicates that the owner of an apartment community can also arrange for the provision of laundry equipment and services by a third party, and receive a fee based on a percentage of the <u>gross</u> laundry income, without being considered to actively engage in a business.

The IRS released revenue procedure 2002-22 in March to address the use of fractional ownership interests as replacement property in IRC Section 1031 exchanges. Commonly referred to as "tenancy-in-common" or TIC interests, these fractional interests offer significant advantages to taxpayers completing 1031 exchanges.

Under section 1031, a taxpayer may defer gain recognition by exchanging for like-kind property. The replacement property cost must equal or exceed the net sales price of the relinquished property and the taxpayer must replace all debt and equity. To successfully complete the exchange, the taxpayer must meet certain requirements. Specifically, he or she must identify potential replacement property within 45 days of selling the relinquished property.

Finding an attractive replacement property in the right price range in such a short time can be difficult, and a taxpayer must take title to the property he or she ultimately buys in the same manner as the relinquished property. (For example, a taxpayer tired of the hassles of owning and managing a rental house cannot exchange it for a partnership interest in a professionally managed shopping center.) This title requirement often precludes taxpayers from buying a share in a larger, potentially more attractive property.

In response to the need for "ready-to-buy" investment products that taxpayers could purchase with varying amounts of cash and debt, a small group of companies began offering TIC interests as replacement property. To address the title issue, they used a co-ownership structure. Despite this arrangement, many CPAs were still concerned the IRS might see the TIC interests as essentially partnership interests, jeopardizing the benefits of an exchange.

After declining to answer several letter ruling requests on this matter, the IRS decided not to issue any more rulings pending further review. Revenue procedure 2002-22 is the result of this review. Although the IRS did not establish a safe harbor provision, it did spell out some requirements for TIC interests to qualify as co-ownership interests.

■ The maximum number of tenants-in-common permitted is 35.

■ The sponsor or organizer of the interests may own the property (or an interest therein) for only six months before selling 100% of the units.

■ Unanimous decisions are required on anything of material or economic impact to the property or its owners.

■ The management agreement (if applicable) must be at a market rate and renewable annually.

The pronouncement urges taxpayers wanting a definitive blessing on a particular product to seek a letter ruling. The IRS will make such a ruling based on the specific facts of the TIC offering. Despite a flurry of ruling requests, there has been only one private letter ruling released since the issuance of Revenue Procedure 2002-22. See Private Letter Ruling 200327003 (approving the taxpayer's "plain vanilla" offering of TIC interests in property net leased to a single tenant). Although the IRS has indicated that further rulings in the near future are not to be expected, TIC structured transactions continue to be completed based on tax opinions issued by legal counsel.

Observation. Given this new information, many companies selling TIC interests are likely to structure their offerings to comply with the new guidelines, as well as seek an individual blessing from the IRS on their product. For the group offering the product, revenue procedure 2002-22 appears to provide a foundation to build on. For taxpayers, the guidance opens the door to a new product that may allow them more choice and flexibility when completing a section 1031 exchange.

The issuance of Revenue Ruling 2004-86 on July 20, 2004 reflects the continuing evolution of TIC structures after Revenue Procedure 2002-22. This ruling permits an entity known as a Delaware statutory trust to hold fee title to replacement property in an exchange rather than individual tenants in common. Under this structure, tenants in common own interests in the trust rather than undivided interests in the real estate, and a trust company is typically hired to act as trustee. Furthermore, given that such trusts are considered "disregarded entities" for federal income tax purposes, interests in such trusts are considered to be owned by the individual trust beneficiaries.

Commentators suggest that the ruling will facilitate TIC structured transactions in that it simplifies the overall process. Rather than up to thirty five co-tenants owning property, the ruling permits a single fee title holder. Lenders applaud the ruling given that such trusts are by definition bankruptcy-remote and are single purpose entities under Delaware law. Furthermore, the trust structure simplifies the issue of permitted transfers in loans to TIC structures, since the issue of individual co-tenants coming and going is less of an issue given that there is one entity holding fee title to the property.

The ruling places significant restrictions on a trustee's right to exercise discretion on behalf of trust beneficiaries, however. The ruling provides that the trustee's acts must be limited to accepting income generated by property owned by the trust, and the renegotiation of lease or loan terms by a trustee is explicitly prohibited by the ruling. In light of these circumstances, a prudent trustee would likely terminate such a trust rather than risk the liability associated with making decisions prohibited by the ruling. (The practical effect of such a termination would be that trust beneficiaries would be distributed their individual interests and thereafter would hold such interests as tenants-in-common under the guidelines of Revenue Procedure 2002-22.)

(The content of this section is largely derived from the author's attendance of a teleconference on July 28, 2004 entitled Practical Planning for Tenancy-In-Common (TIC) Exchanges sponsored by the Section of Taxation of the American Bar Association.)

9. Electing Out of Subchapter K. Section 1031(a)(2)(D) provides that nonrecognition treatment does not apply to any exchange of interests in a partnership. The "flush language" at the end of Section 1031(a)(2), however, provides as follows:

> "For purposes of this section, an interest in a partnership which has in effect a valid election under Section 761(a) to be excluded from the application of all of Subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership."

This provision could be considered an apparent invitation to allow co-owners to hold title through a limited liability company or other state law entity taxed as a partnership for federal tax purposes, but to have the benefits of "true co-ownership" for federal tax purposes. However, it is unclear that a limited liability company or similar organization would be allowed to "elect out" of Subchapter K. In a June 11, 1999 field service advisory (FSA 1999 23017), the Service states in part "generally, the Service does not allow entities formed under a state's partnership or limited partnership laws to elect out of Subchapter K." Reg. § 1.761-2(a)(2)(i) would appear to restrict the election to situations where the participants in the joint purchase, retention, sale or exchange of investment property "own the property as co-owners". Accordingly, parties who expressly exchange partnership interests in an actual (as opposed to defacto) partnership proceed at their own risk.

10. Property by Property Special Allocations. A modified form of the exchange/partnership split-up may be possible where the parties are willing to remain as partners, and to provide for special allocations under which significant benefits and burdens of individual partnership properties are specially allocated to the respective partners. For example, instead of a "drop and swap", the partnership could acquire two separate replacement properties, and then allocate income and expense from the first property to Partner A and from the second property to Partner B. If all of the other provisions of the regulations under Section 704 are met, such allocations would probably have substantial economic effect.

Example 10 under Reg. § 1.704-1(b)(5) involved a travel agency formed by S&T as a general partnership. The partnership agreement provided that T, a resident of a foreign country, was to be allocated 90%, and S 10%, of income derived from operations conducted within that country, while all remaining

income was to be allocated equally between S&T. The example concludes that the allocations have substantial economic effect, since the amount of separately allocated income could not, under the circumstances, be predicted with any reasonable certainty.

If 100% of the benefits and burdens of a Replacement Property were allocated to a particular partner, however, such allocation could be considered tantamount to a distribution of that property to the partner. In that circumstance, the transaction would probably be recharacterized as a "swap and drop".

11. "<u>Mixing Bowl" Transactions</u>. The ability to contribute and distribute appreciated properties to and from partnerships, without gain recognition, led to the availability of an exchange outside of Section 1031 which has been referred to as a "mixing bowl" transaction. In such a transaction, each partner contributes an appreciated property to a partnership, and subsequently receives the <u>other</u> property in a liquidating distribution. Potential abuses led to the enactment of Sections 704(c)(1)(B) and 737. Generally, a seven year holding period is now required before the contributed partners can receive a property contributed by someone else without recognizing gain. However, under Code § 704(c)(2), property contributed by a partner may be distributed by the partnership to another partner if the contributing partner receives a distribution of property of a like-kind to his contributed property not later than the earlier of the 180th day after the distribution of his contributed property or the due date (determined with regard to extensions) for the contributing partner's tax return.

The anti-mixing bowl rules apply to property contributed to a partnership. Accordingly, the rules would not apply for the partnership purchases property. It may be possible to accomplish something analogous to an exchange/partnership split-up by having the partnership acquire property by purchase, and then distribute that property to one partner in liquidation of his partnership interest. However, if the distributee partner selects the property, and arranges for its purchase, with the partnership never bearing any significant "benefits and burdens" of ownership, then it may be considered that the distributee receive cash, in a taxable transaction, and then reinvested the cash, through the purchase of his property, in a separate transaction.

12. <u>Managing Liability Allocations</u>. Under IRC Section 752(b), any decrease in a partner's share of partnership liabilities will be treated as a distribution of money to that partner by the partnership. Such a deemed distribution will reduce the partner's basis in his partnership interest ("outside basis"), but not below zero. To the extent that any such deemed distributions, together with any actual cash distributions, exceed a partner's outside basis, gain will be recognized by the distributee partner under IRC Section 731(a).

Under Reg. Section 1.752-1(f), if a single transaction results in both an increase and a decrease of a partner's share of partnership liabilities, only the <u>net</u>

decrease will be treated as a distribution to that partner. In Rev. Rul. 2003-56, 2003-1 C.B. 985, the IRS acknowledged that a netting would be allowed even when the partnership incurs an offsetting liability (upon acquisition of replacement property) in the tax year subsequent to the liability reduction arising when the relinquished property is disposed of. However, since IRC Section 752 and the regulations thereunder provide different rules for the allocation of recourse and non-recourse partnership liabilities, exchange transactions which are otherwise completely tax deferred to a partnership may result in gain to one or more partners, if sufficient care is not taken.

Such an exposure will typically occur when the relinquished property is encumbered by non-recourse debt, while some, but not all, of the partners guarantee recourse debt incurred in connection with the replacement property. While recourse partnership obligations are effectively allocated to the obligors "of last resort" in a worst-case scenario, limited partners and others who are not expected to incur substantial risk in connection with partnership activities may nevertheless be protected from the taxable deemed distributions potentially inherent in this type of transaction. This approach is facilitated by certain rules and presumptions under the Section 752 regulations.

In allocating partnership recourse liabilities, Reg. Section 1.752-2(b)(1) employs a "constructive liquidation analysis" which assumes in part that the assets of the partnership have <u>no value</u> (apart from any assets contributed to secure partnership liabilities), and that the partnership is liquidated through a fully taxable disposition of all of its property, for no consideration, except liability relief from creditors whose repayment rights are limited solely to one or more partnership assets. In addition, Reg. Sections 1.752-2(b)(6) and 1.752-2(j)(3) effectively assume that all partners and related persons actually perform their obligations in connection with partnership liabilities, irrespective of their respective net worths, unless the facts and circumstances indicate a plan to circumvent or avoid such obligations.

Accordingly, a partner will be entitled to an allocation of partnership recourse debt, if such partner executes a "bottom" guarantee or "bottom" deficit restoration obligation. Such a "bottom" obligation would provide that the partner will not be obligated actually to make any payment unless and until all attempts to enforce the obligation against the partnership have failed to produce gross proceeds to the lender of at least the limited amount of the "bottom" obligation. Since the Regulations assume that the partnership assets have no value, the "bottom" limitation of this obligation will effectively be disregarded for liability allocation purposes. In any such arrangement, however, the partner which incurs any such obligation must waive any rights of reimbursement or contribution with respect the general partner and any other guarantors.

C. IMPROVEMENTS TO REPLACEMENT PROPERTY

In some cases, a taxpayer may wish to identify and acquire replacement property that either does not exist at the time of identification, or is in the process of being constructed. A number of issues arise in this context and should be addressed.

1. How should the property be identified? Regs. 1.1031(k)-1(e)(2)(i) says the identification requirements will be met if a "legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time the identification is made." IRS does not clearly define how much detail regarding construction is "practicable" at the time of identification. If any detailed plans and specifications have been created by the time the property is identified, they would support "practicable" detail; however, too much detail can cause problems if the significant changes are made to the plans whereby the property received is not "substantially the same" as the property identified.

2. Will changes to the to-be-constructed replacement property plans cause the property not to be "substantially the same" as the identified property? The Regulations (1.1301(k)-1(e)(3)(i)) state that "variations due to usual or typical production changes are not taken into account" for determining whether the replacement property is substantially the same as what was identified. However, if substantial changes are made in the property to be produced, the replacement property will not be considered substantially the same.

3. How does the 200-percent rule work when dealing with to-be-constructed replacement property? The 200-percent rule relates to the limitations on identifying replacement property. If the taxpayer identifies more than three replacement properties, the aggregate fair market value of identified replacements cannot exceed 200 percent of the fair market value of the relinquished property. According to Regs. 1.031(k)-1(e)(2)(ii), the fair market value of to-be-constructed replacement property is the estimated fair market value of the property as of the date it is expected to be received by the taxpayer. Note that if the replacement property is not expected to be completed by the time it is acquired by the taxpayer (for instance, the projected completion date exceeds 180 days from the relinquished property transfer), the taxpayer must estimate the fair market value of the incomplete property as of the expected transfer date in determining if the 200-percent rule has been met or exceeded.

4. What if the replacement property is not completed when received by the taxpayer? Can it still be considered "substantially the same" as what was identified? In the case of personal property, the replacement property must be completed by the time the taxpayer receives it in order to be substantially the same (Regs. 1.1031(k)-1(e)(3)(ii)). Real property does not have to be completed by the time the taxpayer takes title (Regs. 1.1031(k)-1(e)(3)(iii)); however, only

the fair market value of the construction that has been completed will qualify as "like kind" property. Any future construction services or building materials received but not yet integrated into the property are not considered "like kind" (Regs. 1.1031(k)-1(e)(4)). In addition, the completed property must be substantially the same as the identified property in terms of having no substantial changes (excluding "variations due to usual or typical production changes"). The Regulations provide an example that can be summarized as follows:

A taxpayer enters into a deferred exchange agreement with another person involving some personal property for like kind personal property to be produced and some real property for real property to be produced. On the 180th day after the relinquished properties were transferred, the replacement personal property is 90% complete and the replacement real property is 20% complete. If the construction of the improvements to the real property had been completed, the property would have been considered to be substantially the same as identified. Under local law, the real property and incomplete improvements constitute real property.

Since the personal property was not completed at the time of transfer, it <u>will not</u> be considered substantially the same as the property identified, and therefore is not like kind. The real property, even though it was only 20% complete, <u>will</u> be considered substantially the same to the extent of the work that was done when title was transferred to the taxpayer. Any construction that occurs after title is passed will not be like kind property.

As this example demonstrates, the "substantially the same" requirements are stricter for personal property than they are for real property. How close to completion the property is at the time it is acquired by the taxpayer is irrelevant in terms of the "substantially the same" requirement, but it is very relevant in terms of determining the recognized gain (if any) on the exchange. Because only the fair market value of the property actually constructed on the transfer date will qualify as like kind, a sufficient amount of construction must take place in order to defer the entire gain, even if the completed property's fair market value will far exceed the relinquished property's fair market value. EXAMPLE: Todd disposes of property worth $100,000 with a basis of $50,000 under a deferred exchange agreement. Within the identification period, he identifies land and a building yet-to-be-constructed as his replacement property. The replacement property has a projected fair market value of $125,000 upon completion, which is expected to occur before the 180th day. The projected fair market value is comprised of $25,000 land cost and $100,000 construction costs. Due to a labor shortage and unseasonably heavy rains, construction is delayed. On the 180th day when the property is transferred to Tom, the building is only 70% complete. The fair market value of like kind property he has received in the exchange will be $95,000 ($25,000 land + $100,000 x 70% building). Unless Tom also identified and acquired other replacement property, he will recognize a gain of $5,000 ($100,000 FMV relinquished property - $95,000 FMV replacement property).

5. Can a taxpayer construct replacement property on land it already owns? As a general rule, a taxpayer cannot construct replacement property on land it already owns because land and improvements, while both considered real property, are not of the same nature or character (Rev. Rul. 76-391). It may be possible to transfer the property owned by the taxpayer to an unrelated third party who is not acting as the taxpayer's agent. This third party then constructs the to-be-produced improvements and transfers the land and the improvement to the taxpayer. In addition, it may be possible for a taxpayer to exchange into a ground lease and improvements on land that the taxpayer owned as a fee interest (Pri. Ltr. Rul. 9243038). Such a transaction may be risky and is not highly recommended.

D. COMBINING EXCHANGES AND INSTALLMENT SALES

Code Section 453(f)(6) coordinates the installment sale rules with the rules for simultaneous Exchanges by providing that the installment sale method is applied with the following adjustments: (i) the total contract price is reduced to take into account the fair market value of the Replacement Property (ii) the gross profit is reduced to take into account any amount not recognized by reason of Section 1031 and (iii) any property permitted to be received in the Exchange without recognition of gain is not treated as a payment for purposes of Section 453. Regulation Section 1.1031-1(j)(2) coordinates Deferred Exchanges with the installment reporting provisions. Under this regulation, receipt by the Taxpayer of an evidence of indebtedness of the Buyer is treated as the receipt of an evidence indebtedness of the person acquiring the property from the Taxpayer, notwithstanding the fiction that the Taxpayer acquired the property from the intermediary.

V. AFTER THE EXCHANGE

A. ALLOCATION OF BASIS

There are several basis allocation issues that arise in like kind exchanges of real property. One of these is determining how the replacement property basis should be allocated among multiple replacement properties. Allocation should be based on the relative fair market values of the replacement properties (assuming all real property, no personal property). EXAMPLE: Wendy disposes of real property in an exchange and acquires three replacement properties. The calculated combined basis of the replacement property is $400,000. The three properties have fair market values of $100,000, $150,000 and $250,000. Basis will be allocated as follows:

	FMV	%	Allocated Basis
Property 1	100,000	20%	80,000
Property 2	150,000	30%	120,000
Property 3	250,000	50%	200,000

Totals	500,000	100%	400,000

If the exchange includes a mix of real and personal property, Regs. 1.1031(j)-1 applies. An example of such a situation is an exchange of one apartment building for another. Although the personal property (appliances, etc.) is deemed incidental for identification purposes, it must be segregated by general asset class or product class and accounted for separately in determining gain or loss to be recognized. The basis for multiple properties within an "exchange group" is allocated using the relative fair market values of the assets within the group.
Next, the issue of allocating real property basis between land and improvements may arise for exchanges of property that include land and buildings. Here again, the basis is allocated based on relative fair market values of the land and building (Rev Rul. 68-36, 1986-1 CB 357).

B. ALTERNATIVE MINIMUM TAX BASIS

Please note that separate realized gain, recognized gain and basis computations should be made for the property for alternative minimum tax purposes. Prior to 1999, the depreciable life for real property for regular tax purposes (generally 27.5, 31.5, or 39 years depending on the nature of the property and when it was placed in service) differed from that for alternative minimum tax (generally 40 years), although both tax systems used the straight-line method with mid-month convention. Similarly, the depreciated basis of the property for regular tax purposes will differ from that for AMT. As a result, the AMT basis in replacement property will not be the same as the regular tax basis and should be calculated separately. For 1999 and after, the depreciable life for AMT is the same as that for regular tax, but for personal property the method may still be different (150% declining balance for AMT vs. 200% declining balance for many regular tax asset classes).

C. DEPRECIATION

Once basis has been allocated among the replacement property assets, depreciation deductions can be calculated. Until early 2000, when the IRS issued Notice 2000-4, practitioners were uncertain of the proper way to depreciate replacement property. Should the life begin upon the acquisition date of the replacement property, or could the life of the relinquished property be applied to the replacement property? Which method should be used in depreciating the replacement property: the current method under IRC Section 168, or the method that was in place for the relinquished property?

On February 27, 2004, the IRS issued temporary regulations under 1.168(i)-6T (Treasury Decision 9115) replacing Treasury Notice 2000-4. These regulations relate to the computation of MACRS depreciation deductions under Section 168 after replacement property has been acquired by a taxpayer as part of a Section 1031 or 1033 exchange. A significant development of the new regulations is that

a taxpayer is given the option of treating its carry over basis as being placed in service at the time the replacement property is acquired. Formerly, taxpayers were required to depreciate their carry over basis using the same depreciation schedule as that of their relinquished property. For further analysis of the new regulations, see Lewis S. Weller and Dean A. Halfacre, IRS Issues New Rules for Depreciating Replacement Property in Nonrecognition Exchanges, Journal of Taxation, May 2004.

D. HOLDING PERIOD:

In an exchange, the holding period of the relinquished property "tacks on" to the replacement property (Section 1223(1)). If the relinquished property had a long-term holding period, the replacement property will assume that long-term holding period. Keep in mind however, that sales quickly following an exchange run the risk of causing an exchange to fail the "held for" requirement. Even though a sale of replacement property may qualify as long-term because of the "tacked on" holding period, the exchange could be jeopardized if the property is not deemed to be held for investment or for use in a trade or business. In addition, the benefits of exchanging are diminished when the replacement property is disposed in a taxable transaction shortly after the exchange. Remember, one of the main benefits of exchanging is the time value of money.

E. STATE TAX ISSUES

1. <u>Exchanging from one state to another: state income tax effects</u>: Be aware of the fact that states may treat an exchange as taxable upon exchanging out of that state. Following is a summary of consequences for several Southern states:

Alabama: The amount of gain or loss recognized shall be determined in accordance with IRC section 1031. (Sec. 40-18-8)

Georgia: Both relinquished and replacement property must be located in Georgia for exchange to be tax deferred (corporations – Section 48-7-21, individuals – Section 48-7-27).

Mississippi: Both relinquished and replacement property must be located in Mississippi for exchange to be tax deferred (Mississippi Reg. 203).

Florida: The state of Florida does not tax the income of individuals or passthrough entities. With proper planning, taxes on the disposition of real property can be avoided.

Tennessee: The state of Tennessee only taxes the income of limited liability entities. With proper planning, taxes on the disposition of real property can be avoided.

2. Exchanging from one state to another: entity considerations: Another state issue that arises when exchanging from one state to another concerns the type of entity which is exchanging the property. If the taxpayer is a limited liability company, make sure that LLC's are a permissible entity for doing business in that state. Also be aware of how such entities are taxed. For instance, the state of Tennessee recently passed legislation that will tax all limited liability entities as corporations subject to income and franchise taxes. Tennessee franchise taxes can be significant.

3. State tax issues: transfer taxes: When structuring an exchange remember to consider potential transfer taxes. In states where transfer taxes are material, direct deeding may be an appropriate way to avoid being taxed twice on the transfer of the same property.

F. PENALTIES ON AN EXCHANGE GONE BAD

1. Accuracy-related penalty – Section 6662: The amount of the accuracy-related penalty is 20 percent of the underpayment resulting from negligence or disregard of rules and regulations or the substantial understatement of income tax. What is "substantial understatement"? Substantial understatement is an understatement of tax exceeding the greater of 10 percent of the tax required to be shown on the return for the tax year or $5,000 ($10,000 for C corporations). The accuracy-related penalty will not be applied for the reason of substantial understatement of tax if the taxpayer has substantial authority (Internal Revenue Code; final, temporary or proposed Regulations; court cases; administrative pronouncements; tax treaties; and congressional intent as reflected in committee reports) for the position taken or if the taxpayer discloses certain information in the return and has a reasonable basis for his position. The disclosure is made on Form 8275 or 8275-R. Even if a taxpayer discloses his position, the accuracy-related penalty may still apply due to negligence or disregard of rules or regulations. What are "negligence" and "disregard of rules or regulations"? Negligence includes any failure to make a reasonable attempt to comply with the tax law. Disregard includes any careless, reckless or intentional disregard of the tax law.

The penalty will not be imposed on any portion of an underpayment if the taxpayer shows reasonable cause and that he acted in good faith with respect to that portion of the underpayment (Section 6664(c)). Reasonable cause and good faith are determined on a case-by-case basis by looking at facts and circumstances. A key factor is the taxpayer's effort to determine the property tax liability. Other factors include, to name a few, the taxpayer's experience, knowledge, education, and reliance on professional advice (Regs. 1-6664-4). Note that reliance on professional advice may not be considered "in good faith" if the taxpayer knew that the advisor lacked knowledge in the relevant aspects of the tax law or if the taxpayer failed to disclose a fact that he knew or should have known was relevant in determining proper tax treatment.

2. <u>Fraud penalties (Section 6663):</u> The amount of the fraud penalty (civil fraud) is 75 percent of the underpayment of tax; however, if the fraud penalty applies, the accuracy-related penalty will not. Fraud is not defined in the Code or the regulations, but case law provides a working definition of engaging in intentional acts with the specific intent to avoid tax that the taxpayer knew to be owed (*Akland,* 85-2 USTC 9593; *Bradford,* 86-2 USTC 9602). The IRS has the burden of proving fraud, and that proof must be "clear and convincing evidence." Circumstantial evidence may be used to prove fraud.

3. <u>Criminal fraud (Section 7201):</u> The burden of proof on the IRS in cases of criminal fraud is more difficult to prove than that for civil fraud. For criminal fraud, the burden of proof is "beyond a shadow of any reasonable doubt." Criminal fraud is a felony, punishable by a fine not to exceed $100,000 ($500,000 for corporations) and/or imprisonment for a period not to exceed five years. A taxpayer convicted of criminal fraud may also be subject to the civil fraud 75% penalty; however, a taxpayer subject to the civil fraud penalty may or may not be guilty of criminal fraud since the burden of proof is higher in criminal cases.

4. <u>Preparer penalties (Section 6694):</u> The tax return preparer may be subject to penalties if the understatement on the return is due to unrealistic positions being taken or willful or reckless conduct by the preparer. The unrealistic position penalty is $250 and does not apply if the preparer can show reasonable cause and that he acted in good faith. The willful or reckless conduct penalty is $1,000.