

# LIKE KIND EXCHANGE TRANSACTIONS

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A. GENERAL OVERVIEW

1. General rules. Section 1031 permits certain like-kind property to be exchanged on a tax free basis. Like-kind property must be property held for productive use in a trade or business or for investment. It must be exchanged for property held for productive use in a trade or business or for investment.
  - a. Compare with Section 1033 and 1034 Exchange v. Sale
  - b. Like kind looks to nature and character of property, not its grade or quality. This means, for example, that raw land can be exchanged for an apartment building.
  - c. Section 1031(a)(1) provides an exception from the general rule requiring the recognition of gain or loss upon the sale or exchange of property. Under Section 1031(a)(1), no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment. Under Section 1031(a)(1), property held for productive use in a trade or business may be exchanged for property held for investment. Similarly, under Section 1031(a)(1), property held for investment may be exchanged for property held for productive use and vice versa. Treas. Reg./1.1031(a)-1(a)(1).
  - d. Boot is taxable. Boot is anything received in the exchange that does not qualify as like kind property, such as cash. There is a special rule for liabilities discussed below.
  - e. Gain realized is recognized, but only to extent of the boot
  - f. If the taxpayer receives other property (in addition to property permitted to be received without recognition of gain) or money (i.e. boot)
    - (1) In an exchange described in Section 1031(a) of property held for investment or productive use in trade or business for property of like kind to be held either for productive use or for investment, the gain, if any, to the taxpayer will be recognized under Section 1031(b) in an amount not in excess of the sum of the money and the fair market value of the other property, but the loss, if any, to

the taxpayer from such an exchange will not be recognized under Section 1031(c) to any extent. Treas. Reg./1.1031(b)-1(a).

- (2) In an exchange described in Section 1035(a) of insurance policies or annuity contracts, or
- (3) In an exchange described in Section 1036(a) of common stock for common stock, or preferred stock for preferred stock, in the same corporation and not in connection with a corporate reorganization, the gain, if any, to the taxpayer will be recognized under Section 1031(b) in an amount not in excess of the sum of the money and the fair market value of the other property, but the loss, if any, to the taxpayer from such an exchange will not be recognized under Section 1031(c) to any extent. Treas. Reg./1.1031(b)-1(a).
- (4) Generally, the taxpayer's basis in the like-kind property received is the same as the basis in the like-kind property exchanged, decreased by any money received and increased by any gain recognized. If the boot consists of unlike-kind property, the basis in the unlike-kind property is its fair market value. Section 1031(d).
- (5) Example 1: A, who is not a dealer in real estate, exchanges real estate held for investment, which he purchased for \$5,000, for other real estate (to be held for productive use in a trade or business) which has a fair market value of \$6,000, and \$2,000 in cash. The gain realized from the transaction is \$3,000, but is recognized only to the extent of the cash received of \$2,000. Treas. Reg./1.1031(b)-1(a)(4)(b).

Under I.R.C. / 1031(d), A's basis in the like-kind property received is his old basis decreased by any money received and increased by any gain recognized, or  $\$5,000 - \$2,000 + \$2,000 = \$5,000$ . If A had received unlike-kind property with a fair market value of \$2,000 instead of cash, A's gain recognized and basis in the like-kind property received would be the same, and the basis in

the nonlike-kind property would be \$2,000. Treas. Reg. / 1031(d)-1(c).

- g. (1) Generally, relief of liability is treated as boot. Section 1031(d). Thus in the above example, if A's property had had a fair market value of \$8,000, but was subject to a liability of \$2,000, and was exchanged for like-kind property with a fair market value of \$6,000, the answer would have been the same. A would still have recognized \$2,000 of gain and his basis in the property received would still have been \$5,000.
- (2) However, if both the like-kind property exchanged and received are subject to liability, only the net liability relief is treated as boot. Treas. Reg. / 1.1031(d)-2. Thus, continuing with the example in g, if A received like-kind property in the exchange with a fair market value of \$7,000 and subject to a liability of \$1,000, his net liability relief and therefore his boot would only be \$1,000. Only \$1,000 of gain would be recognized. A's basis in the property received would be  $\$5,000 - \$2,000 + \$1,000 = \$6,000$ .
- (3) Continuing with the example, if A received like-kind property with a fair market value of \$9,000 subject to a liability of \$3,000, he would recognize no gain since the liabilities assumed exceed the \$2,000 of liabilities to which his exchanged property was subject. In this case, A's basis in the like-kind property received would be  $\$5,000 - \$2,000 + \$3,000 = \$6,000$ , where the second \$3,000 is the assumption of liabilities on the like-kind property received. Note that A still has \$3,000 of inherent, as yet unrecognized gain, the same he had in the property he exchanged. Treas. Reg. / 1.1031(d)(2) Example 2.

2. Relinquished property

a. In general

b. Personal property

- (1) While less common, Section 1031 can apply to exchanges of

depreciable tangible personal property, which must be of same kind or class

- (2) Regs list Asset Classes and Product Classes
- (3) Tangible depreciable personal property must fit in Asset Class or Product Class to be of like kind

c. Depreciable tangible personal property

- (1) General rule. Depreciable tangible personal property is exchanged for property of a like kind under Section 1031 if the property is exchanged for property of a like kind or like class. Depreciable tangible personal property is of a like class to other depreciable tangible personal property if the exchanged properties are either within the same General Assets Class or within the same Product Class. A single property may not be classified within more than one General Assets Class or within more than one Product Class. In addition, property classified within any General Asset Class may not be classified within a Product Class. A property's General Asset Class or Product Class is determined as of the date of the exchange. Treas. Reg./1.1031(a)-2(b)(1).
- (2) General asset classes. Property within a General Asset Class consists of depreciable tangible personal property described in one of asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87-56, 1987-2 C.B. 674. These General Asset Classes describe types of depreciable tangible personal property that frequently are used in many businesses. The General Asset Classes are as follows:
  - (a) Office furniture, fixtures, and equipment,
  - (b) Information systems (computers and peripheral equipment),
  - (c) Data handling equipment, except computers,
  - (d) Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines),
  - (e) Automobiles, taxis,

- (f) Buses,
- (g) Light general purpose trucks,
- (h) Heavy general purpose trucks,
- (i) Railroad cars and locomotives, except those owned by railroad transportation companies,
- (j) Tractor units for use over-the-road,
- (k) Trailers and trailer-mounted containers,
- (l) Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction, and
- (m) Industrial steam and electric generation and/or distribution systems. Treas. Reg./1.1031(a)-2(b)(2).

(3) Product classes. Property within a product class consists of depreciable tangible personal property that is described in a 6-digit product class within Sectors 31, 32 and 33 (pertaining to manufacturing industries) of the North American Industry Classification System (NAICS), set forth in Executive Office of the President, Office of Management and Budget, North American Industry Classification System, United States, 2002 (NAICS Manual), as periodically updated. Copies of the NAICS Manual may be obtained from the National Technical Information Service, an agency of the U.S. Department of Commerce, and may be accessed on the internet. Sectors 31 through 33 of the NAICS Manual contain listings of specialized industries for the manufacture of described products and equipment. For this purpose, any 6-digit NAICS product class with a last digit of 9 (a miscellaneous category) is not a product class for purposes of this section. If a property is listed in more than one product class, the property is treated as listed in any one of those product classes. A property's 6-digit product class is referred to as the property's NAICS code. Treas. Reg./1.1031(a)-2(b)(3).

- (a) Example 1. Taxpayer A transfers a personal computer to B

in exchange for a printer (asset class 00.12). With respect to A, the properties exchanged are within the same General Asset Class and therefore are of a like class.

(b) Example 2. Taxpayer C transfers an airplane to D in exchange for a heavy general purpose truck (asset class 00.242). The properties exchanged are not of a like class because they are within different General Asset Classes.

(c) Example 3. Taxpayer E transfers a grader to F in exchange for a scraper. Neither property is within any of the general asset classes. However, both properties are within the same product class (NAICS code 333120). The grader and scraper are of a like class and deemed to be of a like kind for purposes of Section 1031. Treas. Reg. / 1.1031(a)-2(b)(7).

d. Real property

e. Intangible or nondepreciable personal property

(1) Must be of like kind

(2) No like classes are provided

(3) Look to nature or character of rights involved and nature and character of underlying property to which it relates.

(4) General rule. An exchange of intangible personal property or nondepreciable personal property qualifies for nonrecognition of gain or loss under Section 1031 only if the exchanged properties are of a like kind. No like classes are provided for these properties. Whether intangible personal property is of a like kind to other intangible personal property generally depends on the nature or character of the rights involved (e.g., patent or a copyright) and also in the nature or character of the underlying property to which the intangible personal property relates. Treas. Reg./1.1031(a)-2(c)(1).

(5) Goodwill and going concern value. The goodwill or going concern

value of a business is not of a like kind to the goodwill or going concern value of another business. Treas. Reg. / 1.1031(a)-2(c)(2).

(6) Example 1. Taxpayer K exchanges a copyright on a novel for a copyright on a different novel. The properties exchanged are of a like kind.

(7) Example 2. Taxpayer J exchanges a copyright on a novel for a copyright on a song. The properties exchanged are not of like kind. Treas. Reg./1.1031(a)-2(c)(3).

f. Multiple asset exchanges

3. Replacement Property

- a. Held for productive use in trade or business or for investment
- b. In general
- c. Holding period
- d. Related parties

4. Excluded Property

- a. In general
- b. Stock in trade
- c. Dealer property - held primarily for sale to customers in the ordinary course of business.
- d. Stocks, bonds, note
- e. Choses in action
- f. Partnership interest - applies to general partnership interest or limited partnership interest in same partnership or different partnerships. If elect out of Subchapter K, this exception will not apply.
- g. Certificate of trust or beneficial interest.

B. HOLDING REQUIREMENT

1. Section 1031(a) requires the replacement property acquired in a like kind exchange be held for productive use in a trade or business or for investment both before and after the exchange. The taxpayer should avoid pre-arranged plans to dispose of replacement property
  
2. PLR 200521002.
  - a. A testamentary trust that transfers replacement property to a single member LLC, which is deemed a disregarded entity, will be considered the direct owner of the replacement property for Federal income tax purposes. Consequently, the transfer of the replacement property by the trust to the LLC will not violate the holding requirement of Section 1031.
  
  - b. In addition, the trust will not violate the holding requirement of Section 1031 even though by its terms it must terminate 20 years after the date of the death of the decedent and distribute the properties to its remainder beneficiaries at that time, as long as it holds the replacement property for investment until it terminates. See Part F.5., infra.
  
3. Compare Rev. Rul. 75-292, 1975-2 C.B. 333 (acquisition of replacement property followed by the immediately pre-arranged transfer of the property to the individual s newly created corporation in exchange for stock in the corporation pursuant to Section 351 violates the holding requirement) and Rev. Rul. 77-337, 1977-2 C.B. 305. In a prearranged plan, the individual taxpayer liquidated his wholly owned corporation and transferred the corporation s sole asset to a third party in exchange for like kind property. The Service held that the individual could not hold its corporation s property for use in a trade or business or for investment because the corporation s prior trade or business use could not be attributed to its sole stockholder. Thus, avoid pre-arranged plans. Note use of LLC as disregarded entity.

4. PLR 9850001. Taxpayer sells relinquished property to a QI who uses the proceeds to purchase replacement property in the name of a wholly owned LLC of the taxpayer. The taxpayer then liquidates into its parent and the parent then merges into an unrelated corporation. This series of transactions does not violate the rule that the replacement property be held by the taxpayer for the productive use in a trade or business or for investment.

C. DEFERRED EXCHANGES

1. Exchanges do not necessarily have to be simultaneous. For example, if A transfers an apartment building to B (the relinquished property), B need only transfer like kind property back to A (the replacement property) by a specified later date. Typically, A identifies the property B is to acquire, purchase, and transfer back to A. General rules are found in Section 1031(a)(1) and Treas. Reg. Section 1.1031(k)-1.
2. Must identify replacement property within 45 days after the transfer of the relinquished property. Section 1031(a)(3)(A); Treas. Reg. Section 1.1031(k)
  - a. Identification and receipt requirements. Treas. Reg./1.1031(k)-1(b)(2).
    - (1) In general. In the case of a deferred exchange, any replacement property received by the taxpayer will be treated as property which is not of a like kind to the relinquished property if
      - (a) The replacement property is not identified before the end of the identification period or
      - (b) The identified replacement property is not received before the end of the exchange period.
    - (2) Identification period and exchange period.
      - (a) The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight on

the 45th day thereafter.

- (b) The exchange period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the earlier of the 180<sup>th</sup> day thereafter or the due date (including extensions) for the taxpayer's Federal income return for the taxable year in which the transfer of the relinquished property occurs.
- (c) If, as part of the same deferred exchange, the taxpayer transfers more than one relinquished property and the relinquished properties are transferred on different dates, the identification period and the exchange period are determined by reference to the earliest date on which any of the properties are transferred.
- (d) Property is transferred when the property is disposed of within the meaning of Section 1001(a).

(3) Example: A enters into an agreement for an exchange of property with B that requires A to transfer property X to B. Under the agreement, A is to identify like-kind replacement property which B is required to purchase and to transfer to A. A transfers property X to B on November 16, 1992. The identification period ends at midnight on December 31, 1992, the day which is 45 days after the date of transfer of property X. The exchange period ends at midnight on April 15, 1993, the due date for A's Federal income tax return for the taxable year in which A transferred property X. However, if A is allowed an extension of time for filing his tax return, the exchange period can end as late as midnight on May 15, 1993, the day which is 180 days after the date of transfer of property X.

- 3. The replacement property in a forward exchange must be received after the earlier of: (i) 180 days from the date the taxpayer transfers the relinquished property, or

(ii) the due date (including extensions) for the taxpayer's income tax return for the taxable year in which the transfer of the relinquished property occurs. Section 1031(a)(3)(B). In a reverse exchange, the relinquished property must be transferred, and the replacement property received, within 180 days after the transfer of qualified indicia of ownership of the replacement property to the EAT. See Rev. Proc. 2000-37, infra at Part D.

4. For multiple relinquished properties, identification and exchange periods begin on date of sale of earliest relinquished property. Id.
5. Manner of identifying replacement property:
  - a. Written document signed by taxpayer,
  - b. Delivered to a party to the exchange,
  - c. Unambiguously described. Treas. Reg. 1.1031(k)-1(c)(3)
  - d. Replacement property is identified only if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either
    - (1) The person obligated to transfer the replacement property to the taxpayer (regardless of whether that person is a disqualified person); or
    - (2) Any other person involved in the exchange other than the taxpayer or a disqualified person. Examples of persons involved in the exchange include any of the parties to the exchange, an intermediary, an escrow agent, and a title company. An identification of replacement property made in a written agreement for the exchange of properties signed by all parties thereto before the end of the identification period will be treated as satisfying the requirements. Treas. Reg. /1.1031(k)-1(c)(2).
  - e. Replacement property is identified only if it is unambiguously described in the written document or agreement. Real property generally is

unambiguously described if it is described by a legal description, street address, or distinguishable name (e.g., the Mayfair Apartment Building). Personal property generally is unambiguously described if it is described by a specific description of the particular type of property. For example, a truck generally is unambiguously described if it is described by a specific make, model and year. Treas. Reg./1.1031(k)-1(c)(3).

6. Number of properties to identify
  - a. The taxpayer may identify more than one replacement property. Regardless of the number of relinquished properties transferred by the taxpayer as part of the same deferred exchange, the maximum number of replacement properties that the taxpayer may identify is:
    - (1) Three properties without regard to the fair market values of the properties (the 3-property rule ), or
    - (2) Any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200% of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer (the 200-percent rule ). Treas. Reg./1.1031(k)-1(c)(4)(i).
  - b. If, as of the end of the identification period, the taxpayer has identified more properties as replacement properties than permitted, the taxpayer is treated as if no replacement property had been identified. The preceding sentence will not apply, however, and an identification satisfying the requirements will be considered made, with respect to
    - (1) Any replacement property received by the taxpayer before the end of the identification period, and
    - (2) Any replacement property identified before the end of the identification period and received before the end of the exchange period, but only if the taxpayer receives before the end of the exchange period identified replacement property the fair market

value of which is at least 95% of the aggregate fair market value of all identified replacement properties (the 95-percent rule ).

For this purpose, the fair market value of each identified replacement property is determined as of the earlier of the date the property is received by the taxpayer or the last day of the exchange period. Treas. Reg./1.1031(k)-1(c)(4)(ii).

- c. For purposes of applying the 3-property rule, the 200% rule, and the 95% rule, all identifications of replacement property, other than identifications of replacement property that have been revoked in the manner described below, are taken into account. For example, if, in a deferred exchange, B transfers property X with a fair market value of \$100,000 to C and B receives like-kind property Y with a fair market value of \$50,000 before the end of the identification period, property Y is treated as identified by reason of being received before the end of the identification period. Thus, B may identify either two additional replacement properties of any fair market value or any number of additional replacement properties as long as the aggregate fair market value of the additional replacement properties does not exceed \$150,000. Treas. Reg./1.1031(k)-1(c)(4)(iii).
- d. Revocation of identification. An identification of replacement property may be revoked at any time before the end of the identification period. An identification of replacement property is revoked only if the revocation is made in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to the person to whom the identification of the replacement property was sent. An identification of replacement property that is made in a written agreement for the exchange of properties is treated as revoked only if the revocation is made in a written amendment to the agreement or in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to all of the parties to the agreement. Treas. Reg./1.1031(k)-1(c)(6).

7. Safe harbors.

a. In general. There are four safe harbors in the storm of like-kind exchanges. If any are met, the taxpayer will find safe haven and will be found to be not in actual or constructive receipt of money or other property for purposes of Section 103. More than one safe harbor can be used in the same deferred exchange, but the terms and conditions of each must be separately satisfied. For purposes of the safe harbor rules, the term taxpayer does not include a person or entity utilized in a safe harbor (e.g., a qualified intermediary). Treas. Reg./1.1031(k)-1(g)(1).

b. First Safe Harbor - Security or guarantee arrangements. Treas. Reg./1.1031(k)-1(g)(2).

(1) In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured or guaranteed by one or more of the following:

- (a) A mortgage, deed of trust, or other security interest in property (other than cash or a cash equivalent),
- (b) A standby letter of credit which satisfies all of the requirements of Treas. Reg./15A.453-1(b)(3)(iii) and which may not be drawn upon in the absence of a default of the transferee's obligation to transfer like-kind replacement property to the taxpayer, or
- (c) A guarantee of a third party.

This safe harbor rule ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive money or other property pursuant to the security or guarantee arrangement.

c. Second Safe Harbor - Qualified escrow accounts and qualified trust. Treas. Reg./1.1031(k)-1(g)(3).

- (1) General Rule. In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured by cash or a cash equivalent if the cash or cash equivalent is held in a qualified escrow account or in a qualified trust.
- (2) Qualified escrow account. This is an escrow account where:
  - (a) The escrow holder is not the taxpayer or a disqualified person, and
  - (b) The escrow agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account.
- (3) Qualified trust. This is a trust where:
  - (a) The trustee is not the taxpayer or a disqualified person, except that for this purpose the relationship between the taxpayer and the trustee created by the qualified trust will not be considered a relationship under Section 267(b)), and
  - (b) The trust agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held by the trustee.
- (4) This safe harbor rule ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the qualified escrow account or qualified trust. Rights conferred upon the taxpayer under state law to terminate or dismiss the escrow holder of a qualified escrow account or the

trustee of a qualified trust are disregarded for this purpose.

- (5) A taxpayer may receive money or other property directly from a party to the exchange, but not from a qualified escrow account or a qualified trust, without affecting the application of paragraph (g)(3)(i) of this section.

d. Third Safe Harbor - Qualified intermediaries. Treas Reg./1.1031(k)-1(g)(4).

- (1) General rule. Sometimes the person transferring property in a delayed exchange prefers to use a neutral third-party qualified intermediary or QI. The relinquished property is transferred to the QI and the QI obtains and transfers the replacement property back to the initial transferor. In the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of Section 1031(a). In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer.
- (2) Restrictions on qualified intermediary. The general rule applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary.
- (3) Definition. A qualified intermediary is a person who:
  - (a) Is not the taxpayer or a disqualified person, and
  - (b) Enters into a written agreement with the taxpayer (the exchange agreement) and, as required by the exchange agreement, acquires the replacement property, and transfers

the replacement property to the taxpayer.

- (4) Treatment of qualified intermediary. Regardless of whether an intermediary acquires and transfers property under general tax principals, solely for purposes of the exchange agreement provision.
- (a) An intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property.
  - (b) An intermediary is treated as acquiring and transferring the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person, and
  - (c) An intermediary is treated as acquiring and transferring replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer.
- (5) Solely for purposes of the definition of a qualified intermediary and treatment of a qualified intermediary above, 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 that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. For example, if a taxpayer enters into an agreement for the transfer of relinquished property and thereafter assigns its rights in that agreement to an intermediary and all parties to that agreement are notified in

writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as entering into that agreement. If the relinquished property is transferred pursuant to that agreement, the intermediary is treated as having acquired and transferred the relinquished property.

- (6) Powers of qualified intermediary. The general rule regarding qualified intermediaries does not apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. Rights conferred upon the taxpayer under state law to terminate or dismiss the qualified intermediary are disregarded for this purpose.
- (7) Receipt of non-like-kind property. A taxpayer may receive money or other property directly from a party to the transaction other than the qualified intermediary without affecting the general rule regarding qualified intermediaries.

#### D. REVERSE EXCHANGES

1. The statute only contemplates forward exchanges; i.e., exchanges where the taxpayer first sells the relinquished property and then acquires the replacement property. Section 1031(a)(3). The Service, however, recognizes reverse exchanges, whereby the replacement property is acquired first and the relinquished property is sold second, as discussed below.
2. Rev. Proc. 2000-37, 2000-2 C.B. 308, as amended by Rev. Proc. 2004-51, 2004-\_\_\_\_ C.B. \_\_\_\_\_.
  - a. Before Rev. Proc. 2000-37, taxpayers parked the replacement property with an accommodation party until the taxpayer arranged for the transfer of the relinquished property to its ultimate transferee in a simultaneous

exchange.

- b. To assist taxpayers with a workable means of qualifying their transactions under Section 1031 in situations where the taxpayer has a genuine intent to accomplish a like kind exchange at the time it arranges for the acquisition of the replacement property and actually accomplishes the exchange within a short time thereafter , the Service adopted Rev Proc. 2000-37 to provide a safe harbor that allows a taxpayer to treat the accommodation party as the owner of the property for Federal income tax purposes.
- c. Safe harbor tests. The Service will not challenge the qualification of property as either replacement property or relinquished property or treatment of the exchange accommodation titleholder ( EAT ) as the beneficial owner of such property for Federal income tax purposes if the property is held in a qualified exchange accommodation arrangement ( QEAA ). Property is held in a QEAA if the following six (6) tests are met:
  - (1) Test 1 - Ownership. Qualified indicia of ownership is held by an exchange accommodation titleholder ( EAT ) who is not the taxpayer or a disqualified person. Such person must not be subject to Federal income tax, or if treated as a partnership or S corporation, more than 90% of its interests or stock are owned by partners or stockholders who are subject to Federal income tax. As a result, the EAT will generally be a single member LLC owned by a C corporation which acquires the replacement property.
  - (2) Test 2 - Intent. When qualified indicia of ownership is transferred to the EAT, the taxpayer has the bona fide intent that the property held by the EAT represents either the replacement property or

relinquished property in an exchange that is intended to qualify under Section 1031.

- (3) Test 3 - Qualified Exchange Accommodation Agreement (QEAA). Within five (5) business days after the transfer of qualified indicia of ownership of the replacement property to the EAT, the taxpayer and EAT must enter into a QEAA that provides that:
- (a) The EAT is holding the property for the benefit of the taxpayer to facilitate a Section 1031 exchange, and
  - (b) The EAT and the taxpayer agree to report the acquisition, holding and disposition of the replacement property as provided in the revenue procedure. The QEAA must specify that the EAT will be treated as the beneficiary owner of the replacement property for all Federal income tax purposes. Both parties must report the Federal income tax attributes of the replacement property on their Federal income tax returns consistent with the QEAA.
- (4) Test 4 - 45 Day Identification Rule. Within 45 days after the transfer of qualified indicia of ownership of the replacement property to the EAT, the relinquished property must be identified in a manner consistent with Treas. Reg./1.1031(k)-1(c).
- (5) Test 5 - 180 Day Closing Rule. Within 180 days after the transfer of qualified indicia of ownership of the replacement property to the EAT, the replacement property must be transferred: (i) to the taxpayer either directly or through a qualified intermediary, or (ii) to a person who is not the taxpayer or a disqualified person as

relinquished property.

(6) Test 6 - combined time. The total time that the relinquished property and replacement property may be held in a QEAA may not exceed 180 days.

d. Seven - permissible arrangements. Property will not fail to be treated as being held in a QEAA if any of the following seven (7) arrangements apply, regardless of whether such arrangements contain terms that typically would result from arm's length bargaining between unrelated parties with respect to such arrangements.

(1) Qualified Intermediary. The same person may serve as EAT for the replacement property and as QI for the relinquished property.

(2) Debt. The taxpayer or a disqualified person ( DP ) may guarantee some or all of the obligations of the EAT, including secured or unsecured debt to acquire the replacement property, or may indemnify the EAT against costs and expenses.

(3) Advance or guarantees. The taxpayer or DP may loan or advance funds to the EAT or guarantee a loan or advance to the EAT.

(4) Lease. The replacement property may be leased by the EAT to the taxpayer or a DP.

(5) Management. The taxpayer or DP may manage the property, supervise improvements, act as a contractor or otherwise provide services to the EAT with respect to the replacement property.

(6) Purchase and sale. The taxpayer and the EAT may enter into

agreements or arrangements relating to the purchase or sale of the replacement property, including puts and calls at fixed or formula prices effective for a period not to exceed 185 days from the date the property is acquired by the EAT.

- (7) Values. The taxpayer and the EAT may enter into agreements or arrangements providing that any variation in the value of the relinquished property from the estimated value on the date of the EAT's receipt of the replacement property be taken into account upon the EAT's disposition of the relinquished property through the taxpayer's advance of funds to, or receipt of funds from, the EAT.

3. Rev. Proc. 2004-51, 2004-\_\_\_\_ C. B. \_\_\_\_, modifying Rev. Proc. 2000-37, *supra*.

- a. The Service will treat an EAT as the beneficial owner of property if the property is held in a Qualified Exchange Accommodation Arrangement (QEAA). Property held in a QEAA may qualify as either replacement property or relinquished property if the exchange meets the other tests for deferral of gain or loss under Section 1031.
- b. However, property owned by the taxpayer before the transfer to the EAT does not qualify as replacement property in a like kind exchange designed to park the deferred replacement property. In other words, the safe harbor rules of Rev. Proc. 2000-37 will not apply if the property is owned by the taxpayer within the 180 day period ending on the date of transfer of qualified indicia of ownership to an EAT. Thus, the safe harbor rules of Rev. Proc. 2000-37 do not apply if the taxpayer owns property intended to qualify as replacement property before starting a QEAA. This is designed to prevent a taxpayer from transferring property to an EAT who builds improvements on the property and transfers it back to the taxpayer as

replacement property.

E. CONSTRUCTIVE RECEIPT

1. TAM 200130001

- a. Husband and wife entered into three agreements with three separate purchasers to sell three parcels of real estate. No notice was given to the purchasers that the sellers intended to effect a like kind exchange.
- b. The deferred exchange agreement with the qualified intermediary did not limit the taxpayers rights to receive, pledge, borrow or otherwise obtain sales proceeds from relinquished properties.
- c. Held: Section 1031 does not apply because there were no limits on taxpayers access to, or use of, the proceeds of the relinquished property. The Service ruled such restrictions are required to assure that the qualified intermediary is not considered an agent of the taxpayer, and the taxpayer is not in constructive receipt of the relinquished property proceeds.
- d. Planning:
  - (1) Give written notice to the purchaser of the relinquished property of the intent of the seller to assign the relinquished property contract to the buyer.
  - (2) Impose limits on the seller s access to, or use of, the proceeds of sales of relinquished property.

F. DISREGARDED ENTITIES

1. A disregarded entity is typically an LLC with one owner. The LLC is ignored for federal income tax purposes and anything owned by the LLC is considered to be owned by the owner. This federal tax treatment has no state law effect. For state law purposes, the LLC is treated as a separate legal person with a liability shield. What this means is that for federal income tax purposes, ownership of the interest in a single-member LLC which owns real property is the same as owning the real property itself. This means that the interest in the LLC can be transferred in a qualifying like kind exchange for other real property or for an interest in another single-member LLC which owns real property. This approach can sometime avoid state law transfer taxes on the transfer of real property, since for state law purposes, an interest in an LLC rather than a real property interest is being transferred.
2. PLR 200118023. The acquisition of an exchange accommodation, which was formed as a single member limited liability company to acquire real property in a reverse delayed exchange, is deemed the acquisition of a disregarded entity for Federal income tax purposes and hence is treated as the acquisition of qualifying like kind replacement property. The purpose for acquiring the LLC interest rather than acquiring the property from the LLC was to avoid real property transfer taxes.
3. PLR9807013. Where a limited partnership disposes of a single parcel of improved real property and forms multiple single member limited liability companies to acquire multiple parcels of real property in exchange for the disposed single parcel of improved real property, the receipt of the replacement properties by the disregarded entities is treated as the receipt of the real property directly by the limited partnership for purposes of qualifying the receipt of the replacement properties for nonrecognition of gain under Section 1031.
4. PLR9751012. Two subsidiary corporations of the taxpayer and a brother-sister brother-sister corporation identified the replacement properties. The subsidiaries then liquidated into the taxpayer under Section 332 and the brother-sister corporation merged into the taxpayer under Section 368(a)(1). Thereafter, the taxpayers formed three separate single member limited liability companies to

receive each replacement property. The Service held that the taxpayer would be treated as the transferor of the relinquished properties and the transferee of the replacement properties, and that the acquisition of each replacement property by a separate LLC that is wholly owned by the taxpayer was deemed an acquisition by the taxpayer. Since there is a carryover of tax attributes under Section 381 following the Section 332 liquidation and the Section 368 merger, the intervening liquidation and reorganization do not prevent the receipt of the replacement properties by the taxpayer through disregarded entities (non-electing LLCs) from being treated as received in exchange for the relinquished property. Compare Rev. Rul. 77-337, 1977-2 C.B. 305 where the Service held that an individual taxpayer who, in a prearranged plan, liquidated his wholly owned corporation and transferred the corporation's sole asset to a third party in exchange for like kind property could not hold the corporation's property for use in a trade business or for investment because the corporation's prior trade or business use could not be attributed to its sole stockholder.

- a. PLR 9850001. Taxpayer sells relinquished property to a QI who uses the proceeds to purchase replacement property in the name of a wholly owned LLC of the taxpayer. The taxpayer then liquidates into its parent and the parent then merges into an unrelated corporation. This series of transactions does not violate the rule that the replacement property be held by the taxpayer for the productive use in a trade or business or for investment.
- b. PLR 200521002. Transfer of replacement property by a testamentary trust to a single member LLC is disregarded and the trust is considered the direct owner of the replacement property for Federal income tax purposes. See Part B.2., supra.

## 5. RELATED PARTY EXCHANGES

- a. General rule. If a taxpayer exchanges property with a related person which

qualifies as a like-kind exchange under Section 1031, and within two years after the date of the last transfer which was part of the Section 1031 exchange the related person disposes of the property received from the taxpayer, or the taxpayer disposes of the property received from the related person, gain or loss is recognized to the taxpayer with respect to the exchange as of the date on which the disposition occurs. Section 1031(f).

- b. Exceptions. Nonrecognition treatment will apply, however, on exchanges between related parties if within two years after the date of the last transfer between the taxpayer and the related person:
  - i. The taxpayer or the related party deceases;
  - ii. An involuntary conversion under Section 1033 if the exchange occurred before the threat or imminence of the conversion; or
  - iii. The Service determines that neither the exchange nor the disposition had as one its principal purpose the avoidance of Federal income tax. Section 1031(f)(2).
- c. Related person is any person bearing a relationship to the taxpayer described in Section 267(b) or 707(b)(1). Section 1031(f)(3). This includes, for example, family members and entities controlled by the taxpayer.
- d. Section 1031 does not apply to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of the related party rules. Section 1031(f)(4).
- e. Teruya Bros. v. Commissioner, 124 T.C. No. 4 (2005). The taxpayer transferred two parcels of property to a QI, which then sold them to an unrelated third party. The QI used the sales proceeds to purchase real

property from the taxpayer's 62% owned subsidiary. The court held that the exchange by the taxpayer of the two parcels of real estate for replacement property formerly owned by the subsidiary, which received the sales proceeds, was economically equivalent to a direct exchange of properties between the parent and its 62% owned subsidiary, followed by the subsidiary's sales of the properties to the unrelated parties. Using the QI to effect the transaction did not alter the results. Thus, since the transaction was designed to avoid a direct transaction between the parent and its subsidiary, the related party rules of Section 1031(f), and, in particular, Section 1031(f)(4) also applied since the taxpayer failed to establish that one of the principal purposes of the transactions was not the avoidance of Federal income tax or that the transaction was not designed to avoid the related party rules.

- f. Rev. Rul. 2002-83, 2002 - \_\_\_ C.B. \_\_\_. Taxpayer A transferred low basis Property 1 to a qualified intermediary who then transferred the Property to taxpayer C. One week later the qualified intermediary acquired Property 2 from taxpayer B, who is related to taxpayer A pursuant to Section 267(b). The QI paid taxpayer B the proceeds from the QI's sale of Property 1, and transferred Property 2 to taxpayer A. Held: The QI is used to circumvent the related party rules. Absent the related party rules, A could have exchanged Property 1 for Property 2 with B, and B could have sold Property 1 to C. A, however, structured the transaction to avoid the related property rules.
- g. PLR 200440002 . Partnership AB transferred Property 1 to a QI and related Partnership CD transferred Property 2 to the QI. AB identified Property 2, owned by CD, as one of its replacement properties. CD planned to exchange Property 2 for other like kind property with an unrelated party. AB represented it would not dispose of Property 2 within two years of its receipt as its replacement property. CD represented that it would not dispose of CD's replacement property within two years of its receipt of the replacement

property. The Service held that the related party rules of Section 1031(f) do not apply and distinguished the PLR from Rev. Rul. 2002-83 by noting that in the PLR CD used the proceeds from the sale of Property 2 to acquire like-kind property in a Section 1031 exchange. Thus, the exception under Section 1031(f)(2)(C) (the not for tax avoidance rule) applied because CD received replacement from a related party through a QI and the related party is also doing a Section 1031 exchange of the replacement property transferred. Thus, where both related parties are doing a Section 1031 exchange, related parties can exchange properties without violating Section 1031(f)(4).

- h. TAM 200126007. Taxpayer engaged in a multi-party exchange involving a related party. Shortly thereafter, the related party disposed of the property acquired from the related party. The Service denied like kind exchange treatment because low basis property was shifted to the related party in exchange for replacement property. The transaction was designed to avoid the related party rules.

## 6. BUILD TO SUIT

- a. Often a taxpayer will sell the relinquished property in exchange for replacement property on which improvements will be built.
- b. Treas. Reg./1.1031(k)-1(d)(ii) provides that the replacement property received must be substantially the same as the property identified.
- c. Special rules for identification and receipt of special property to be produced.
  - i. Treas Reg./1.1031(k)-1(e)(1) provides that a transfer of relinquished property in a deferred exchange will not fail to qualify merely because the replacement property is not in existence or is

being produced at the time the property is identified as replacement property. Produced and production are defined pursuant to Section 263A(g)(1). Thus, this regulation recognizes build to suit .

- ii. In the case of replacement property to be produced, the replacement property must be identified in accordance with the identification rules set forth in Treas. Reg./1.1031(k)-1(c). If the identified replacement property consists of improved real property where the improvements are to be constructed, the description of the replacement property must contain a legal description for the underlying land and as much detail regarding construction of the improvements as is practicable at the time the identification is made. Treas. Reg./1.1031-1(k)(e)(2)(i). This may mean attaching blue prints, construction contracts and other construction documents. For purposes of the 200% of value rule under Treas. Reg./1.1031(k)-1(c)(4)(i)(B), the fair market value of the replacement property to be produced is its estimated fair market value as of the date it is expected to be received by the taxpayer. Treas. Reg./1.1031(k)-1(e)(2)(ii).
- iii. In determining whether the replacement property received is substantially the same property as identified where the identified replacement property is property to be produced, variations due to usual or typical production changes are disregarded. If substantial changes are made in the property to be produced after identification, the replacement property is not considered to be substantially the same property as identified. Treas. Reg./1.1031(k)-1(e)(3)(i).
- iv. If the identified replacement property is personal property to be produced, the replacement property received will not be considered to be substantially the same property as identified unless the

production of the replacement property received is completed on or before the date the replacement property is received by the taxpayer. Treas. Reg./1.1031(k)-1(e)(3)(ii).

- v. If the identified replacement property is real property to be produced and the production of the property is not completed on or before the date the taxpayer receives the replacement property, the property to be received is considered to be substantially the same property as identified only if, had the production been completed on or before the date the taxpayer receives the replacement property, the property received would have been considered to be substantially the same property as identified. Even so, the property received is considered to be substantially the same property as identified only to the extent the property received constitutes real property under local law. Treas. Reg./1.1031(k)-1(e)(3)(iii).

- d. The transfer of relinquished property is not within the provisions of Section 1031 if the relinquished property is transferred in exchange for services (including production of services). Thus, any additional production occurring with respect to the replacement property after the property is received by the taxpayer is not treated as the receipt of property of a like kind. Treas. Reg./1.1031(k)-1(e)(4).
- e. To qualify improvements to be produced for Section 1031(a) treatment, the taxpayer should have the improvements constructed by the transferor of the replacement property before the transfer takes place (though the transferor of the replacement property is unlikely to take this risk), or by the QI or the EAT (in a reverse exchange) before the property is transferred to the taxpayer. See Coastal Terminals, Inc. v. U.S., 320 F.2d 333 (C.A. 4,1963). In any event, the production must be completed before the transfer, or only so much of the production as is completed before the transfer to the taxpayer

will qualify for like kind exchange treatment.

- f. Exchange of real estate owned by the taxpayer for improvements on land owned by the taxpayer does not qualify for like kind exchange treatment. See Section 2.05 of Rev. Proc. 2004-51, 2004-\_\_\_\_\_ C.B. \_\_\_\_\_, which modifies Rev. Proc. 2000-37.
- g. Improvements completed after the taxpayer takes title to the property does not qualify for like kind exchange treatment. Bloomington Coco Cola Bottling Co. v. Commissioner, 189 F.2d. 14 (C.A. 7, 1951). Thus, as noted, the improvements must be completed before the taxpayer acquires the replacement property.
- h. Case law may be of some help in build to suit matters if the tests under the regulations for forward or delayed exchanges can be met, or if the tests under Rev. Proc. 2000-37 and Rev. Proc. 2004-51 are met.
  - i. J.H. Baird Publishing Company v. Commissioner, 39 T.C. 608 (1962) (Improvements made by an accommodation party before the taxpayer acquired the replacement property and disposed of relinquished property).
  - ii. Coastal Terminal, Inc. v. U.S., 320 F.2d 333 (C.A. 4, 1963) (Transferor of replacement property purchased the replacement property and constructed improvements on the replacement property and then transferred the replacement property and the improvements to the taxpayer)
  - iii. Boise Cascade Corp. v. Commissioner, T.C. Memo 1974-315 (Purchaser of replacement property constructed improvements on the property and then exchanged it to the taxpayer).

## 7. FRACTIONAL INTERESTS

a. Tenant In Common. Rev. Proc. 2002-22, 2002-1 C.B. 733, superseding Rev. Proc. 2000-46, 2000-2. C.B. 438, provides conditions under which the Service will consider a request for a ruling that co-owners in rental real estate will be treated as tenants in common ( TIC ) and not as partners in a partnership. TIC interests in real property are like kind property with other real property interests and thus qualify for like kind exchange treatment under Section 1031. Partnership interests, on the other hand, do not qualify as like kind property under Section 1031. An issue for planners sometimes is to see how many TIC owners a property can have before the agreements necessary to manage the property and deal with the TIC owners cause the arrangement to cross the line and constitute a tax partnership (meaning that the participants own partnership interests and not TIC interests for tax purposes). (This issue also arises when there are, for example, two owners of real property, one of whom want to do an I.R.C./ 1031 exchange and the other of whom wants to sell for cash.) The Revenue Procedure sets forth guidelines which, if followed, assure the taxpayer that the TIC interest replacement will not be characterized as a partnership interest. Note that the Rev. Proc. applies to co-ownership of rental real property in an arrangement classified under local law as tenancy-in-common

i. 14 major tests to qualify TIC interest as replacement property.

1. TIC Ownership. Each of the co-owners must hold title to the property (either directly or through a disregarded entity) as a TIC under local law. Thus, title to the property as a whole may not be held by an entity recognized under local law (such as a corporation or partnership).
2. Number of Co-Owners. The number of co-owners must be 35

persons or less.

3. Non-Entity Treatment. The co-ownership must not be treated as an entity, may not file a corporate or partnership return, or hold themselves out as stockholders or partners or members of a business entity.
4. Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that runs with the land.
5. Voting. The co-owners must retain the right to approve the hiring of any manager, sale or disposition of the property, any leases of all or a portion of the property, or the creation or modification of a blanket lien.
6. Restrictions On Alienation. Each co-owner must have the rights to transfer, partition and encumber the co-owner s undivided interest in the property without the approval of any person.
7. Sharing Proceeds And Liabilities of Sale. If the property is sold, any debt received by a blanket lien must be satisfied and the remaining sales proceeds distributed to the co-owners.
8. Sharing of Profits and Losses. Each co-owner must share in all revenues generated by, and costs incurred with respect to, the property in proportion to the co-owner s undivided interest in the property.
9. Sharing of Debt. Co-owners must share indebtedness secured by a blanket lien in proportion to their undivided interests.

10. Options. A co-owner may issue an option to purchase the co-owner's undivided interest (a call option), but may not acquire an option to sell the co-owner's undivided interest to another co-owner, or the lender (a put option).
  11. No Business Activity. The activities of the co-owners must be limited to those customarily performed in connection with the maintenance and repair of the property. The co-owners must not, however, engage in any business activity with respect to the property.
  12. Management and Brokerage Agreements. The co-owners may enter into management or brokerage agreements.
  13. Leasing Arrangements. All leasing arrangements must be bona fide lease for Federal tax purposes.
  14. Loan Agreements. The lender on debt encumbering the property may not be a related person to any co-owner, the manager or the lessee of the property.
- ii. Result. Where the guidelines of Rev. Proc. 2002-22 are met, the taxpayer may acquire a TIC interest as replacement property.
  - iii. Multiple properties. The Rev. Proc. also applies to multiple properties. Where multiple parcels of property owned by co-owners are leased to single tenant pursuant to a single lease agreement and any debt of one or more co-owners is secured by all of the parcels, the Service will generally treat all of the parcels as a single property. To so qualify, the following three tests must be met.

1. Each co-owner's percentage interest in each parcel must be identical to the co-owner's percentage in every other parcel.
2. Each co-owner's percentage interest in the parcels may not be separated and traded independently.
3. The parcels of property are properly viewed as a simple business unit.

Contiguous parcels are generally treated as comprising a single business unit. But even if the parcels are not contiguous, the Service may treat multiple parcels as comprising a single business unit where there is a close connection between the business use of one parcel and the business use of another parcel. For example, an office building and a garage that services the tenants of the office building may be treated as a single business unit even if the office building and the garage are not contiguous. Thus, it would appear that unless multiple properties are treated as a single business unit, a TIC interest in multiple properties will be treated as an interest in a partnership.

iv. Result. If the above rules are met, it would appear that the Service will not deem a TIC interest to be a partnership interest for Federal tax purposes.

- b. Delaware Statutory Trust. Rev. Rul. 2004-86, 2004-\_\_\_\_ C.B. \_\_\_\_\_ addresses the issue of whether a Delaware Statutory Trust ( DST ) is a disregarded entity for purposes of the first test of Rev. Proc. 2002-22, supra, and whether an interest in a DST constitutes an interest in a partnership. Based on the terms of the trust, the Service held that the trust was an entity separate from its owners, was a grantor trust (in this case the beneficiary of

the grantor trust was treated as the owner of the trust and its assets) and not a business entity, and therefore could be treated as a disregarded entity for Federal tax purposes. For federal income tax purposes, the income and expenses of a grantor trust are passed through to the owner of the trust. The trust is thus disregarded for federal income tax purposes. Accordingly, the exchange of real property by two taxpayers for all of a third taxpayer's interest in a DST through a qualified intermediary qualifies for nonrecognition of gain or loss under Section 1031.

- c. In PLR 200513010 the Service found that a taxpayer's co-ownership arrangement satisfied all the tests set forth in Rev. Proc. 2002-22. Accordingly, based on the facts of the ruling, the Service concluded that an undivided fractional interest in rental real property does not constitute an interest in a business entity for purposes of qualifying the undivided fractional interest as eligible replacement property under Section 1031.
- d. Election Out of Subchapter K. Notice 2004-53, 2004- \_\_\_\_ C.B. \_\_\_\_\_. The Service is reconsidering its position that individuals who own investment property through a state law entity may elect out of Subchapter K. The Service is soliciting comments whether the provisions of Treas. Reg. / 1.761-2(a)(2) regarding election out of Subchapter K should be revised, modified or clarified.

## 8. PRINCIPAL RESIDENCE

- a. Section 121(d) was added to the Code by Section 840 of the American Jobs Creation Act of 2004 (Pub. L. 108-357). It provides that if a taxpayer acquires property in an exchange to which Section 1031 applies, the principal residence exclusion rules of Section 121 will not apply if the sale or exchange of the property occurs during the five year period beginning on the date of the acquisition of the property. This provision is effective for sales or

exchanges after October 22, 2004.

- b. A technical corrections tax bill was introduced in the House and Senate on July 22, 2005, in response to issues raised by the American Jobs Creation Act of 2004. One of the proposed corrections pertains to the sale of a principal residence following a like kind exchange. The proposed provision clarifies that the exclusion of all or some of the gain realized from the sale of a principal residence under Section 121 is denied to a taxpayer who did not recognize gain under Section 1031 on the exchange in which the residence was acquired (or by a person whose basis in the residence is determined, in whole or in part, with reference to the basis of the residence in the hands of the taxpayer).
- c. Neither Sections 121 nor 1031 addresses the application of both provisions to a single exchange of property.
- d. Rev. Proc. 2005-14, 2005-7 I.R.B. \_\_\_\_ was issued to apply to taxpayers who exchange property that satisfies the requirement for both the exclusion of gain from the exchange of a principal residence under Section 121 and the nonrecognition of gain on the exchange of like-kind properties under Section 1031. Thus, Rev. Proc. 2005-14 applies only to taxpayers who satisfy the held for productive use in a trade or business or for investment requirement of Section 1031(a)(1) with respect to the relinquished business property and the replacement business property. Where applicable the taxpayer may apply both the exclusion of gain from the exchange of a principal residence under Section 121 and the nonrecognition of gain from the exchange of like-kind properties under Section 1031 to an exchange of property. The Rev. Proc. gives six (6) examples.

## 9. INSTALLMENT REPORTING

- a. Rev. Rul. 2003-56, 2003-2 C.B. 249. If a partnership enters into a like kind exchange in which property subject to a liability is transferred in one taxable year of the partnership and property subject to a liability is received in the following taxable year of the partnership, the liabilities are netted for purposes of Section 752. Any net decrease in a partner's share of partnership liability is taken into account for purposes of Section 752(b) in the first taxable year of the partnership, and any net increase in a partner's share of partnership liability is taken into account for purposes of Section 752(a) in the second taxable year of the partnership. Cash boot is taxable in the year received. Treas. Reg./1.1031(k)-1(j)(2).
  
- b. Smalley v. Commissioner, 116 T.C. 450 (2001). Taxpayer does not have to recognize income in 1994, the year it sold timber cutting rights on its land in exchange for fee simple interests in three parcels of real property which it received in 1995, since the taxpayer had a bona fide intent to enter into a deferred like kind exchange. The fact that the transferee's obligation to convey the replacement property is secured by cash or cash equivalent is irrelevant if the cash or cash equivalent is held by a qualified intermediary, provided the taxpayer had a bona fide intent to enter into a deferred exchange of like kind property at the beginning of the exchange.
  
- c. In using installment sales, do not forget to review Sections 453 and 453A regarding installment sales, and Treas Reg./1.1031(k)-1(j)(2) which provides for coordination between Sections 1031 and 453.

#### 10. EXTENSION OF TIME IN DEFERRED EXCHANGES

- a. Rev. Proc. 2001-53, 2001-2 C.B. 506. The 45 day identification rule and 180 settlement rule may be extended for taxpayers affected by a presidentially declared disaster, or terrorist or military action or individual serving in the armed forces in a combat zone.

- b. Rev. Proc. 2004-13, 2004-\_\_\_\_ C.B. \_\_\_\_\_. Reaffirms Rev. Proc. 2001-53, supra, and supplements the list of acts that are automatically postponed under Section 7508 (of which like kind exchanges are not one). Extensions under Rev. Proc. 2004-13 are not automatic, as they are under Section 7508, but are dependent on releases by the IRS.
- c. Notice 2005-3, 2005-\_\_\_\_\_ I.R.B. \_\_\_\_\_, modifying Rev. Proc. 2004-13, applies to the 45 day identification period, 180 day exchange period, and 5 day qualified exchange accommodation period in reverse deferred exchanges to presidentially declared disasters if the IRS issues a news release regarding postponement of deadlines.
- d. Notice 2005-5, 2005-\_\_\_\_\_ I.R.B. \_\_\_\_\_, modifying Rev. Proc. 2004-13. The last day of the 45 day identification period or the 180 day exchange period is postponed, at the election of the taxpayer, by 120 days or to the last day of the general disaster extension period authorized by an IRS news release, provided certain tests set forth in the Notice are met.

## 11. MUTUAL FUND SHARES

- a. Paradiso v. Commissioner, T.C. Memo. 2005-187. Sale and purchase of mutual fund shares does not qualify as a like kind exchange under Section 1031 because Section 1031 does not apply to the sale of stock or other securities.

## 12. TOBACCO

- a. Under the Fair and Equitable Tobacco Reform Act of 2004 the tobacco marketing quota program and the tobacco price support program were terminated. The United States Agriculture Department offered to enter into a

contract with eligible tobacco quota owners under which the owners would receive \$7.00 per pound of quota in ten equal annual payments in fiscal years 2005 through 2014.

- b. For Federal income tax purposes, the payments are treated as the proceeds from a sale of the owner's tobacco quota. Gain is treated as capital gain, whereas loss is treated as an ordinary loss under Section 165.
- c. Notice 2005-57, 2005-32 I.R.B. \_\_\_\_ describes the computation of gain and loss, and the calculation of the adjusted basis of a quota.
- d. Section 11 of Notice 2005-57 provides that an owner may enter into a like kind exchange of a quota, and Section 12 of the Notice provides transitional relief to allow tobacco quota holders additional time to enter into an agreement with a qualified intermediary for like kind exchange treatment