Fundamentals of Section 1031 Tax-Free Exchanges

Principles and Practical Applications of
I.R.C. Section 1031

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About Bradley T. Borden

Brad Borden is an internationally known expert on transactional real estate and passthrough taxation and LLC and partnership law. He is a tenured professor at Brooklyn Law School and a tax lawyer. As a lawyer, he advises clients regarding tax aspects of complex transactions and ownership structures. With his focus on tax law and specific aspects of business law, he works closely with real estate and business attorneys to help ensure their clients receive critical tax-structuring advice for their transactions. He is also hired as a consultant and expert witness on complex litigation and other matters that raise tax or legal issues related to his areas of expertise. In all of these matters, he draws upon his extensive knowledge and experience as a lawyer, expert witness, consultant, author, teacher, and lecturer.

CREDENTIALS

- JD, LL.M. (Taxation)
- Certified Public Accountant
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- Fellow, American Bar Foundation
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- Columnist, Journal of Passthrough Entities
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- Member, Florida Tax Review Board of Advisors
- Past Chair, Sales, Exchanges & Basis Committee, Section of Taxation, American Bar Association
- Member, Business Law Section, New York State Bar Association
- Member, Real Property Law Section, New York State Bar Association
- Member, Tax Section, New York State Bar Association
- Member, New York City Bar Association
- Member, New York County Lawyers Association
- Author, TAX-FREE LIKE-KIND EXCHANGES – comprehensive treatise on Section 1031
- Author, LIMITED LIABILITY ENTITIES: STATE-BY-STATE GUIDE TO LLCS, LPS AND LLPS

Chapter 1: Introduction to Section 1031

The Section 1031 Exchange

Section 1031 of the Internal Revenue Code (the “Code”) allows Exchangers to maximize profit and preserve net worth by exchanging like kind property. The Section 1031 Exchange has become the tool of choice for Exchangers who wish to defer taxes on the disposition of property. Property owners, managers, and professionals, such as attorneys, accountants, financial advisors, and real estate professionals, should understand the benefits of Section 1031 and be able to identify the transactions to which it applies.

The Section 1031 Exchange is referred to by different names, such as “Like-Kind Exchange,” “Starker Exchange,” “Deferred Exchange”, “Delayed Exchange,” “Tax-Free Exchange,” “Tax-Deferred Exchange,” “Simultaneous Exchange”, “Concurrent Exchange,” “Reverse Exchange,” and “Two-, Three-, or Four-Party Exchange,” to list a few. These many different names all refer to transactions intended to qualify for Section 1031 treatment.

There are several reasons Exchangers choose to enter into a Section 1031 Exchange: (1) to obtain property with more potential to appreciate; (2) to alleviate joint tenancy or partnership problems; (3) to reduce management problems by exchanging into a management-free property; (4) to diversify properties; (5) to consolidate properties; and (6) to do estate planning. While gain is deferred in a Section 1031 Exchange, the Exchanger may avoid paying taxes on the gain at death. At death, the heirs, in most cases, will inherit the property with a stepped-up basis equal to the market value of the current property being held by the investor’s estate, avoiding gain altogether.

To defer all taxes on the disposition of property an Exchanger must purchase Replacement Property of equal or greater value. Taxes will be owed on any cash or non like-kind property received or net debt from which the Exchanger is relieved. The benefit of Section 1031 becomes apparent by comparing the results of a taxable disposition of property to the results of a Section 1031 Exchange. When a property disposes of appreciated property in a taxable transaction, the gain equals the consideration the property owner receives (i.e., amount realized) minus the property’s adjusted basis (i.e., the property’s cost minus allowable depreciation deductions). Example 1 presents the results of a taxable disposition.

Example 1:

Taxable Sale of Real Property

Allen had never heard of Section 1031 and sells his ranch. He initially bought the property for $50,000 but due to a strong market was able to sell for $250,000 cash. His adjusted basis in ranch is $50,000 (land does not qualify for depreciation deductions), and his amount realized is $250,000. He uses the cash and an additional $100,000 loan to acquire an apartment building worth $350,000.

Allen would realize (experience the economic benefit) and recognize (report on tax return) $200,000 of gain on this transaction, which he derives from subtracting the $50,000 adjusted basis from the $250,000 amount realized. Assuming the gain recognized is long-term capital gain, Allen incurs a $40,000 (gain of $200,000 × 20%) tax liability on the disposition, computed as follows.

Cash Received (Amount Realized)	$250,000
Adjusted Basis	$50,000
Gain Realized	**$200,000**
Gain Recognized	$200,000
Tax Rate	20%
Tax Owed	**$40,000**

After paying the tax, Allen would only have $210,000 of net worth, which would equal the $350,000 value of the apartment building he acquired minus the $100,000 liability and minus the $40,000 of tax he owes. Thus, his net worth decreases as a result of these transactions.

Compare that result to the result of a Section 1031 exchange presented in Example 2.

Example 2:

Tax Benefits of Exchanging Real Property

Allen's tax advisor advises him to structure the sale of his ranch as a Section 1031 Exchange. He enters into an exchange by selling his ranch (with an adjusted basis of $50,000) for $250,000, directing the buyer to deposit the Exchange Proceeds with a Qualified Intermediary (Qualified Intermediaries are discussed below). He then directs the Qualified Intermediary to use the Exchange Proceeds to acquire an apartment building worth $350,000 (Allen uses a loan of $100,000 to cover the higher purchase price). As shown in the following computation, Allen still realizes $200,000 of gain, but he recognizes none of it, so he owes no tax on this transaction.

Cash Received (Amount Realized)	$250,000
Adjusted Basis	$50,000
Gain Realized	**$200,000**
Gain Recognized	$0
Tax Rate	20%
Tax Owed	**$0**

Because Allen owes no tax on this transaction, his net worth following the exchange remains $250,000, which equals the $350,000 value of the apartment building minus the $100,000 loan to which it is subject.

These examples demonstrate the following points.

- Generally speaking, a property owner does not recognize gain on the disposition of real property if all the Exchange Proceeds are properly reinvested in Replacement Property.

- Exchange Proceeds that are not reinvested will generally result in gain recognition.

- By exchanging instead of selling, property owners can preserve net worth that would have been lost to taxes if the property had not been exchanged.

The remainder of this brochure provides an overview of Section 1031, describing the technical requirements of Section 1031 and various structures that property owners may consider to defer gain recognition on a Section 1031 Exchange.

Chapter 2: Section 1031 Tax Savings

Section 1031 provides an exception to the general rule that requires a property to pay tax on the entire amount of gain that is recognized on the sale or exchange of real property held for investment or business use. This exception to the gain recognition rule creates significant tax savings for many property owners.

Exchange or Sell?

The benefits of Section 1031 are demonstrated by comparing the tax results of a Section 1031 Exchange with a straight sale.

Example 3:

Comparison of Sale and Exchange

Exchanger owns property worth $45,000,000 with an adjusted basis of $10,000,000. For comparison purposes, assume that any gain recognized on the disposition of the property will be taxed at 20%. (A 25% tax rate applies to any unrecaptured section 1250 gain Exchanger recognizes on the sale. Alternatively, a higher rate may apply if the property has been held for less than one year or if the built-in gains tax will be imposed.)

	Taxable Sale	Section 1031 Exchange
Sale Proceeds	$45,000,000	$45,000,000
Gain	$35,000,000	$0
Tax	($7,000,000)	NONE
Available for Re-investment	**$38,000,000**	**$45,000,000**

By exchanging instead of selling the property, the Exchanger preserved $7,000,000 of net worth

Effect of Receiving Boot

If an Exchanger receives money or non-like-kind property (*i.e.*, boot) in a transaction that otherwise qualifies for Section 1031 treatment, the taxpayer may be required to recognize gain on the transaction. The amount of gain such taxpayer may be required to recognize will be equal to the amount of money or the fair market value of non-like-kind property received, but shall not exceed the gain realized. If the taxpayer is relieved of a liability as part of a transaction, such relief shall be treated as money received by the taxpayer on the exchange (see below for specials issues related to liability). The following general rules apply to exchanges that include boot.

- If gain realized is greater than boot received, gain recognized = boot received
- If boot received is greater than gain realized, gain recognized = gain realized

- Net liability relief = boot

The tax consequences of receiving boot are demonstrated in the following examples. In Example 4, the amount of boot received is less than the amount of gain realized, so the Exchanger recognizes gain equal to the amount of boot received.

Example 4:

Gain Recognized to Extent of Boot Received

Company C owns Old Building that it uses in its business. The old building is worth $25,000,000 and has an adjusted basis to Company C of $12,000,000. Company C wants to sell the Old Building and buy a New Building worth $20,000,000. Thus, Company C will receive $5,000,000 on the transaction. The transaction will obtain the following tax results:

Value of New Building	$20,000,000
Cash Boot	$5,000,000
Amount Realized	$25,000,000
Adjusted Basis of Old Building	$12,000,000
Gain Realized	**$13,000,000**
Boot Received	$5,000,000
Gain Recognized	$5,000,000
Gain Deferred	$8,000,000

Because the amount of cash boot is less than the amount of gain realized, the taxpayer must recognize gain equal to the amount of cash boot received (i.e., $5,000,000). The gain deferred is $8,000,000..

In Example 4, gain realized is greater than the boot received, so the Exchanger recognizes gain equal to the amount of boot received. In Example 5, the amount of boot received is greater than the amount of gain realized.

Example 5:

Gain Realized is Fully Recognized

Company D owns Old Building that it uses in its business. Old Building is worth $25,000,000 and has an adjusted basis to Company D of $22,000,000. Company D wants to sell Old Building and buy New Building worth $20,000,000. The transaction will obtain the following tax results:

Value of New Building	$20,000,000
Cash Boot	$5,000,000
Adjusted Basis of Old Building	$22,000,000
Gain Realized	**$3,000,000**
Boot Received	$5,000,000
Gain Recognized	**$3,000,000**

Because the gain realized is less than the amount of cash boot received, the taxpayer must recognize gain equal to the gain realized (i.e. $3,000,000). As a general rule, there is no tax deferral in an exchange unless the Replacement Property costs more than the adjusted basis in the old property. In this example the replacement property was $2,000,000 less than the adjusted basis in the old building, therefore, no deferral of gain.

Loss Disallowed

Although realized gain must be recognized if boot is received, loss is not allowed in the like-kind exchange context even though boot may be received.

Basis and Adjustments (Mechanics of Gain Deferral)

Exchangers shall take a basis in Replacement Property equal to the adjusted basis the Exchanger had in Relinquished Property. The adjusted basis is decreased by the amount of money received in the exchange, increased by any gain recognized, and decreased by any loss recognized. If other property is received, the adjusted basis of the Relinquished Property is allocated among the properties received. Any non like-kind property is assigned a basis equal to its fair market value. Example 4A illustrates how the basis of the Relinquished Property carries over to the basis of the Replacement Property, deferring the unrecognized gain.

Example 4A:

Basis Carryover with Boot Received

Thus in Example 4, Company C would have a basis in New Building of $12,000,000 determined as follows:

Adjusted Basis in Old Building	$12,000,000
Plus Gain Recognized	$5,000,000
Less Money Received	($5,000,000)
Basis in New Building	**$12,000,000**

The effect of adjusting the basis is that any unrecognized gain is deferred until the Replacement Property is subsequently disposed of. Thus, in Example 4, although the taxpayer recognizes only $5,000,000 of the $13,000,000 realized gain at the time the exchange occurs, the taxpayer will recognize the remaining $8,000,000 when the new building is subsequently disposed of in a taxable transaction.

Because the New Building is worth $20,000,000 with a basis of only $12,000,000 immediately following the exchange, the deferred gain is $8,000,000.

Exchanges Involving Liabilities

Exchanges involving liabilities require special consideration. Incorrectly structured exchanges involving liabilities may cause the Exchanger to recognize gain.

Liability Relief Treated as Cash Received

If the Exchanger transfers property subject to a liability or if an Exchanger's liabilities are assumed as part of the transaction, the liabilities from which the Exchanger is relieved shall be treated as money received by the Exchanger. In Example 6, the Exchanger has liability relief that exceeds gain realized, so the Exchanger recognizes all of the gain realized.

Example 6:

Liability-Relief Boot

Company E owns Property A worth $20,000,000. The property has an adjusted basis in the hands of Company E of $12,000,000 and is subject to a $10,000,000 mortgage. Company E transfers Property A to an unrelated third party in exchange for Property B, which is worth $10,000,000. The third party also assumes the $100,000 mortgage. The assumption of the mortgage by the third party is treated as cash received by Company E. Therefore, Company E is required to recognize a gain of $8,000,000 on the transaction, computed as follows:

Amount Realized Property B	$10,000,000
Liability Relief	$10,000,000
Total amount realized	$20,000,000
Adjusted Basis of Property A	($12,000,000)
Gain Realized	**$8,000,000**
Boot (amount of liability relief)	$10,000,000
Gain recognized (lesser of gain realized or boot)	**$8,000,000**

Company E has boot equal to its $100,000 of liability-relief boot, but its $80,000 of gain realized is less than the boot, so it recognizes all of the gain realized.

Assumption of Liabilities Offsets Liability Relief

If the Exchanger receives property subject to a liability or the Exchanger assumes liabilities in the exchange, the liabilities so assumed will offset liabilities from which the Exchanger is relieved. Example 7 demonstrates how acquiring Replacement Property subject to liability offsets liability relief to reduce or eliminate liability-relief boot.

Example 7:

Liability-Netting Reduces Boot

Company F owns Property A worth $20,000,000, which is subject to a $10,000,000 mortgage and has an adjusted basis in Company F's hands of $12,000,000. Company F transfers Property A to an unrelated third party in exchange for Property B, which is worth $18,000,000 and subject to an $8,000,000 mortgage. Company F assumes the third party's mortgage, and the third party assumes Company F's mortgage. The mortgage Company F assumes offsets the mortgage from which Company F is relieved. Therefore, Company F is required to recognize only $2,000,000 of gain on this transaction, computed as follows:

Amount Realized Property B	$18,000,000
Liability Relief	$10,000,000
Liability assumed	($8,000,000)
Total amount realized	$20,000,000
Adjusted Basis of Property A	($12,000,000)
Gain realized	**$8,000,000**
Boot (amount of liability relief)	$2,000,000
Gain recognized (lesser of gain realized or boot)	**$2,000,000**

The $8,000,000 of liability that Company F assumes with the acquisition of the Replacement Property offsets some of its $10,000,000 of liability relief, so its liability-relief booth is only $2,000,000.

Cash Paid Offsets Liability Relief

Furthermore, cash paid by the Exchanger in a transaction offsets the amount of liability from which the Exchanger is relieved. Thus, if, as in Example 8, an Exchanger has additional capital, the Exchanger may use those funds as part of the acquisition of Replacement Property to offset liability relief and avoid boot.

Example 8:

Netting Cash Paid Against Liability Relief

Company G owns Property A, which is worth $20,000,000, has an adjusted basis to Company G of $12,000,000, and is subject to a $10,000,000 mortgage. Company G transfers Property A and $4,000,000 to an unrelated third party in exchange for Property B, which is worth $14,000,000. The third party assumes the $10,000,000 mortgage. Because the $4,000,000 Company G transfers as part of the transaction offsets the amount of liability from which it is relieved, Company G will recognize gain of only $6,000,000, computed as follows:

Amount Realized Property B	$14,000,000	
Liability Relief	$10,000,000	
Total Amount Realized		$24,000,000
Adjusted Basis of Property A	($12,000,000)	
Cash	($4,000,000)	
Total Adjusted Basis		($16,000,000)
Gain realized		**$8,000,000**

Boot (amount of liability relief)		$6,000,000
Gain recognized (lesser of gain realized or boot)		**$6,000,000**

The $4,000,000 of cash that Company G pays to acquire the Replacement Property offsets the some of its $10,000,000 of liability relief, so its liability-relief boot is only $6,000,000.

Liability Assumed Does Not Offset Cash Received

Although cash paid offsets liability relief, liability assumed does not offset cash received, as Example 9 demonstrates.

Replacement of Debt

Example 9:

Cash Received

is Always Boot

Company H owns Property A, which is worth $20,000,000 and has an adjusted basis to Company H of $12,000,000. Company H transfers Property A to an unrelated third party in exchange for Property B and $6,000,000 of cash. Property B is worth $24,000,000 and is subject to a $10,000,000 mortgage. Because the receipt of $6,000,000 of cash is not offset by the mortgage Company H assumes, Company H will recognize $6,000,000 of gain, computed as follows:

Amount Realized Property B	$24,000,000	
Cash	$6,000,000	
Liability assumed	($10,000,000)	
Total amount realized Adjusted Basis of Property A		$20,000,000 $12,000,000
Gain Realized		**$8,000,000**
Boot (amount of liability relief)		$6,000,000
Gain recognized (lesser of gain realized or boot)		**$6,000,000**

Because of the Section 1031 Exchange Requirement, any cash actually or constructively received is boot. Liability assumed does not affect that rule, so the $6,000,000 of cash that Company H receives is boot.

As these examples demonstrate, any debt encumbering Relinquished Property must be replaced by an equal amount of debt on the Replacement Property or with cash put into the transaction or a combination of both. A failure to replace the debt or invest additional cash will result in the Exchanger being treated as receiving boot.

Refinancing (Nanosecond Rule or the Buy & Refi Rule)

Borrowing against Relinquished Property before the exchange or borrowing against the Replacement Property following the exchange should not destroy the Section 1031 treatment, but there is little authority on this point. It is clear, however, if the borrowing, either before or after the exchange, is considered to be part of the exchange, the debt proceeds received by the Exchanger will be boot, most likely triggering gain recognition. To avoid that result, Exchangers and their advisors should ensure that the exchange has closed before borrowing against the Replacement Property. Tax commentators believe that exchangers can borrow against the Replacement Property immediately following the exchange, even within one nanosecond of the exchange. Thus, many commentators refer to this practice as the nanosecond rule or the buy and refi rule.

Chapter 3: Elements of a Section 1031 Exchange

To qualify for Section 1031 treatment, five general requirements must be satisfied:

1. Relinquished Property must be exchanged for Replacement Property (the "Exchange Requirement");

2. The Relinquished Property and Replacement Property must be real property (the "Real-Property Requirement");

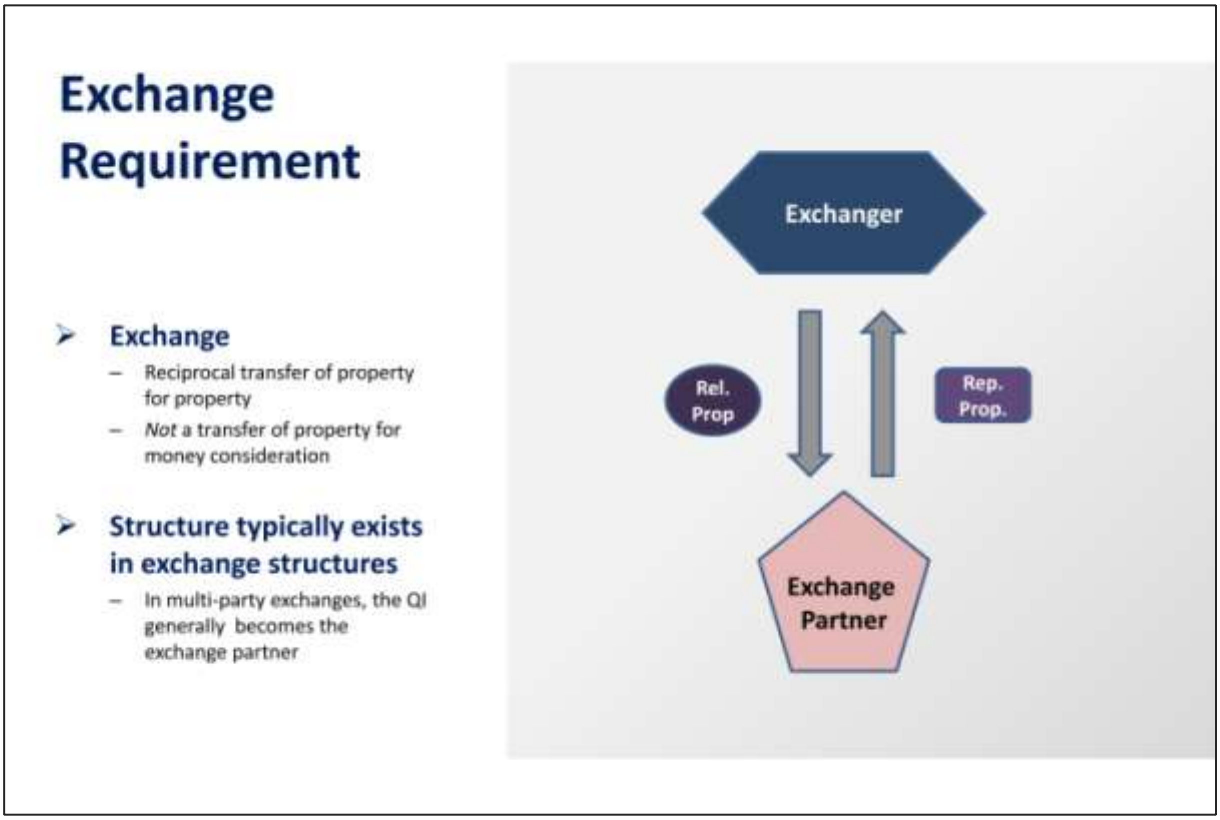
3. The Relinquished Property and the Replacement Property must be like kind (the "Like-Kind Property Requirement");

4. The Relinquished Property and the Replacement Property must be held by the Exchanger for productive use in a trade or business or for investment (the "Holding and Use Requirement"); and

5. The Relinquished Property and the Replacement Property must be qualified assets (the "Qualified-Asset Requirement").

The Exchange Requirement

An exchange is defined as a reciprocal transfer of property for property, as opposed to a transfer of property for money. Often it is necessary to involve an intermediary to ensure the exchange requirement is satisfied, especially if multiple parties are involved.



Real-Property Requirement

The Tax Cuts and Jobs Act of 2017 restricted the application of Section 1031 to exchanges of real property. Although the new law does not include a definition of real property, generally speaking, real property includes land and permanent structures.

Like-Kind Property Requirement

To qualify for Section 1031 treatment, the Relinquished Property and Replacement Property must be like kind. Most real property is like kind to other real property, with the exception of some partial interests in real property as discussed below. In all cases, like kind refers to the nature and character of the properties, not their grade or quality.

Real Property

Almost any real property is like kind to other real property. Thus, an apartment complex can be exchanged for raw land, an office building, a shopping center, another apartment complex, certain mineral interests, and most other property that satisfies the definition of real property under state law.

Natural Resources	State law determines if mineral interests are real property, but some mineral interests, even though defined as real property under state law, may not be like kind to other real property. Generally, working interests, undivided interests (perpetual mineral and royalty rights) in oil and gas deposits in place, and producing overriding royalties are like kind to fee interests in real property. In most states oil and gas in the subsurface is considered real property, but when it is brought to the surface it becomes personal property. Thus, oil payment rights probably are not like kind to other real property. Likewise, a mineral interest that is deemed to be a carve-out (see below for a discussion on carve-outs) does not qualify for nonrecognition treatment.
Water Rights	Water rights that are real property under state law are generally like kind to other real property. If the water right does not grant first priority or is not perpetual, however, it may not be like kind to other real property, even though it may be defined as real property under state law.
Leasehold Interest	In general, fee interests in real property are like kind to leaseholds of real property that have a term of 30 or more years. For this purpose, a lease with an initial term of 5 years and 5 optional renewal periods of 5 years each would qualify as like kind to other real property because the initial period and the optional renewal periods, in the aggregate, exceed 30 years.

Easements	Although it is important to look to the treatment of easements under the applicable state laws, in many cases an easement is considered like kind to other real property. State law determines whether an easement is real property. Thus, in states that treat conservation easements as real property, such easements may be exchanged for any other form of real property.
Life Estates and Remainder Interests	Generally, a life estate with an expected duration of at least 30 years is like kind to a fee estate, another qualifying life estate, and leaseholds of at least 30 years. Further, a remainder interest in one property is generally like kind to a remainder interest in another property, to a qualifying life estate, and to other real property.
Carve-Outs	As a general rule, a lease is like kind to real property only if it is being acquired. A lease, or a life estate, carved out of existing property generally does not qualify for Section 1031 nonrecognition treatment. A grant of a mineral interest is also deemed a carve-out if the grantor retains an economic interest in the property.
Foreign Property	United States property generally is not like kind to foreign property.

The Holding and Use Requirements

To qualify for Section 1031 treatment, both the Replacement Property and the Relinquished Property must be either investment property or business-use property. This requirement precludes personal use property and property held for sale from qualifying for Section 1031 treatment.

The Holding Period

Section 1031 does not impose a minimum holding period for either the Relinquished Property or the Replacement Property. Instead, courts have established that an Exchanger's intent at the time of exchange determines the use for which property is held. Thus, facts should be present at the time of an exchange to establish the requisite intent.

Business-Use Property

The Relinquished Property and the Replacement Property will satisfy the holding and use requirement if held by the Exchanger for productive use in a trade or business. Depreciable buildings and other permanent improvements used for offices and manufacturing are examples of property held for productive use in a trade or business or for investment.

Investment Property

Property held for future appreciation in market value generally qualifies as investment property. Personal-use property, such as principal residences and vacation homes, however, does not meet this requirement.

Principal Residences	Principal residences do not qualify for Section 1031 treatment because they are personal use assets. A personal residence may, however, qualify for gain exclusion under Section 121 (see discussion below).
Vacation Homes	Whether a vacation home qualifies for Section 1031 treatment depends largely on whether and how often it is used for personal use. Even if used for personal use, adjacent property may qualify for Section 1031 treatment if held for investment.

Section 121 Gain Exclusion

Section 121 allows homeowners to exclude $250,000 ($500,000 if married and filing a joint return) of gain on the sale of a principal residence. Section 121 applies only if the property has been owned by and used as the personal residence of the Exchanger for two of the five years preceding the sale of the property. The two years do not have to be consecutive. The homeowner can live in the property one year, rent it out the next, and then again move in and occupy it as a principal residence. If the ownership and use requirements are satisfied, the property can be depreciated during a rental period and still qualify for Section 121 exclusion, but depreciation generally must be recaptured in the year the property is sold. Because Section 121 provides for gain exclusion (as opposed to gain deferral) if applicable, it is preferred over Section 1031. If property has been used as a principal residence during the five years preceding the sale, the property owner should consider Section 121.

Combination of Sections 121 and 1031

If Section 121 does not apply to all or a portion of a sale of property, the Exchanger may be able to rely on Section 1031. For example, if a person sells a ranch that includes a house that the person was using as a principal residence, only a portion of the property sold may qualify for Section 121 treatment. The remaining portion may qualify for Section 1031 treatment. In such transactions the property that is part of the principal residence must be carefully distinguished from the other property. Also, the sales price and adjusted basis of the entire piece of property must be properly allocated between the residence and the other property.

Section 121 Preference

Because Section 121 is a gain exclusion provision, it provides greater tax advantages when available. Any gain eligible for Section 121 treatment is permanently excluded from income, and the sale proceeds that qualify for Section 121 treatment may be reinvested in any manner the seller deems appropriate.

Practical Application

The holding and use requirement does not require that the Relinquished Property and the Replacement Property be held for the same purpose. Therefore, the Relinquished Property could be held for investment while the Replacement Property is held for productive use in a trade or business.

Qualified-Asset Requirement

Section 1031 treatment is limited to qualified assets. A qualified asset is any real property that is not held primarily for sale.

Dealers and Developers

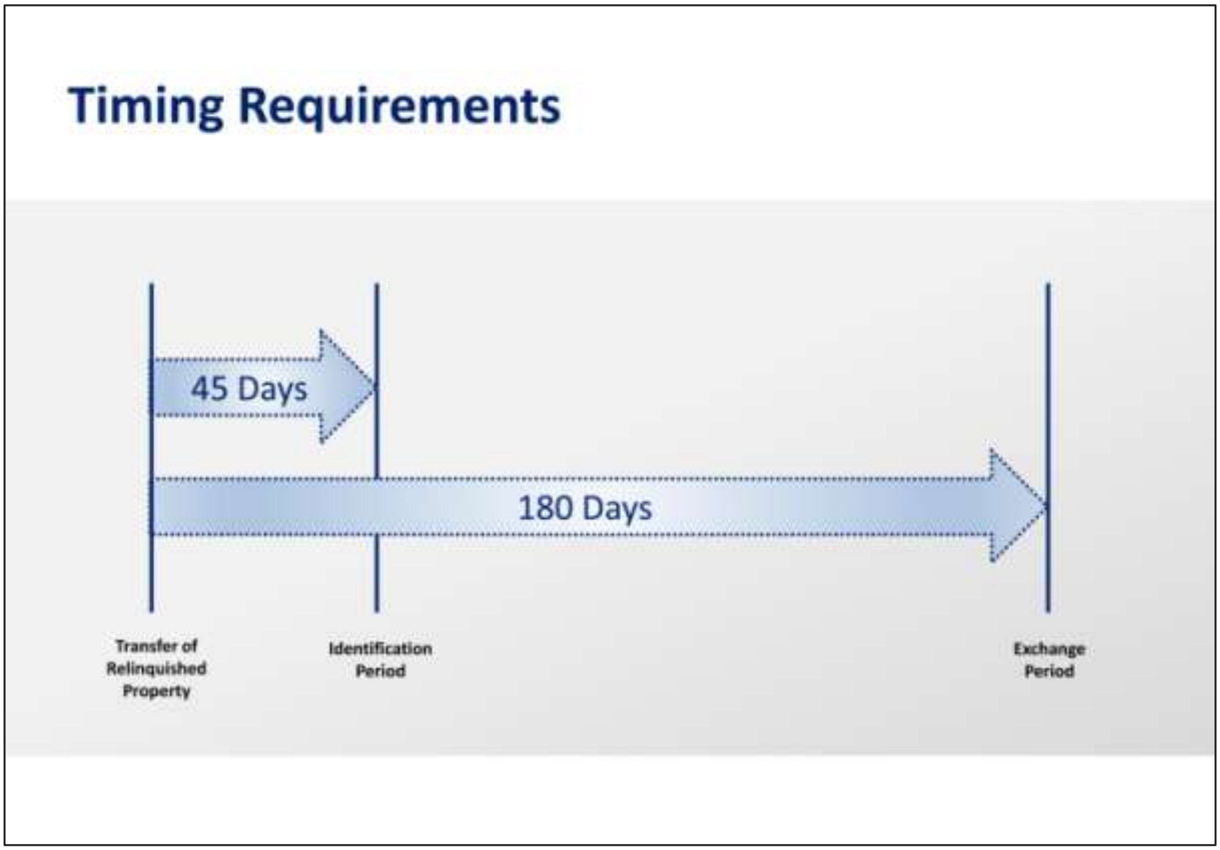
The qualified asset requirement excludes property held primarily for sale. Thus, property that is subdivided and developed before being sold often fails to qualify for Section 1031 treatment. In addition, a fixer-upper purchased and held for resale does not qualify for Section 1031 treatment. This rule also excludes property held for sale even if the property owner is not a dealer. The following factors are often used by courts to determine whether a property owner is a dealer:

- The nature and purpose of the acquisition of the property and the duration of the ownership;
- The extent and nature of the taxpayer's efforts to sell the property;
- The number, extent, continuity, and substantiality of the sales;
- The extent of subdividing, developing, and improving the property that was done to increase sales;
- The use of a business office and advertising for the sale of the property;

- The character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and
- The time and effort the taxpayer actually devotes to the sale of the property.

Chapter 4: Identification and Receipt Requirements

In addition to satisfying the four basic elements of a Section 1031 Exchange, Exchangers must properly identify Replacement Property during the Identification Period and receive the identified Replacement Property before the end of the Exchange Period. The Identification Period runs for 45 days, and the Exchange Period runs for up to 180 days. Both periods begin running when the Exchanger transfers the Relinquished Property.



The Identification Period

The Identification Period begins when Relinquished Property is transferred and ends on the date that is 45 days after the date of transfer. The Exchanger must identify Replacement Property during this

Identification Period. If the following rules are violated, the Exchanger will be treated as having identified no properties. There are four rules that govern the identification of property.

The Three-Property Rule

The Three-Property Rule allows an Exchanger to identify up to three Replacement Properties regardless of their fair market value.

The 200% Rule

The 200% Rule allows an Exchanger to identify any number of Replacement Properties so long as the total fair market value of all of the Identified Properties does not exceed 200% of the market value of the Relinquished Property. Market value of the identified Replacement Properties is determined as of the end of the Identification Period. The market value of the Relinquished Properties is determined as of the date of transfer.

The 95% Rule

If both the Three-Property Rule and the 200% Rule have been violated, the Exchanger will be treated as having identified properties if the Exchanger receives property with a value of ninety-five percent of the total market value of all identified properties. This may be difficult to achieve as a practical matter because it will require that the Exchanger invest additional funds in Replacement Property acquired during the Identification Period.

Property Received Rule

All property received prior to the end of the Identification Period will be treated as properly identified. If all Replacement Property is acquired during the Identification Period no other written identification is required. In determining whether the Three-Property Rule and 200% Rule have been violated, Exchangers must count Replacement Properties acquired during the Identification Period.

The Exchange Period

Property not acquired before the end of the Exchange Period will not be like kind to Relinquished Property. The Exchange Period begins when the Relinquished Property is transferred and ends on the earlier of

(i) the day that is 180 days after the date the Relinquished Property was transferred, or

(ii) the tax return due date for the tax year during which the Relinquished Property was transferred.

The Identification Requirement

The Regulations provide rules that must be followed in order to properly identify Replacement Property within the Identification Period. With the exception of Replacement Property received before the end of the Identification Period, all Replacement Property must be identified, in the manner described below, during the Identification Period.

Property Received Prior to the End of the Identification Period

Any Replacement Property received before the end of the Identification Period will be treated as properly identified before the end of the Identification Period.

Manner of Identifying the Replacement Property

The following rules apply to all Replacement Property not received during the Identification Period.

The Document	The Replacement Property must be designated as Replacement Property in a written document signed by the Exchanger.
The Delivery	The signed document must be either hand delivered, mailed, telecopied, or otherwise sent to an allowed recipient before the end of the Identification Period.
An Allowed Recipient	An allowed recipient is (1) the person obligated to transfer the Replacement Property or (2) any other person involved in the exchange other than the Exchanger or a disqualified person. Thus, a Qualified Intermediary may receive the identification.
Guaranteed Identification	If Replacement Property is identified in a written agreement signed by all parties to the agreement before the end of the Identification Period, such identification will satisfy these requirements.

Required Description

Any Replacement Property not received before the end of the Identification Period must be 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).

The Receipt Requirement

The Exchanger must also adhere to the rules governing the receipt of Replacement Property to qualify for like-kind exchange treatment. Property is received before the end of the Exchange Period if (1) the Exchanger receives the Replacement Property before the end of the Exchange Period and (2) the property received is substantially the same property as identified.

Example of Substantially the Same Property

The erection of a fence on unimproved land after the land is identified does not change the nature or character of the land.

Example of Property that is not Substantially the Same

Receipt of only a barn and the underlying property when the property identified was real property consisting of a barn, the underlying property, and two acres of land does not meet the receipt requirement because the property received differed in nature and character from the property transferred. The fact that the value of the two acres is only twenty-five percent (25%) of the total value of identified property is not relevant. The Exchanger must consider the nature and character of the property, and in this example, the barn is not the same nature and character as the barn and two acres.

Example of Substantially the Same Property

Receiving only seventy-five percent of the identified unimproved real property satisfied the receipt requirement. The property received was of the same nature and character as the identified property.

Identification of Property to be Produced

The Regulations provide rules that must be followed in order to properly identify Replacement Property within the Identification Period. With the exception of Replacement Property received before the end of the Identification Period, all Replacement Property must be identified, in the manner described below, during the Identification Period.

Chapter 5: Types of Section 1031 Exchanges

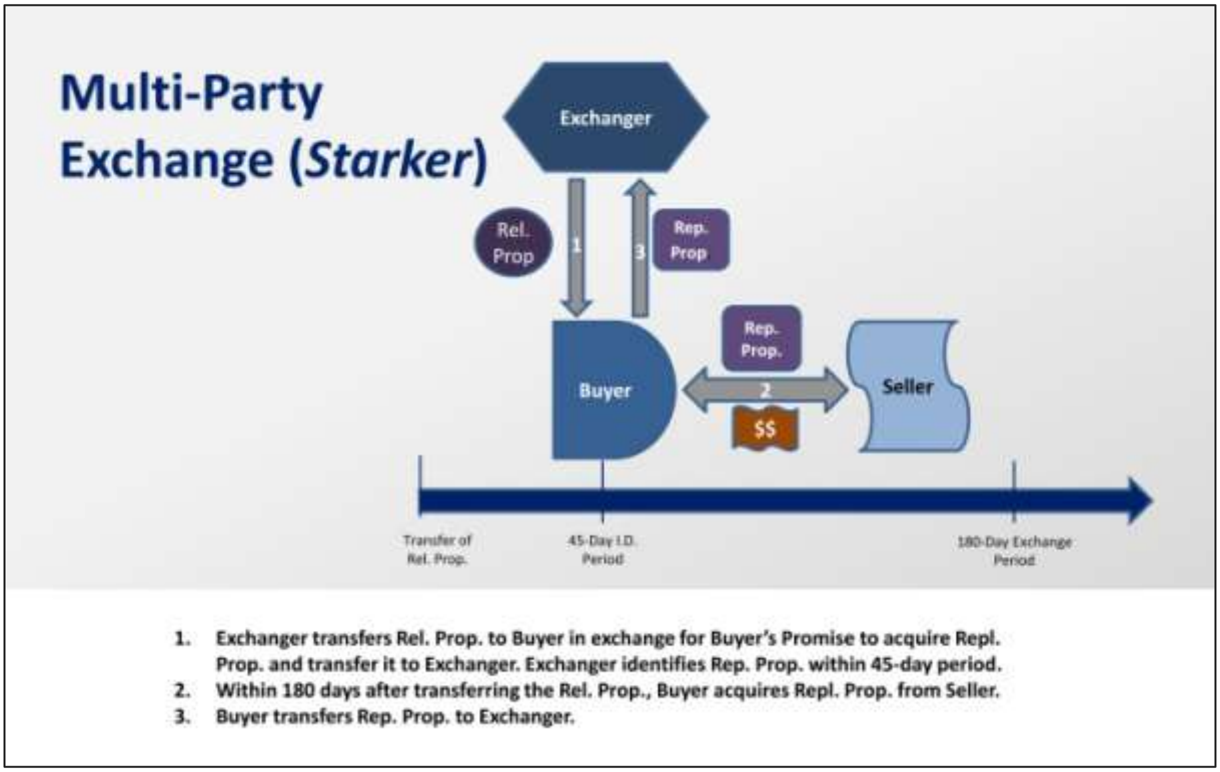
Depending on an Exchanger's situation, one of the following types of Section 1031 Exchanges may allow the Exchanger to obtain Section 1031 treatment.

Simultaneous Exchanges

While extremely rare, the simultaneous exchange is the most basic type of Section 1031 Exchange. If only two parties and two properties are involved, a simultaneous exchange can be accomplished without the assistance of an intermediary. In fact, simultaneous exchanges must be reported under Section 1031, if all other requisites are satisfied. If, however, multiple parties are involved or the exchange does not occur simultaneously, an intermediary is generally needed.

Simultaneous Multi-Party Exchanges

In most cases, the person purchasing the Relinquished Property does not have property that would be suitable as Replacement Property. In such situations, the Replacement Property must be purchased from another party. Because the purchaser of the Relinquished Property is different from the seller of the Replacement Property, the transaction is referred to as a multi-party exchange. If neither of the parties involved in a multi-party exchange agrees to facilitate the exchange, or if the taxpayer does not feel comfortable having one of the parties facilitate the exchange, a third-party intermediary should be engaged. For federal income tax purposes a Qualified Intermediary is treated as the buyer of the Relinquished Property and the seller of the Replacement Property, even though the Qualified Intermediary never takes legal title to either property. Multi-party exchanges are also known as three-corner exchanges and four-corner exchanges.



Deferred Exchanges

The normal Section 1031 Exchange does not involve the sale of the Relinquished Property closing on the same date as the acquisition of the Replacement Property. A transaction in which Relinquished Property is transferred and Replacement Property received at a later date is known as a Deferred Exchange. Such an exchange may also be referred to as a delayed exchange or a *Starker* exchange. The two crucial aspects of a Deferred Exchange are (1) satisfying the time requirements, and (2) avoiding actual or constructive receipt of the Exchange Proceeds by the Exchanger.

The Time Requirements

As stated earlier, the Replacement Property must be identified during the 45-day Identification Period and the Replacement Property must be received within the 180-day Exchange Period (modified when appropriate by the tax return due date).

Actual or Constructive Receipt

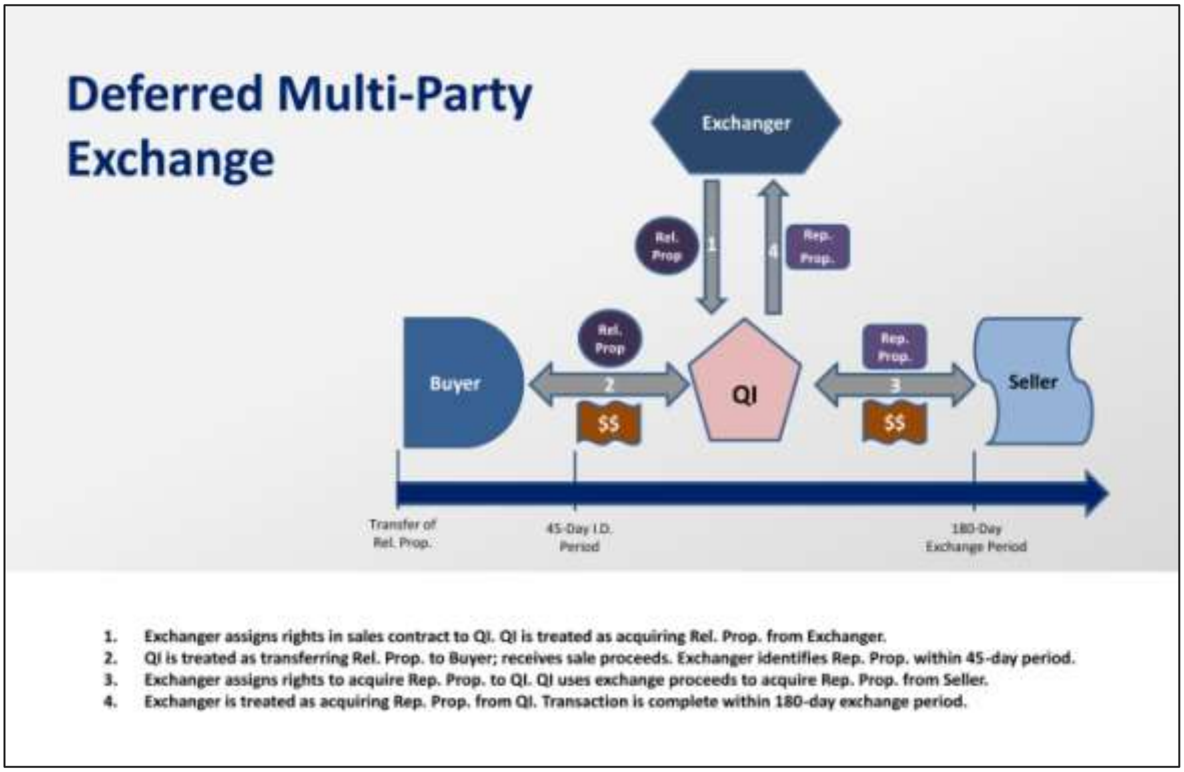
If the Exchanger obtains the unrestricted use of the Exchange Proceeds from the sale of Relinquished Property, the transition will fail to qualify for Section 1031 treatment to the extent of Exchange Proceeds received. If the Exchange Proceeds are transferred at closing to the Exchanger's agent, CPA, attorney, or a person or entity related to the Exchanger, the Exchanger will be deemed to be in constructive receipt of the Exchange Proceeds and the exchange will fail to qualify for Section 1031 treatment. Thus, a key aspect of a successful exchange is ensuring that the Exchanger is not in actual or constructive receipt of Exchange Proceeds. The most common, and often the simplest, way to avoid actual and constructive receipt of the Exchange Proceeds is to hire a Qualified Intermediary to facilitate the exchange. The Internal Revenue Service treats proceeds transferred directly to a Qualified Intermediary as being controlled by the Qualified Intermediary and out of the control of the Exchanger, so long as certain restrictions are placed on the Exchanger's access to the Exchange Proceeds. Thus, the use of a Qualified Intermediary helps the Exchanger avoid actual and constructive receipt of Exchange Proceeds.

Direct Deeding

Qualified Intermediaries generally do not take title to exchange properties during the course of Deferred Exchanges. Parking transactions, as discussed below, are the exception to this rule, as title generally is held by an entity related to the Qualified Intermediary. Typically, purchase and sale agreements or earnest money contracts are assigned by the Exchanger to the Qualified Intermediary for the sale of the Relinquished Property and the purchase of Replacement Property. Therefore, for federal tax purposes the Qualified Intermediary becomes a party to the transaction, and is treated as selling the Relinquished Property and buying the Replacement Property. Title, however, is directly deeded from the Exchanger to the buyer of the Relinquished Property and from the seller of the Replacement Property to the Exchanger. Direct deeding in this manner greatly simplifies the Exchange Process.

Deferred Multi-Party Exchanges

Deferred Exchanges typically involve multiple parties. The buyer of the Relinquished Property is different from the seller of the Replacement Property and as a practical matter, the transactions do not usually occur simultaneously. A deferred multi-party exchange generally involves a Qualified Intermediary. Through an assignment of the Exchanger's interest in the sale contract and direct deeding, the Exchanger is deemed to transfer the Relinquished Property to the Qualified Intermediary. The Exchange Proceeds are transferred to and held by the Qualified Intermediary. Because the exchange is a Deferred Exchange, the Identification Period and Exchange Period requirements must be satisfied. When the Replacement Property is acquired, the Exchange Proceeds are transferred to the seller, and through an assignment of the Exchanger's interest in the purchase contract and direct deeding, the Replacement Property is deemed to be acquired by the Qualified Intermediary and transferred to the Exchanger.



Reverse Exchanges/Parking Transactions

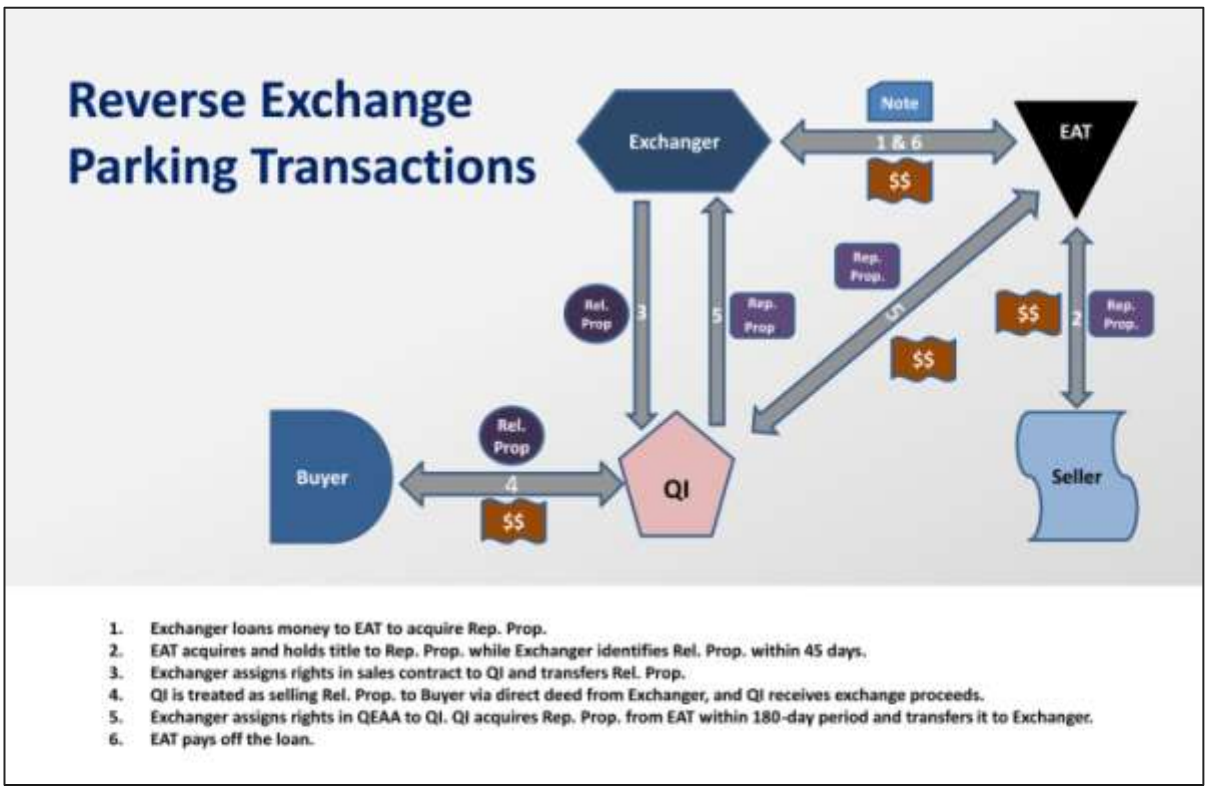
A Reverse Exchange is a transaction in which an Exchanger acquires Replacement Property before disposing of the Relinquished Property. Because there is no authoritative guidance that allows a Reverse Exchange, Exchangers began doing Parking Transactions, which have since been sanctioned by the Internal Revenue Service. In a Parking Transaction, an Accommodation Titleholder is hired to hold property until such time as the Exchanger is prepared to accomplish an exchange. If properly structured, the Accommodation Titleholder will be treated as the owner of the parked property for federal income tax purposes. This allows the Exchanger to avoid the premature receipt of Replacement Property. Two important principals govern Parking Transactions: (1) proper timing of the receipt of Replacement Property and (2) interdependence of transactions.

Timing Issues

In a Parking Transaction, the Replacement Property should be received at the same time Relinquished Property is transferred, or at a point in time thereafter that satisfies the Deferred Exchange timing requirements. Thus, an Exchanger may direct that the Replacement Property be transferred to the Accommodation Titleholder and direct the Accommodation Titleholder to hold the Replacement Property until the Exchanger is prepared to dispose of the Relinquished Property, at which time the exchange will occur (this is known as an "Exchange-Last Parking Transaction"). In the alternative, the Exchanger may acquire the Replacement Property and simultaneously transfer the Relinquished Property to the Accommodation Titleholder and direct the Accommodation Titleholder to hold the Relinquished Property until the Exchanger arranges for its disposition (this is known as an "Exchange-First Parking Transaction").

Interdependence

This requirement stems from several cases that disallowed Section 1031 treatment to transactions that involved the acquisition of one piece of property and the subsequent unrelated disposition of another piece of property. Thus, to qualify for Section 1031 treatment, the acquisition of Replacement Property and the disposition of Relinquished Property must be interdependent. Interdependence will be obtained if a transaction is carried out pursuant to the requirements in Rev. Proc. 2000-37. With such transactions, the Exchanger parks title to Replacement Property with an Exchange Accommodation Titleholder (EAT) while the Exchanger prepares to sell the Relinquished Property. The EAT may hold title for 180 days.



Rev. Proc. 2000-37

The Internal Revenue Service sanctioned Parking Transactions in Rev. Proc. 2000-37 by stating that it will treat an Accommodation Titleholder as the owner of parked property if several technical requirements are satisfied. The Accommodation Titleholder is referred to as an "Exchange Accommodation Titleholder" in Rev. Proc. 2000-37. Consequently the Accommodation Titleholder is often called an EAT.

The Requirements

The following are among the requirements in Rev. Proc. 2000-37:

- A written agreement is entered into between the Exchanger and the Exchange Accommodation Titleholder.
- The Exchange Accommodation Titleholder takes qualified indicia of ownership in the parked property (i.e., legal title or sole ownership of a disregarded special purpose entity that holds legal title).
- Exchange Accommodation Titleholder cannot hold property for more than 180 days.
- Exchanger must identify Relinquished Property within 45 days after the Exchange Accommodator Titleholder takes title to the Replacement Property.
- There are other requirements to be satisfied which are beyond the scope of this article.

Permitted Agreements

The revenue procedure permits many non-arms-length agreements, including the following:

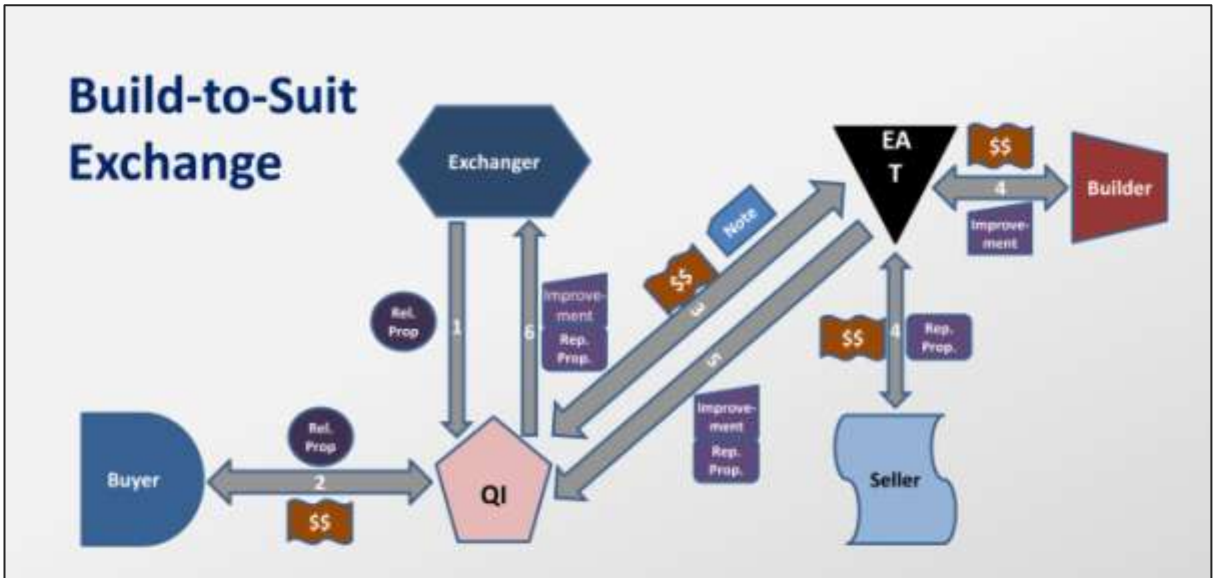
- The Exchanger may guarantee all or part of the obligations of the Exchange Accommodator Titleholder.
- The Exchanger may loan or advance funds to the Exchange Accommodator Titleholder at below-market rates.
- The Exchange Accommodator Titleholder may lease the property to the Exchanger at below-market rates.
- The Exchange Accommodator Titleholder may enter into a management agreement with the Exchanger at below-market rates.
- The Exchanger may, at below-market rates, act as contractor or supervisor with respect to the property.
- The Exchange Accommodator Titleholder and the Exchanger may enter into put and call agreements at fixed or formula prices for subsequent dispositions.

Build-to-Suit Exchanges

Also referred to as Improvement Exchanges or Construction Exchanges, Build-to-Suit Exchanges, with proper planning, allow an Exchanger to use Exchange Proceeds to construct improvements on Replacement Property or on property the Exchanger owns. In order to use Exchange Proceeds to construct improvements, the property on which such improvements are constructed must be deemed owned, for federal tax purposes, by someone other than the Exchanger. Thus, Parking Transactions are often used to accomplish Build-to-Suit Exchanges.

Construction on Replacement Property

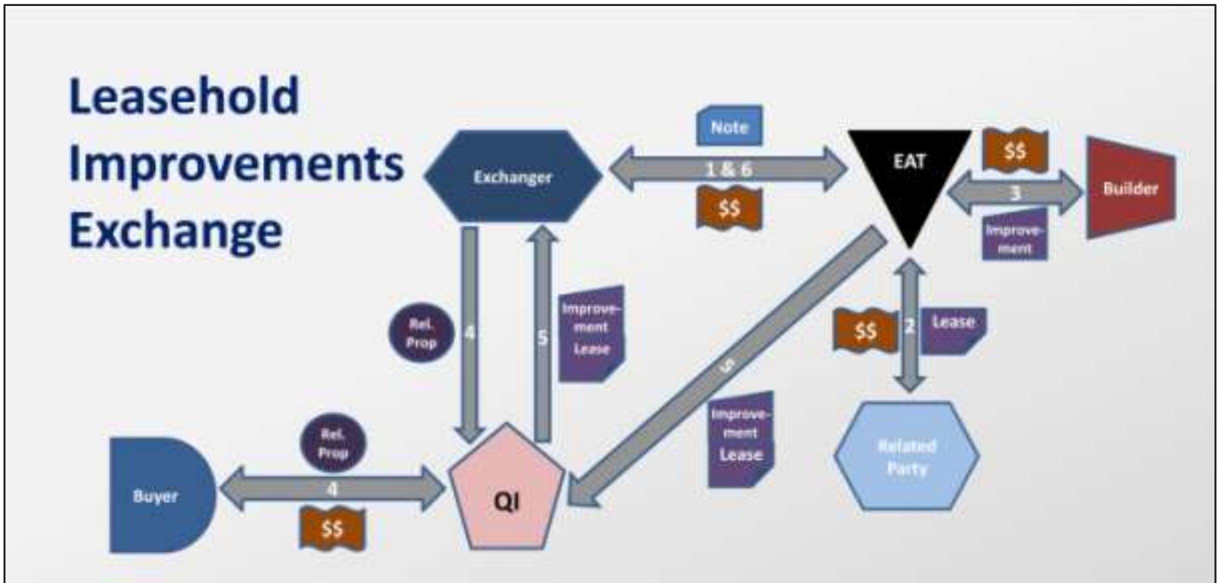
If exchange proceeds are to be used to construct improvements on Replacement Property, an Exchange Accommodation Titleholder takes title to the Replacement Property and constructs the improvements before the Replacement Property is transferred to the Exchanger. Thus, although Rev. Proc. 2000-37 is often thought of as a Reverse Exchange safe harbor, it can be used in Build-to-Suit Exchanges. In such a situation, it is not uncommon for Relinquished Property to be transferred with the proceeds going to a Qualified Intermediary. The Replacement Property is acquired by the Exchange Accommodation Titleholder and improvements are constructed while the Exchange Accommodation Titleholder holds the Replacement Property. When the improvements are completed, the Replacement Property, with improvements, is transferred to the Exchanger.



1. Exchanger assigns rights in Rel. Prop. sales contract to QI and transfers property.
2. QI is treated as selling Rel. Prop., and QI receives exchange proceeds. Exchanger identifies Rep. Prop. within 45-day ID period.
3. QI advances exchange proceeds to EAT.
4. EAT acquires Rep. Prop., constructs improvements. Exchanger identifies Rel. Prop. Within reverse exchange 45-day ID period.
5. EAT transfers improved Rep. Prop. to QI in satisfaction of note within 180 days after Exchanger transferred Rel. Prop.
6. Exchanger receives improved Rep. Prop.

Construction on Existing Property (Leasehold Improvements Exchange)

Construction on an Exchanger's existing property does not qualify for Section 1031 treatment, but an Exchanger may be able to use exchange proceeds to construct improvements on property owned by a related party. With such a transaction, a leasehold interest in the existing property must be granted to an Exchange Accommodation Titleholder while the improvements are constructed, to avoid negative consequences of the related-party rules discussed below. Once the improvements are completed, the leasehold interest with improvements is transferred to the Exchanger in exchange for the Relinquished Property. The transfer of the existing property is often accomplished through the use of a long-term lease. PLR 200251008 (a ruling obtained by the author), presents a structure for using exchange proceeds to construct improvements on a related party's property. Such transactions are complex and require careful planning, but Exchangers can invest a consider amount of exchange proceeds in the Replacement Property construction within the prescribed time limits.



1. Exchanger lends funds to EAT.
2. Related Party grants an arms-length 32-year leasehold in raw land to EAT.
3. EAT constructs improvements on the leased raw land, and Exchanger identifies Rel. Prop. within 45 days.
4. Exchanger transfers Rel. Prop., and QI is treated as selling Rel. Prop. to Buyer, and QI receives exchange proceeds.
5. QI uses exchange proceeds to purchase improved Rep. Prop. leasehold from EAT and transfer it to Exchanger.
6. EAT pays off construction loan.

Non-Safe Harbor Reverse Parking Transactions

If it appears an exchanger will not be able to dispose of Relinquished Property within 180 days after an Exchange Accommodation Titleholder takes title to Replacement Property, a Non-Safe Harbor Reverse Parking Transaction may be appropriate. Such a transaction involves the Exchange Accommodation Titleholder holding title for more than 180 days. Because this transaction does not come within the Rev. Proc. 2000-37 safe harbor, it must be structured differently than the safe harbor parking transaction. This generally requires that the Exchange Accommodation Titleholder be treated as the beneficial owner of the Replacement Property. Although many observers believe the Exchange Accommodation Titleholder must possess the benefits and burdens of property to be deemed the beneficial owner, the Tax Court adopted a formalistic approach to this matter. Under the formalistic approach, the parties can establish the Exchange Accommodation Titleholder as beneficial owner through an accommodation titleholding agreement. Exchangers structuring parking arrangements outside the safe harbor should adhere closely to the facts in the Tax Court case.

Chapter 6: Exchanges and Business Restructurings

It is not uncommon for members of a partnership or corporation to have differing objectives regarding the future use of exchange proceeds the partnership or corporation is entitled to receive upon the sale of its assets. Some members may wish to receive cash, while others may wish to reinvest the proceeds in other like property. With careful planning, the disposition of the property often may be structured in a manner that will allow all members to achieve their individual goals. Additionally, a person who has sold property that qualifies for Section 1031 treatment may wish to acquire an interest in a partnership. While this is prohibited under Section 1031, creative structuring may allow the exchanger to accomplish this same objective by acquiring Replacement Property and contributing it to a partnership. These transactions are colloquially known as drop-and-swaps and swap-and-drops.

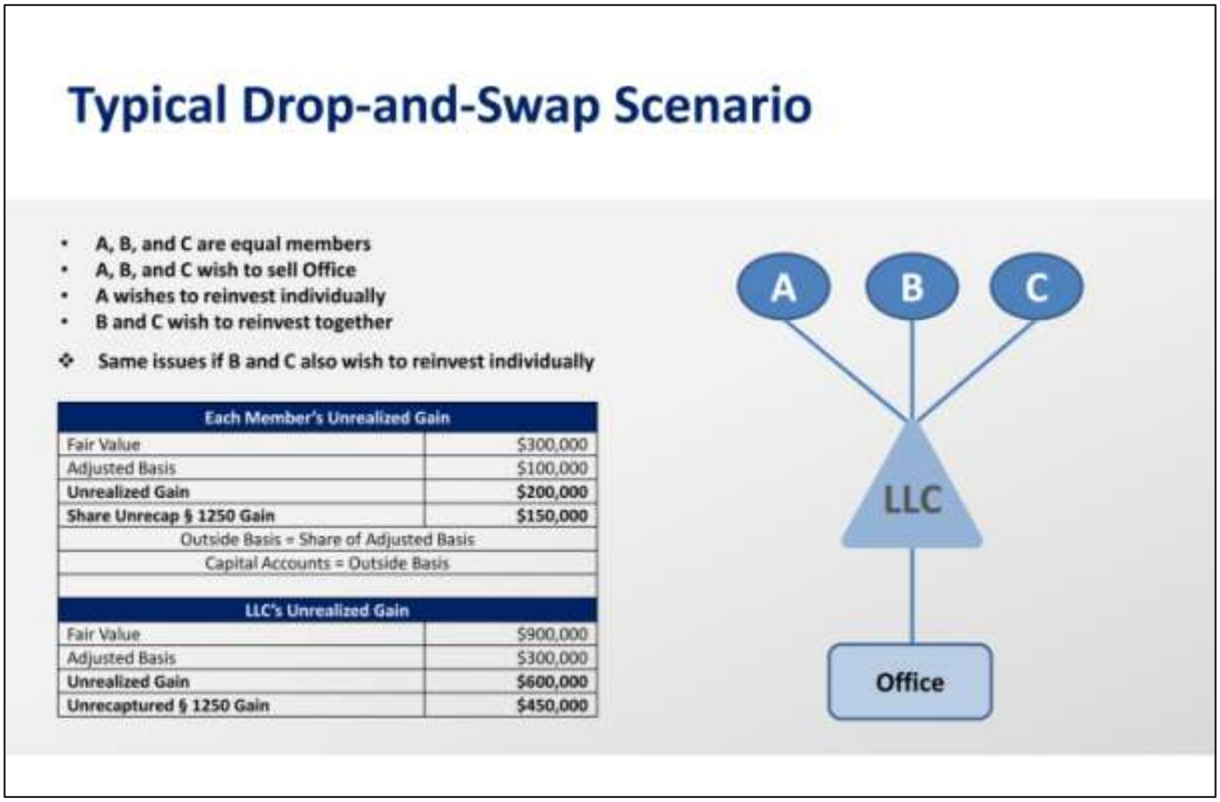
Drop-and-Swaps

Although planning opportunities exist with corporate break-ups, they raise complicated issues that are beyond the scope of this brochure. Thus, the following discussion focuses on business restructurings that involve partnerships. Anytime partnership restructurings occur in proximity to a Section 1031 exchange, care must be taken to ensure that the Section 1031 exchange is not adversely affected and that the partnership tax rules do not negatively impact the transaction. These restructurings in particular raise issues that may relate to the Exchange Requirement and the Holding and Use Requirement.

Typical Drop-and-Swap Scenario

In a typical drop-and-swap scenario, an entity owns property that one or more members wish to dispose of with the members having different objectives regarding the use of the exchange proceeds. For instance, three equal members of an LLC that owns property may wish to dispose of the property, but one member may wish to cash out while the other two members wish to reinvest the sale proceeds in like kind property, as presented in Example 10. In many drop-and-swap scenarios, the subject property is depreciable and will have unrecognized unrecaptured Section 1250 gain, which would be taxed at higher long-term capital gains rates, if the entity were sell the property in a taxable transaction.

Example 10: **Typical Drop-and Swap Scenario**	Alice, Bree, and Celeste are equal members of LLC. LLC owns Office, which is worth \$3,000,000 and has a \$1,000,000 adjusted basis. The property also has \$1,500,000 of unrecognized unrecaptured Section 1250 gain. All three members wish to sell Office, but Alice wishes to reinvest her share of the sale proceeds individually, while Bree and Celeste wish to reinvest their shares of the proceeds together. The following diagram depicts this scenario.



The parties may consider various structures for accomplishing their goals. For instance, they may choose to break up the partnership prior to doing the exchange.

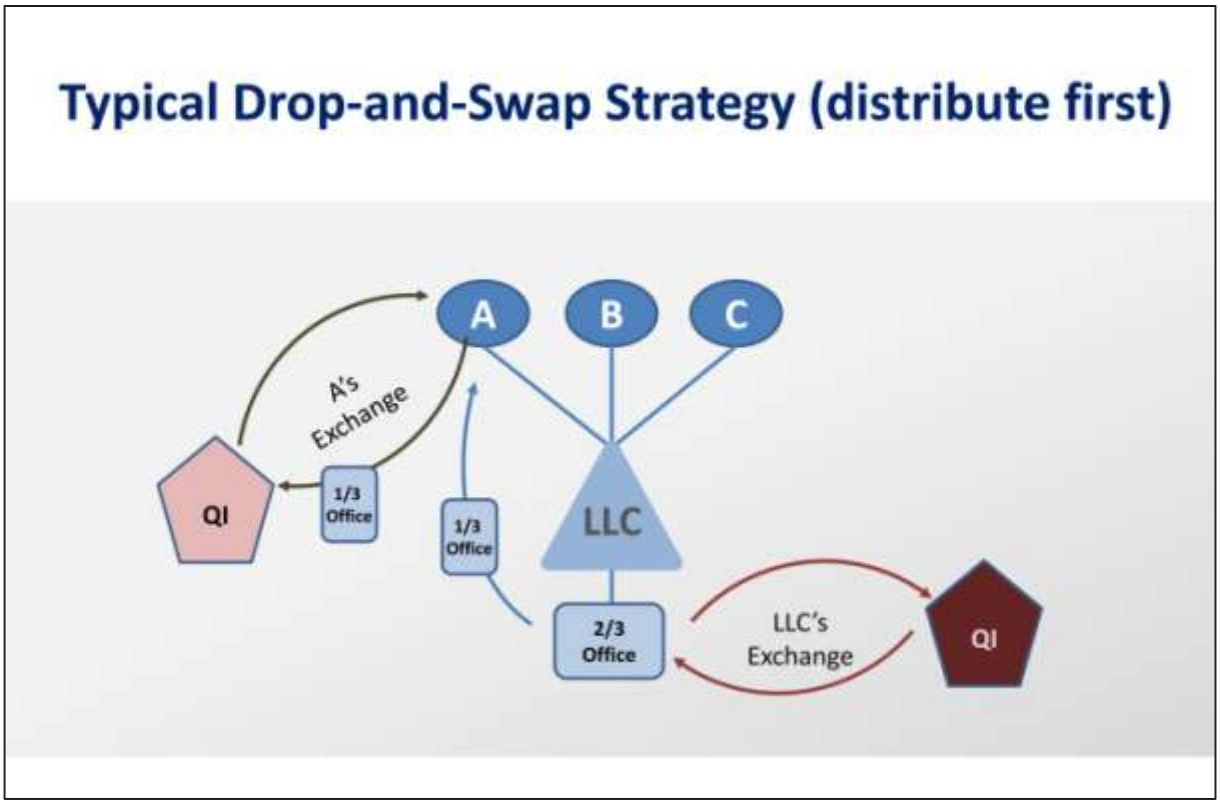
Basic Drop-and-Swap Strategy

The most fundamental drop-and-swap strategy is to break up the entity before the entity disposes of the property. If the entity owns a single property, this structure requires the entity to distribute an interest in the property to at least one of the members. After the distribution, the interest holders will sell their respective interests to the buyer and then do their respective exchanges. Example 11 demonstrates this type of transaction.

Example 11:

Basic Drop-and-Swap Strategy

Alice, Bree, and Celeste are members of LLC, which owns Office. An unrelated party has offered to purchase Office. Bree and Celeste would like to reinvest the sale proceeds in like-kind real property, but Alice would like to use her share of the sale proceeds to do her own exchange. To allow the parties to accomplish their respective objectives, the LLC distributes a one-third interest in Office to Alice in liquidation of her interest in LLC. When the buyer purchases the property, Alice does an exchange into property she will own alone, and LLC does an exchange into property that it will own. The following diagram illustrates this series of transactions.



This transaction can be somewhat complicated to carry out and raises several issues under Section 1031, but often the potential tax savings justify deploying a version of the structure.

Drop-and-swap transactions raise issues related to the Exchange Requirement, the Holding and Use Requirement, and the Real-Property Requirement. Both the entity and the distributee member generally have an interest in ensuring that the transaction satisfies the Section 1031 requirements.

Considering the Exchange Requirement

To satisfy the Exchange Requirement, the person who transfers Relinquished Property must acquire Replacement Property. A drop-and-swap will not qualify for Section 1031 treatment if the entity transfers the Relinquished Property and another person acquires the Replacement Property. Often the distribution and exchanges occur within close proximity, which leaves open the possibility that the IRS could claim that the distribution did not occur until after the entity transferred the Relinquished Property. The probability of such a challenge would appear to increase the closer the distribution is to the closing of the sale of the Relinquished Property. The probability of a challenge such as that being successful decreases, if the entity distributes the property prior to entering into an agreement to sell it. If the entity transfers the Relinquished Property but does not acquire the Replacement Property, then the entity will most likely recognize gain on the portion of the property for which it does not acquire Replacement Property.

Considering the Holding and Use Requirement

The Holding and Use Requirement mandate the distributee member becomes the tax owner of the property prior to the transfer to the buyer. This requires the distributee member to take the benefits and burdens of owning the property. A properly structured distribution will shift the benefits and burdens of ownership of the property to the distributee member. If the distributee member does not become the tax owner of the distributed interest, the entity will be deemed to transfer the interest, but most likely would not acquire the Replacement Property. Thus, the entity would most likely recognize gain, if the distributee does not become the tax owner of the property.

The Holding and Use Requirement also mandates that the distributee member hold the distributed property for investment or use in a trade or business. The distributee should be able to satisfy this requirement, but some observers will express concern that the distributee acquired the property with the intent to exchange it, not hold it for investment or business-use. In *Bolker v. Commissioner*, the Ninth Circuit provided a fairly clear statement of its interpretation of a distributee member's ability to satisfy the Holding and Use Requirement:

> **"[T]he intent to exchange property for like-kind property satisfies the [use] requirement, because it is *not* an intent to liquidate the investment or to use it for personal pursuits."**

This recognition that an Exchanger can satisfy the Holding and Use Requirement, if the Exchanger acquires property with the intent to exchange it for other property that the Exchanger will hold for investment or business-use provides strong support for an Exchanger's argument in favor the Holding and Use Requirement.

The distributee member's failure to hold the distributed interest for investment of business-use will not affect the entity's ability to do a Section 1031 exchange. The distributee member's failure to satisfy this part of the Holding and Use Requirement will only affect the distributee member's attempted Section 1031 Exchange.

Considering the Real-Property Requirement

The property the distributee member receives must be an interest in real property to satisfy the Real-Property Requirement. The hazard here is that the interest the distributee member receives could be an interest in a partnership, and not an interest in real property. For the distributed interest to be real property, it must be a tenancy-in-common (TIC) interest. Both the distributee member and the members who remain part of the distributing entity have an interest in ensuring that the ownership of the property is a TIC, and not a partnership consisting of the distributee member and the entity. If the ownership structure is such a partnership, both the distributee member will be in danger of transferring partnership interests and not real property and both could lose Section 1031 treatment.

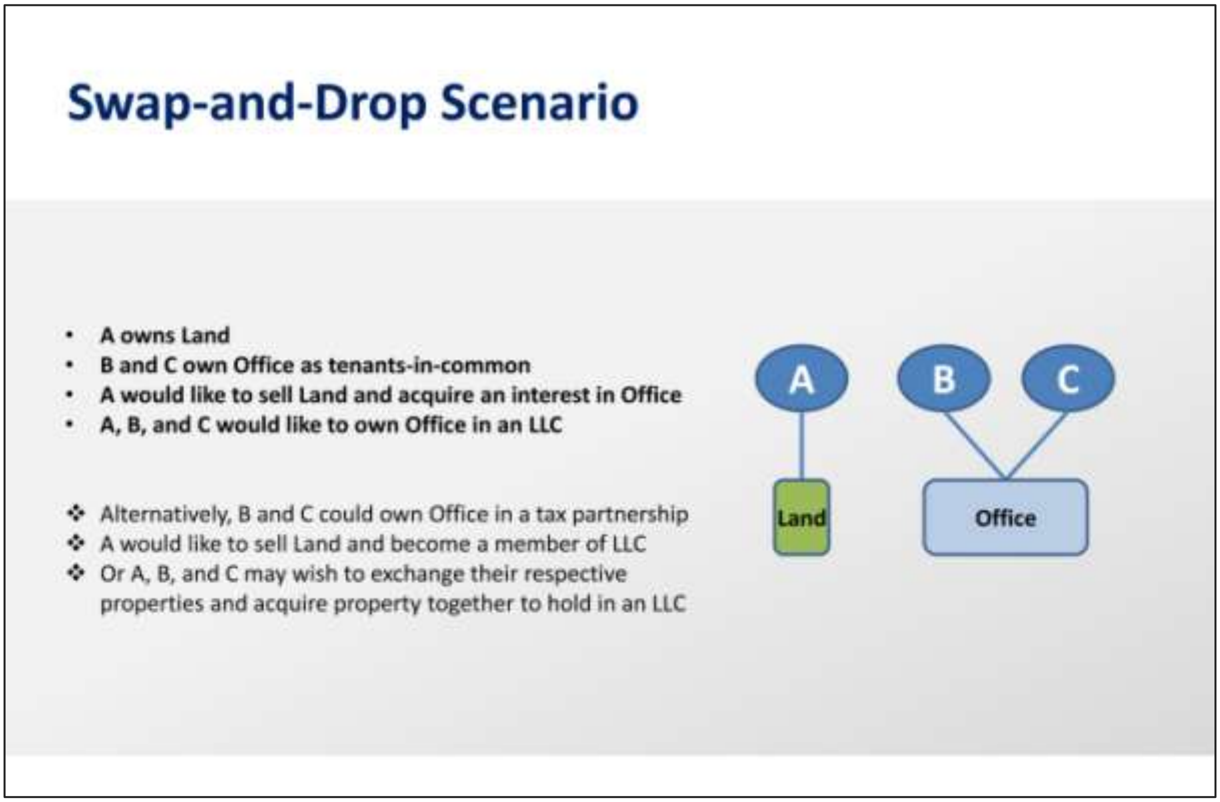
Swap-and-Drops

The inverse of a drop-and-swap is a swap-and-drop. With these transactions, one or more property owners may wish to combine their properties following an exchange.

Typical Swap-and-Drop Scenario

The typical swap-and-drop scenario includes at least one Exchanger who would complete an exchange and then contribute the Replacement Property to an entity. Example 12 presents a typical swap-and-drop scenario.

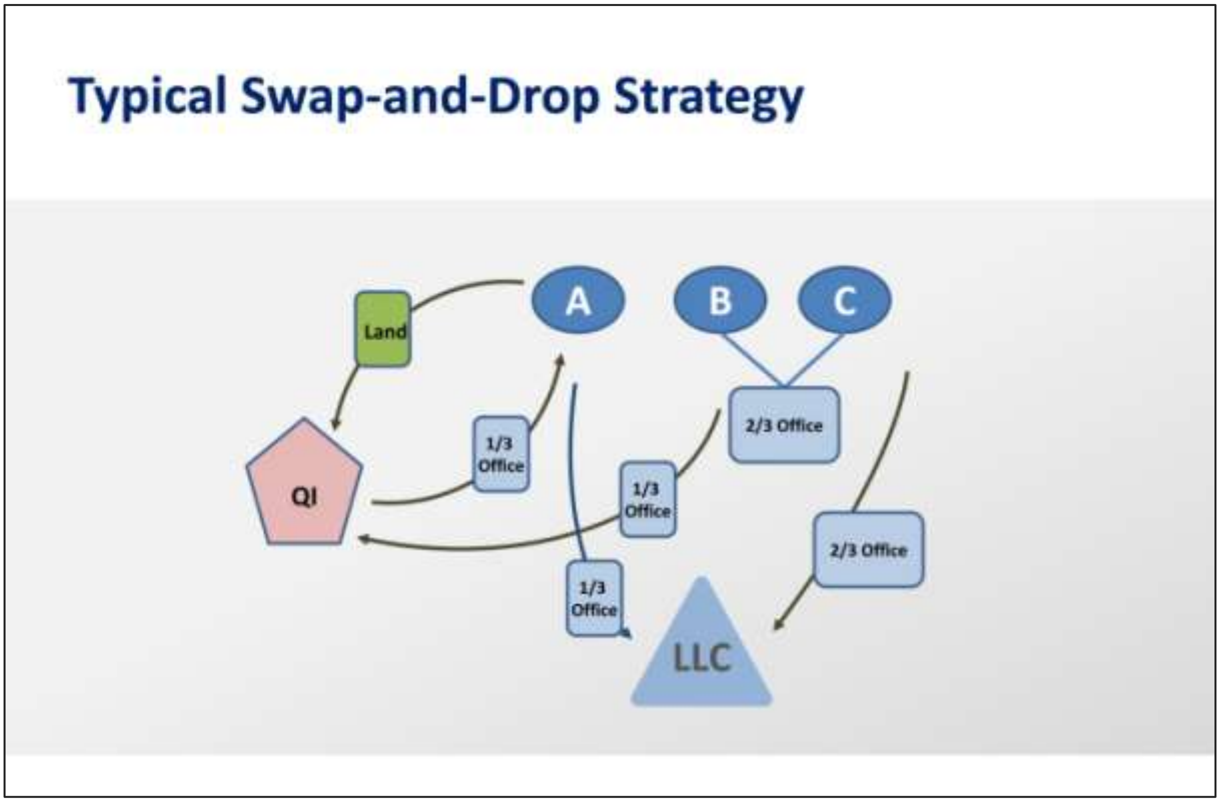
Example 12: Typical Swap -and-Drop Scenario	Astria owns Land, which she plans to sell. Bing and Cree own Office as tenants-in-common. Astria would like sell Land and acquire an interest in Office, and Bing and Cree would like to convert their ownership of Office into an LLC.



Structuring a Swap-and-Drop

If multiple Exchangers are exchanging into new property that they wish to hold collectively, they would consider completing their respective exchanges and then contributing the Replacement Properties into an entity. If one party would like to exchange into an interest in a property and then hold that property with the other owner, the Exchanger would first acquire the interest and then, as co-owners, the parties would consider whether to contribute their respective interests into an entity. Example 13 illustrates such a swap-and-drop.

Example 13: Swap-and-Drop into Property owned by a Continuing Co-Owner	Astria, Bing, and Cree agree that Astria will acquire a one-third interest in Office from Bing and Cree. Thus, Astria disposes of Land and uses the sale proceeds to acquire an undivided interest in Office. Following Astria's acquisition, the parties all contribute their interests in Office to an LLC.



As with drop-and-swaps, swap-and-drops can raise issues related to the basic Section 1031 requirements, including the Exchange Requirement, the Holding and Use Requirement, and the Real-Property Requirement. Exchangers and their advisors should consider each of these requirements as they consider and plan swap-and-drop transactions.

Considering the Exchange Requirement

With a swap-and-drop transaction, the Exchanger must transfer the Relinquished Property and acquire the Replacement Property. If the Exchanger transfers Relinquished Property, joins an entity, and the entity acquires Replacement Property, the transaction will not satisfy the Exchange Requirement. Thus, the Exchanger must exchange into other real property to satisfy the Exchange Requirement.

Considering the Holding and Use Requirement

If an Exchanger completes an exchange and immediately contributes the Replacement Property to an entity, then the Exchanger must consider whether it has acquired the Replacement Property to hold for investment or use in a trade or business. The immediate contribution to an entity may suggest that the Exchanger acquired the Replacement Property with the intent to contribute it to an entity. Nonetheless, the Ninth Circuit in *Magneson v. Commissioner* allays much of such concerns:

> **"So long as . . . the taxpayers continue to own the property and to hold it for investment, a change in the mechanism of ownership which does not significantly affect the amount of control or the nature of the underlying investment does not preclude nonrecognition under section 1031(a)."**

Contributions of Replacement Property to partnerships and LLCs could represent a change in the mechanism of ownership which does not significantly affect control or nature of the underlying investment. Thus, swap-and-drops could satisfy the Holding and Use Requirement.

To be safe, some advisors suggest that Exchangers should wait some period of time after completing an exchange to contribute Replacement Property to an entity. While delaying contributions may be viable in some situations, in others, the nature of the transaction may require immediate contribution to the entity. For instance, a lender may condition a loan on the property being held by the entity. In such situations, Exchangers will be able to rely upon careful planning and *Magneson* to argue that they satisfy the Holding and Use Requirement, if they contribute the Replacement Property to the entity shortly after the exchange.

Considering the Real-Property Requirement

To satisfy the real-property requirement, Exchangers must ensure that the interest they acquire is real property and not an interest in an entity. Thus, if an Exchanger acquires an undivided interest in Real Property, the Exchanger must ensure that the ownership arrangement of that property is a tenancy-in-common or other disregarded structure and not a partnership.

Planning and Potential Pitfalls in S-Corporation Drop-and-Swaps

S-corporations and partnerships are both passthrough entities, so federal law does not impose a tax at the entity level for either type of entity. But contributions to and distributions from S-corporations are subject to the general corporate tax rules. Consequently, S-corporation drop-and-swaps can trigger gain. Furthermore, S-corporations must allocate gain to their shareholders pro rata based upon their ownership interests. That gain increases the shareholders' bases in their stock, but a distribution of property can also trigger gain recognition to the distribute member. Thus, an S-corporation drop-and-swap can trigger gain recognition for all shareholders and may nullify the benefits of doing an exchange for the redeemed member.

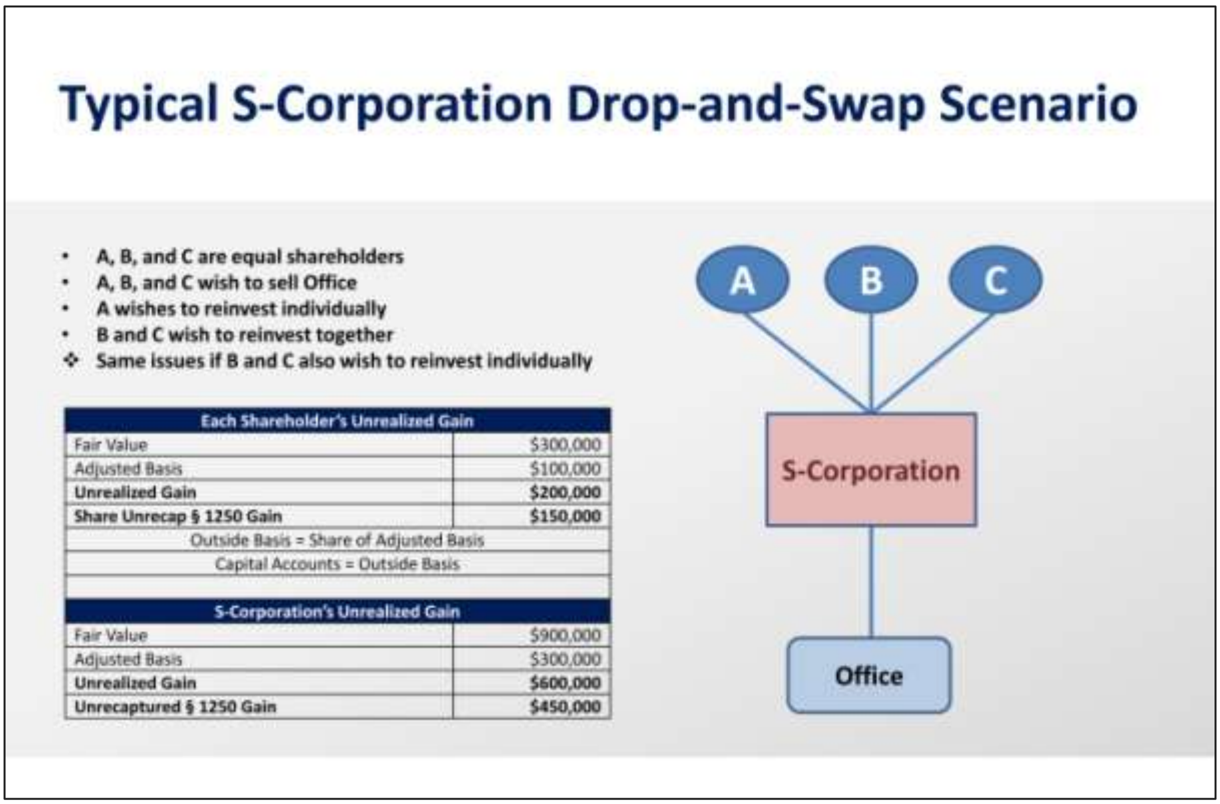
Potential Pitfalls of an S-Corporation Drop-and-Swap

The tax consequences of an S-corporation drop-and-swap create potential pitfalls for shareholders who do not properly plan for the division of an S-corporation. The gain triggered from such pitfalls may make a Section 1031 exchange futile. Examples 14 and 15 illustrate the tax futility of many S-corporation drop-and-swaps.

Example 14:

S-Corporation Drop-and-Swap Scenario

Andrea, Brianna, and Claude are equal shareholders in S-Corporation. S-Corporation owns Office, which is worth $900,000 and has a $300,000 adjusted basis. The value of each shareholder's stock is $300,000, and they each have a $100,000 basis in their stock. S-Corporation received an offer to sell Office. All three shareholders would like to sell Office and reinvest their shares of the proceeds in like-kind property as part of Section 1031 exchanges. Andrea would, however, like to split away from Brianna and Claude and use her share of the proceeds to acquire Replacement Property on her own. Brianna and Claude would like to reinvest together.



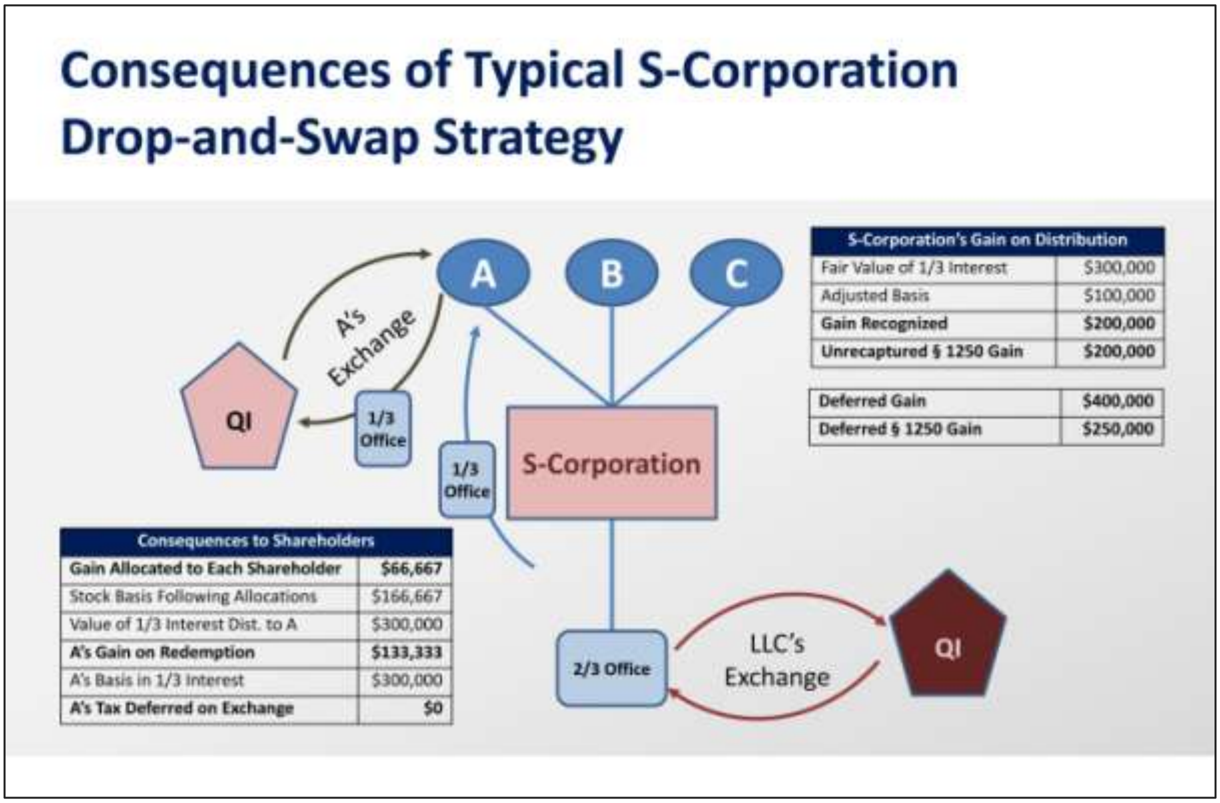
If an S-corporation simply distributes an interest in appreciated property to a departing member, the S-corporation will recognize gain on the distribution, which it must allocate pro rata to each shareholder. The redeemed shareholder will likely recognize gain on the redemption. The amount of gain that an S-corporation recognizes on the distribution of appreciated property is the difference between the property's fair market value and its Adjusted Basis. The gain that a redeemed shareholder recognizes on the receipt of distributed appreciated property equals the difference between the fair market value of the property received and the shareholder's basis in the redeemed stock. After recognizing such gain, the redeemed shareholder would have no reason to do a Section 1031 exchange, because there would be no more gain for the shareholder to defer. Example 15 demonstrates the severe tax consequences of an S-corporation drop-and-swap.

Example 15:

Consequences of an S-Corporation Drop-and-Swap

Assume Andrea, Brianna, and Claude decide that they will distribute a 1/3 interest in Office to allow her to do her own exchange. The fair value of 1/3 interest is $300,000 and it has an adjusted basis of $100,000. Consequently, S-Corporation will recognize $200,000 of gain on the distribution ($300,000 - $100,000). S-Corporation will allocate that gain equally to the shareholders, so each shareholder will report $66,667 of gain from the distribution. That allocated gain increases the basis they each have in their stock to $166,667.

Andrea will also recognize gain on the redemption of her shares. Her gain will equal the $133,333 difference between the $300,000 fair market value of the property she receives and her $166,667 basis she has in her shares. Andrea will take a $300,000 basis in the property she receives. The diagram presents the tax consequences of an S-Corporation drop-and-swap.



The diagram also illustrates the futility of an S-corporation doing a drop-and-swap under the facts presented. Because Andrea had recognized all of the unrealized gain in her S-corporation stock and share of Office on the distribution, she had no more gain to defer after she had received the interest in Office.

These examples illustrate that S-corporation drop-and-swaps can create unwanted tax consequences for all shareholders. Tax advisors must recognize that S-corporations are treated very differently from tax partnerships for purposes of drop-and-swaps. Advisors who simply tell clients that they can drop appreciated S-corporation property into an LLC and then go their separate ways with their respective LLCs, have given bad advice. Such transactions will most likely be deemed distributions of S-corporation property.

Planning to Avoid Pitfalls of S-Corporation Drop-and-Swaps

Shareholders of S-corporations and their advisors may be able to avoid the pitfalls of an S-corporation drop-and-swap by considering a tax-free corporate division, under the right conditions. Corporate divisions can take multiple forms. To obtain tax-free treatment, the divisions must satisfy numerous technical requirements. Divisions usually include one corporation (distributing) distributing stock in another corporation (controlled). Distributing may form controlled as part of the division. The following requirements are particularly relevant to Section 1031 exchanges.

Device Test

A division of an S-corporation will not be tax-free, if the shareholders use it as a device to avoid taxation. Instead of providing a definition of device, the tax regulations list the following characteristics of device: (1) a pro rata distribution of the stock of controlled to distributing's shareholders, (2) a pre-arranged sale of the distributed stock, and (3) the business operated by distributing or by controlled being one whose loss would be missed. A distribution of controlled to one shareholder who continues to own and operate controlled would appear to help the pass the device test.

Active-Conduct Test

Each newly created business must actively conduct a trade or business. A division can satisfy this requirement even if the resulting trades or businesses are the result of a former trade or business in distributing being split into one or more active trades or businesses.

Continuity of Business Enterprise

The continuity of business enterprise requirement extends the active-conduct requirement beyond the date of the division. To satisfy this requirement, a corporation must continue in a trade or business for some time after the division.

Continuity of Proprietary Interests

To have a continuity of proprietary interests some combination of shareholders that owned distributing prior to the division must maintain a stake in controlled and distributing. One shareholder could satisfy this requirement, but so could a group of shareholders. The rule does not impose a post-division overlap in ownership interests, so the rule allows shareholders to use a tax-free divisive reorganization to part ways.

These rules leave open the possibility of doing a tax-free division in proximity to a Section 1031 exchange. Such a division would require an existing S-corporation to contribute part of its property to a subsidiary corporation and then distribute the stock in that corporation to the shareholder that is splitting from the corporation. If both the distributing corporation and the controlled corporation continue to hold the exchange property in an active conduct of trade or business, the division could be tax-free.

A division of an S-corporation would be tax-free only if the corporation conducted an active trade or business, which could include managing real property. Both distributing and controlled of such a business should be able to satisfy the requirement after a division and a Section 1031 exchange, if both post-division corporations are in the active conduct of managing real property. The replacement of relinquished property through a Section 1031 exchange should not affect the ability to satisfy the requirements for a tax-free division.

One hazard of doing an S-corporation division in proximity to an exchange is that a failure of either exchange could disrupt the tax-free status of the division. For instance, an S-corporation could distribute controlled to a shareholder and then controlled and distributing both could begin exchanges. If one of the post-division S-corporations completes an exchange, but the other one does not, then they may fail to satisfy the continuity of business enterprise, which would result in the division being taxable. The resulting gain would be allocated to all pre-division shareholders of distributing, including those shareholders of a corporation that completed a post-division exchange.

S-Corporation Drop-Swap Cash-Outs

S-corporation drop-swap cash-outs also pose challenging tax problems. Such transactions occur when one shareholder of an S-corporation wishes to cash out of an investment while at least one other shareholder wishes to continue an investment in real property. If an S-corporation takes cash out of an exchange, it will be boot and trigger gain recognition at the corporate level. The S-corporation would allocate that gain to the members pro rata. A distribution of an undivided interest will also trigger gain that will be allocated to all members. Thus, the use of existing property to cash out a member will most likely trigger gain.

To avoid entity-level gain recognition on the cash-out of one or more shareholders, the S-corporation may consider borrowing against its property or the replacement property following the exchange and then distributing the loan proceeds. Borrowing is not a taxable event, so the receipt of the loan proceeds would not trigger entity-level gain. The distribution could, however, trigger gain recognition for the distributee shareholders. The parties should carefully compute the effect that avoiding entity-level gain will have on each shareholder and decide how they will divide the economic benefits that result from avoiding that gain.

S-corporations most likely cannot do tax-free divisions as part of a drop-swap cash-out. To illustrate, assume an S-corporation distributes its wholly owned subsidiary (controlled), which holds real property that the distributee shareholder plans to sell for cash, and the distributee shareholder sells the corporate assets of controlled and liquidates it. The transaction will fail to satisfy the continuity of business enterprise requirement. With that result, the distribution of controlled will trigger gain recognition at the entity level of distributing, which it will allocate to all of the shareholders of the pre-division distributing pro rata in accordance to their pre-division interests.

Chapter 7: Concurrent Ownership Structures (TICs and DSTs)

Drop-and-swaps and swap-and-drops often include undivided interests in real property. For the exchange part of such transactions, the interest must be real property and should not be an interest in a partnership. Tax law has its own definition of partnership, so even if an arrangement is not a partnership under state law, it could be a partnership for tax purposes. Taxpayers can use tenancy-in-common (TICs) or Delaware statutory trusts (DSTs) to avoid partnership treatment, but the two forms of ownership are fundamentally different. A TIC is an arrangement that does not come within the definition of a separate entity, whereas a DST comes within the definition of separate entity, but is disregarded. An exchanger who is considering acquiring a tenancy-in-common interest as part of an exchange must consider (1) the tax implications of acquiring such interest, (2) the legal obligations and restrictions that accompany such interest, and (3) the economic aspects of the interest.

Tenancies-in-Common (TICs)

A TIC is an ownership arrangement under which each co-owner can dispose of its interest in the property, partition the property, and borrow against the ownership. The federal definition of tax partnership determines whether an arrangement is a TIC or a partnership, but the IRS has provided ruling guidelines in Rev. Proc. 2002-22, that most practitioners believe function as a safe harbor. Those guidelines include the following conditions for a ruling consideration.

- **Condition 1: TIC Ownership.** The co-ownership arrangement must be a state-law TIC.
- **Condition 2: Number of Co-Owners.** The number of co-owners cannot exceed 35.
- **Condition 3: No Treatment of Co-Owners as Entity.** The co-owners cannot treat the arrangement as an entity by adopting an entity name or filing a tax return.
- **Condition 4: Co-Ownership Agreement.** The co-owners may enter into an agreement that runs with the land and may include a fair value right of first offer (ROFO) to the other co-owners.
- **Condition 5: Voting.** The co-owners must unanimously approve (1) the hiring of any manager, (2) the sale or other disposition of the property, (3) leases of any portion of the property, and (4) the creation or modification of a blanket lien.
- **Condition 6: Unrestricted Alienation.** Each co-owner generally must have the right to transfer, partition, or encumber the co-owner's interest in the property. The co-owners may, however, subject such rights to a ROFO.

- **Condition 7: Sharing Proceeds and Liabilities Upon Sale of Property.** If the co-owners sale the property, the proceeds must satisfy any blanket lien and then be distributed to the co-owners in proportion to their ownership interests.
- **Condition 8: Proportionate Sharing of Net Revenue.** Co-owners must share in revenues and costs in proportion to their ownership interests.
- **Condition 9: Proportionate Sharing of Debt.** Co-owners must share in any blanket liens in proportion to their ownership interests.
- **Condition 10: Options.** Co-owners may grant call options, but the exercise price of such options must reflect fair value.
- **Condition 11: No Business Activity.** The activities performed by co-owners and their agents with respect to the property can only include those activities customarily performed in connection with the maintenance of rental property.
- **Condition 12: Management and Brokerage Agreements.** Management and brokerage agreements must be renewable no less frequently than annually.
- **Condition 13: Leasing Agreements.** All leases must be bona fide market-rate leases.
- **Condition 14: Loan Agreements.** Lenders must be parties other than co-owners, the sponsor, the manager, any lessee, or any party related to one of those persons.
- **Condition 15: Payments to Sponsor.** Payments to the sponsor must reflect fair value for services the sponsor performs.

Delaware Statutory Trusts (DSTs)

DSTs are state law entities that provide limited liability to owners and allow for centralized management. If a DST comes within the tax definition of investment trust, it will be a grantor trust, and tax law will disregard the entity and treat the DST beneficiaries as directly owning interests in the DST. Rev. Rul. 2004-86 provides guidelines for structuring DSTs to come within the definition of investment trust.

- **Single Class of Ownership Interest.** The DST must have a single class of interest.
- **Fixed Interests.** The members' interests in the trust must be fixed with no power to vary the investment of DST's beneficiaries.
- **State Law Classification.** A DST must be a trust described in Delaware Statutory Trust Act.
- **Management.** The trust considered in Rev. Rul. 2004-86 grants the trustee limited powers. For instance the trustee cannot exchange the property, purchase other major assets, or accept additional contributions.

To ensure that a DST does not alter the members' interests, the DST must avoid most types of business transactions. To help investors and sponsors keep track of the general types of activities to avoid, the industry has developed the Seven Deadly Sins of DSTs.

Seven Deadly Sins of a DST

1. Selling and then acquiring or exchanging property
2. Purchasing assets other than short-term obligations
3. Accepting additional contributions of assets
4. Renegotiating terms of debt
5. Refinancing the debt
6. Renegotiating lease or entering into new leases
7. Making more than minor non-structural modifications to property (except as required by law)

The first deadly sin is perhaps illusory because, although a DST may not be able to sale and exchange property, the beneficiaries of the DST are treated as owning interests in the underlying property. Thus, if the DST were to sell the property, the beneficiaries could, as a continuing group, form another DST and acquire replacement property in that DST as part of a Section 1031 exchange.

Chapter 8: Related-Party Caveat

Related-Party Exchanges

Related parties may exchange properties under Section 1031, but both parties generally must hold the exchange properties for at least two years following the exchange to preserve the nonrecognition treatment. If either related party transfers exchange property within two years after an exchange, the exchange generally will not qualify for nonrecognition. Congress restricts related-party exchanges because parties could otherwise use them to exchange high-basis property for low-basis property and avoid tax on the disposition of property that would otherwise result in gain recognition.

Courts and the Internal Revenue Service have also ruled that a transaction in which the exchanger receives property from a related party indirectly through an intermediary, generally does not qualify for Section 1031 nonrecognition treatment. Property transferred to a related party indirectly through an intermediary may, however, qualify for Section 1031 nonrecognition treatment. A related party who acquires property from an Exchanger takes a cost basis in the property, so the related-party restrictions do not apply.

Definition of Related Parties

The following relationships place an Exchanger within the purview of related-party rules:

- Members of your family. This includes only your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).

- A partnership in which you directly or indirectly own more than 50% of the capital interest or the profits interest.

- A corporation in which you directly or indirectly own more than 50% in value of the outstanding stock (see Constructive ownership of stock below).

- A tax-exempt charitable or educational organization that is directly or indirectly controlled, in any manner or by any method, by you or by a member of your family, whether or not this control is legally enforceable.

- A grantor and fiduciary, or the fiduciary and beneficiary, of any trust.

- Fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.

- A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is directly or indirectly owned by or for the trust, or by or for the grantor of the trust.

- A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership.

- Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.

- Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.
- An executor and a beneficiary of an estate (except in the case of a sale or trade to satisfy a pecuniary bequest).

- Two corporations that are members of the same controlled group (under certain conditions, however, these losses are not disallowed but must be deferred).

- Two partnerships if the same persons own, directly or indirectly, more than 50% of the capital interests or the profit interests in both partnerships.

Chapter 9: The Players

A typical Section 1031 usually requires the participation of several parties.

The Exchanger

The Exchanger negotiates the sale and acquisition of all the exchange properties. In addition, the Exchanger must select a person to serve as Exchange Facilitator and the tax and legal advisors to assist with the exchange. In this process, the Exchanger will enter into several agreements with the Exchange Facilitator that are intended to create a safe harbor and to effect a deemed transfer to and from the Exchange Facilitator of all the exchange properties.

The Exchange Facilitator

The vast majority of exchanges involve an Exchange Facilitator. In 1991, the Section 1031 Income Tax Regulations were modified to include the use of a Qualified Intermediary to facilitate a tax-deferred exchange. The Qualified Intermediary is defined as a person who is not related to the Exchanger and who has not acted as the Exchanger's agent (i.e. accountant, attorney, real estate broker, or employee) within the two-year period ending on the date of the transfer of the Relinquished

Property. For determining whether the Exchange Facilitator is related to the Exchanger, the definition of related party is used, but ten percent is inserted in place of fifty percent wherever it appears. In 2000, the IRS published Rev. Proc. 2000-37 which created a safe harbor under which an Exchange Accommodation Titleholder is treated as the owner of parked property. The Exchange Accommodation Titleholder must satisfy the same requirements as a Qualified Intermediary.

The Exchange Facilitator as Intermediary

In its capacity as Intermediary, the Exchange Facilitator will receive and hold Exchange Proceeds and be assigned the Exchanger's rights in purchase and sale contracts for the exchange. A properly structured exchange with a Qualified Intermediary will ensure that the Qualified Intermediary is treated as being in control of the exchange proceeds for federal tax purposes. This will help the Exchanger avoid the actual or constructive receipt of such proceeds, making it possible for the Exchanger to complete a Deferred or Multi-Party Exchange.

The Exchange Facilitator as Exchange Accommodation Titleholder

In its capacity as Exchange Accommodation Titleholder, the Exchange Facilitator takes Qualified Indicia of Ownership in property. This requires the Accommodation Titleholder to take legal title to property, either directly, or indirectly through a disregarded entity. The Exchange Accommodation Titleholder also enters into an Accommodation Exchange Agreement with the Exchanger. The Accommodation Exchange Agreement imposes several restrictions on the transfer of the property held by the Exchange Accommodation Titleholder and helps ensure that the property will be transferred from the Exchange Accommodation Titleholder at the appropriate time. The Exchanger generally arranges for the financing needed for the Exchange Accommodation Titleholder to acquire title to the property. Such financing may be satisfied with the Exchange Proceeds received from the sale of the Relinquished Property if properly structured. The Exchange Accommodation Titleholder's taking title to property is often referred to as parking or warehousing the property.

Entity Structure of the Facilitator

Exchangers must examine Exchange Facilitator companies to ensure that their structure will not jeopardize the security of Exchange Proceeds or parked property. A company that separates the intermediary function and the accommodation function into separate legal entities has taken steps to protect the assets of its clients. In addition, a separate special purpose entity should be established for each piece of property that an Accommodation Titleholder acquires. Such entity will generally be a single-member limited liability company. A separate special purpose entity will not only provide added security for property, it may also reduce or eliminate transfer taxes in some jurisdictions and eliminate the need to acquire title insurance twice.

The Tax Advisor

A Section 1031 Exchange often involves complex issues of federal tax law. Failure to satisfy all of the federal tax law requirements could result in a transaction failing to qualify for Section 1031 treatment. Thus, Exchangers contemplating a Section 1031 Exchange should consult with a Tax Advisor with experience in Section 1031. A Tax Advisor will help structure the exchange in such a manner that it should qualify for Section 1031 treatment. The Tax Advisor also reviews the exchange agreements and other documents provided by the Exchange Facilitator to help ensure that they comply with the requirements in Section 1031. A Tax Advisor is generally a certified public accountant or tax attorney.

The Attorney

In addition to receiving tax advice, Exchangers should also have an attorney review the exchange documents and the real estate documents. While Section 1031 Exchanges are structured for tax purposes, there are generally several legal issues to consider.

The Real Estate Professional and Title Company

The real estate professional assists with locating and negotiating the sale and acquisition of exchange properties. A title company is often used to help close a transaction. Some title companies also provide some intermediary services. Such companies should meet the same standards as a professional intermediary company.

The Danger of Mixing Roles

At times, Exchange Facilitators will hold themselves out as tax experts and tax advisors will offer facilitation services. Exchangers and advisors must accept such mixed roles with caution. The safe harbor regulations provide that if an Exchange Facilitator is a disqualified person, no safe harbor will be created. Under this rule, if an attorney, CPA, or real estate professional acts as Exchange Facilitator, there is a good possibility that a safe harbor will not be created. The only time such person may act as Qualified Intermediary is when the services provided by such person within the two years prior to the exchange are with respect to exchanges or such person is providing services through an entity of which such person has an ownership interest of ten percent or less. Thus, if a CPA has prepared a tax return for the Exchanger or if an attorney has provided other legal services for the Exchanger, within the previous two years, such persons are disqualified from acting as Exchange Facilitator. Exchangers should also remember that an Exchange Facilitator is generally not an attorney. As such, communication with the Exchange Facilitator is not privileged, and the Exchange Facilitator has no duty of confidentiality. Fortunately, there are many quality Exchange Facilitator companies that value the confidentiality of their clients' information.

Chapter 10: The Exchange Process

Accomplishing a successful Section 1031 Exchange requires an understanding of the Exchange Process for each of the various types of exchanges.

Deferred Exchanges

1. Discuss with a competent tax advisor the possibility of using Section 1031 to defer income tax.
2. Engage a Qualified Intermediary.
3. Transfer Relinquished Property through the Qualified Intermediary with the Exchange Proceeds going directly to the Qualified Intermediary.
4. Identify Replacement Property within the 45-day Identification Period.
5. Close on Replacement Property, directing the Qualified Intermediary to transfer the money to the seller and directing the Seller to direct deed the Replacement Property to the Exchanger.

Reverse Exchanges

1. Discuss with a competent tax advisor the possibility of using Section 1031 to defer income tax.
2. Engage an Exchange Facilitator. This person will likely act as both Qualified Intermediary and Exchange Accommodation Titleholder.
3. Secure financing for the acquisition of the Replacement Property and direct that the Replacement Property be transferred to the Exchange Facilitator.
4. Transfer the Relinquished Property through the Exchange Facilitator with the Exchange proceeds going directly to the Exchange Facilitator.
5. Obtain, from the Exchange Facilitator, the replacement property.

Build-to-Suit Exchanges

1. Discuss with a competent tax advisor the possibility of using Section 1031 to defer income tax.
2. Engage an Exchange Facilitator. This person will likely act as both Qualified Intermediary and Exchange Accommodation Titleholder.
3. Transfer Relinquished Property through the Exchange Facilitator with the proceeds going directly to the Exchange Facilitator.
4. Transfer an interest in existing property to the Exchange Facilitator.
5. Oversee construction.
6. Acquire the property interest with improvements from the Exchange Facilitator.

Chapter 11: Special Issues

Many exchanges involve special issues. For example, Exchangers will often prematurely request the distribution of Exchange Proceeds. Also, Exchangers on occasion wish to finance the sale of Relinquished Property. Because improper handling of these issues can destroy a Section 1031 Exchange, they deserve special attention.

Distribution of Exchange Proceeds

To complete a successful Section 1031 Exchange using an Exchange Facilitator, it is necessary that several requirements in the Section 1031 Income Tax Regulations be satisfied.

The (g)(6) Restrictions

One of the requirements found in the Regulations provides that the agreement between the Exchanger and the Exchange Facilitator must expressly limit the Exchanger's right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the Exchange Facilitator (these restrictions are known as the "(g)(6) restrictions"). These restrictions must be included in the Exchange Agreement and must be adhered to by the Exchange Facilitator and the Exchanger. Failure to follow this requirement on any given exchange will eliminate that exchange from the Section 1031 treatment. It may also result in the Exchange Facilitator failing to meet the Qualified Intermediary requirements with respect to other exchanges it facilitates. Therefore, Exchange Facilitators and Exchangers must closely abide by this requirement, and place restrictions on the Exchanger's right to receive Exchange Proceeds. The restrictions that are placed on the Exchanger's right to receive Exchange Proceeds lapse in one of three situations.

Lapse of Restrictions

The restrictions placed on the Exchanger's right to receive or benefit from the Exchange Proceeds held by the Exchange Facilitator lapse at the earliest of one of the following, after which time, the Exchanger may have access to the Exchange Proceeds:

- If the Exchanger has not identified Replacement Property by the end of the Identification Period, the Exchanger may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property at any time after the end of the Identification Period.

- If the Exchanger has identified Replacement Property, the Exchanger may have rights to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property upon or after (1) the receipt by the Exchanger of all of the Replacement Property to which the Exchanger is entitled under the Exchange Agreement, or (2) the occurrence after the end of the Identification Period of a material and substantial contingency.

- The Exchange Facilitator may also distribute Exchange Proceeds to pay for Ordinary Income and Transactional Items, as discussed below.

Improvements on Replacement Property

In a properly structured exchange, Exchange Proceeds may be used to fund the construction of improvements on property the Exchanger has identified as Replacement Property. Exchange Facilitators may distribute Exchange Proceeds for the construction of improvements on Replacement Property in very limited circumstances. If title to the Replacement Property is still held by the seller of that property, in limited circumstances the Exchange Facilitator will lend funds to the seller to construct improvements on the property prior to its being transferred to the exchanger. A better alternative would be to have the seller finance the construction and increase the purchase price of the property to reflect the cost of constructing the improvements. Under this scenario, Exchange Proceeds would not be distributed from the Exchange Facilitator, helping to ensure that the exchange is not adversely affected. In no event, should the Exchange Facilitator distribute Exchange Proceeds to the Exchanger who oversees or directs the construction of improvements on property to be acquired as Replacement Property.

Earnest Money Payments

The question also arises whether Exchange Proceeds may be used to make earnest money payments on the acquisition of Replacement Property. Exchange Facilitators should use Exchange Proceeds to make earnest money payments for Replacement Property only if two conditions are satisfied. First, the purchase sale agreement must be assigned to the Exchange Facilitator. Second, if the earnest money is refundable, it must be refundable and paid to the Exchange Facilitator. If the Exchanger pays earnest money, the Exchange Facilitator should not reimburse the earnest money payments to the Exchanger until after the (g)(6)restrictions expire.

Ordinary Income and Transactional Items

Exchange Proceeds may be used to pay certain items normally paid at closing without destroying the Section 1031 treatment. The items for which the Exchange Proceeds may be distributed include Ordinary Income Items and Transactional Items.

Ordinary Income Items

Ordinary Income Items are payments that an Exchanger may pay on the disposition of Relinquished Property or receive on the acquisition of Replacement Property that are not included in the amount realized from the disposition of the property. These payments include prorated rent, property taxes, utilities and property insurance debited to the Exchanger out of the Exchange Proceeds. Although payment of such items by the Exchange Facilitator from Exchange Proceeds will not destroy the Section 1031 Exchange, the receipt of such payments by the Exchanger may result in the Exchanger recognizing ordinary income. To ensure that the exchange is not accidentally destroyed, it is best to make all distributions only upon the closing of the sale of the Relinquished Property, or upon closing of the acquisition of the Replacement Property. Other than this, Exchange Facilitators should not distribute and Exchangers should not request distributions of Ordinary Income Items.

Transactional Items

Transactional Items are items that typically appear on a closing statement, and include costs incurred for surveys, title examinations, physical inspection reports, environmental studies, brokerage commissions, and financing fees. Items that do not typically appear on a closing statement do not qualify as Transactional Items. To ensure that the Exchange is not destroyed, much like Ordinary Income Items, Transactional Items should only be paid using Exchange Proceeds at the closing of the sale of the Relinquished Property, or at the closing of the acquisition of Replacement Property. Making distributions at other times, may destroy the Exchange if it is later determined that the item paid for did not qualify as a Transactional Item. Transactional Items reduce the amount of gain realized on the sale of Relinquished Property, and are added to the basis of Replacement Property if incurred to acquire the Replacement Property. Loan fees, points, loan application fees, mortgage insurance, lender's title insurance, assumption fees, and other costs related to the acquisition of a loan may appear on a closing statement and may be paid out of Exchange Proceeds under the conditions discussed herein; however, these items are generally capitalized and amortized over the life of the loan, and do not affect the basis of the property received. Transactional Items that do not increase the basis of the Replacement Property most likely will be treated as Boot to the Exchanger if paid for using Exchange Proceeds.

Seller Financing

To avoid gain recognition on a transaction involving a note, the Exchanger must ensure the note was not received as consideration for the Relinquished Property. There are several possible alternatives for structuring an exchange if the Exchanger elects to finance the sale of the Relinquished Property.

Loan from Exchanger

First, the Exchanger could act as a bank and loan the money to the buyer of the Relinquished Property for a note, which is secured by the Relinquished Property. Exchangers should consult their legal and tax advisors to ensure that the loan to the buyer is a separate transaction from the disposition of the Relinquished Property. If the loan and the disposition of the Relinquished Property are treated as a single transaction, the receipt of the note by the Exchanger could be treated as Boot.

Exchanger Buys the Note

Second, the buyer of the Relinquished Property could make the note payable to the Qualified Intermediary and transfer the note to the Qualified Intermediary upon acquisition of the Relinquished Property. The Qualified Intermediary could then sell the note to the Exchanger at its fair market value. If the sale of the note to the Exchanger is at arms-length terms, the sale should not disrupt the safe harbor. There is, however, no guidance and no supporting case law, making this alternative substantially less attractive than the loan from the Exchanger.

Third Party Buys the Note

Third, the installment note could be sold to a third party and the proceeds could be used to acquire the Replacement Property. This can be handled in one of two ways, either of which should obtain the same tax result. First, the buyer's note could be payable to the Qualified Intermediary and then sold to a third party. The proceeds from the sale of the note would be used by the Qualified Intermediary to buy the Replacement Property. In some cases the seller of the Replacement Property will accept the note as part of the sales proceeds. This could be done by having the note originally made payable to the Qualified Intermediary and then transferred at closing to the seller of the Replacement Property or made payable directly to the seller of the Replacement Property by the buyer of the Relinquished Property.

Note is Satisfied

In some cases the note could be paid in full during the Exchange Period. This works only on short-term notes due within the Exchange Period, which gives the buyer of the Relinquished Property time to obtain permanent financing. Under this scenario, the buyer would pay the note in full directly to the Qualified Intermediary, the holder of the note. The Qualified Intermediary would then use the Exchange Proceeds to acquire the Replacement Property.

Glossary of Section 1031 Terms and Bibliography of Sources

Glossary of Section 1031 Terms

(g)(6) RESTRICTIONS: Restrictions imposed by the Income Tax Regulations and the Exchange Agreement that prohibit the early distribution of the Exchange Proceeds. The (g)(6) Restrictions help avoid the Exchanger's Constructive Receipt of the Exchange Proceeds.

ACCOMMODATION TITLEHOLDER: An individual or other legal entity engaged by the Exchanger to hold title to Replacement Property or in rare cases, Relinquished Property, to facilitate a parking transaction. This term is generally used to define the accommodator in non-safe harbor parking transactions.

ADJUSTED BASIS: The basis of property used to compute gain or loss on the disposition of property and to compute depreciation. As a general rule, the Adjusted Basis is the acquisition cost, plus the cost of capital improvements, less depreciation allowable with respect to the property.

BOOT: Money or non like-kind property consideration received in connection with an exchange.

CONSTRUCTIVE RECEIPT: A technical federal income tax concept that treats an Exchanger as receiving property or cash even though such payment of cash is not legally transferred to the Exchanger. Generally, an Exchanger is in Constructive Receipt of property or cash if the Exchanger has the unrestricted use of the property or cash. Receipt by a Qualified Intermediary of the Exchange Proceeds should avoid Constructive Receipt.

DEALERS AND DEVELOPERS: Dealers and Developers are individuals or other legal entities that generally hold property for resale. Such property does not qualify for Section 1031 treatment. Dealer and Developers may, however, exchange property held for investment or use in a trade or business if certain requirements are satisfied.

EXCHANGE ACCOMMODATION AGREEMENT: A contract entered into between the Exchanger and an Exchange Accommodation Titleholder providing that the Exchange Accommodation Titleholder will take title to either the Replacement Property or Relinquished Property and hold it under the Exchanger's supervision.

EXCHANGE ACCOMMODATION TITLEHOLDER: An individual or other legal entity engaged by the Exchanger to hold title to Replacement Property or in rare cases, Relinquished Property, to facilitate a parking transaction. This term is generally used to define the accommodator in safe harbor parking transactions.

EXCHANGE AGREEMENT: A contract entered into between an Exchanger and a Qualified Intermediary providing, among other things, that the Qualified Intermediary will facilitate the exchange and hold the Exchange Proceeds subject to the (g)(6) Restrictions.

EXCHANGE CLAUSES OR COOPERATION CLAUSE: The earnest money contract or purchase and sale agreement begin the paper trail that distinguishes the transaction as a Section 1031 Exchange. An Exchange or Cooperation Clause helps establish the exchanger's intent to make an exchange and further seeks cooperation from the other party to accept an assignment of the sales contract. An example of such language is:

> *For property being sold by exchanger*:
>
> Sale of the Subject Property may be part of a transaction intended to qualify as an exchange under Section 1031 of the Internal Revenue Code. The Buyer agrees to cooperate to help Seller accomplish the desired transaction. No additional cost or liability will be incurred on the part of the buyer.
>
> *For property being purchased by exchanger*:
>
> Purchase of the subject property may be part of a transaction intended to qualify as an exchange under Section 1031 of the Internal Revenue Code. The Seller agrees to allow an assignment of the buyer's interest in this contract to a qualified intermediary to effect said exchange and otherwise cooperate to accomplish the desired transaction. No additional cost or liability will be incurred on the part of the Seller.

EXCHANGE FACILITATOR: A general term used to refer to those individuals or other legal entities that facilitate Section 1031 exchanges. The term Exchange Facilitator is broad enough to include Qualified Intermediaries and Exchange Accommodation Titleholders.

EXCHANGE PERIOD: That period ending 180 days following the date the Relinquished Property is transferred. The Exchange Period will be cut short if the Exchanger files the tax return for the taxable year of the exchange prior to the 180th day. The first day of the Exchange Period is the day after the transfer of the Relinquished Property.

EXCHANGE PROCEEDS: Consideration received for the Relinquished Property. Generally, in a deferred multi-party exchange, a Qualified Intermediary receives Exchange Proceeds.

EXCHANGER: An individual or entity pursuing a Section 1031 Exchange.

IDENTIFICATION PERIOD: That period ending 45 days following the date the Relinquished Property is transferred by the Exchanger. The first day of the Identification Period is the day after the transfer of the Relinquished Property.

INTERNAL REVENUE SERVICE: A bureau of Department of Treasury that is tasked with the enforcement of income tax laws and oversees the collection of federal income taxes.

QUALIFIED INTERMEDIARY: An individual or legal entity that satisfies several requirements in the Income Tax Regulations. Qualified Intermediaries are often used to facilitate Section 1031 Exchanges.

REALIZED GAIN: The Realized Gain is the difference between the sales price received for a property and its Adjusted Basis.

RECOGNIZED GAIN: That portion of the Realized Gain that is required to be reported as income on a federal income tax return.

RELATED PARTIES: The parties related to the taxpayer as defined by Section 267(b) and 707(b)(1). The definition of related party includes, but is not limited to, a spouse, ancestors, descendants, and brothers and sisters. Not related to the taxpayer are aunts, uncles, cousins, nieces and nephews, in-laws, ex-spouse, employees, business associates, and friends. Further, corporations and partnerships are related to the Exchanger if the Exchanger owns more than a fifty percent interest in such entity. As discussed in the section on Related Parties, the group of persons treated as related parties is quite large and sometimes complicated to determine.

RELINQUISHED PROPERTY: Property given up by the Exchanger in an Exchange.

REPLACEMENT PROPERTY: Property identified and ultimately received by the Exchanger in an exchange.

SAFE HARBOR: Structure approved by the Internal Revenue Service, which if followed, will produce a foreseeable tax consequence. For example, the use of a Qualified Intermediary or Exchange Accommodation Titleholder under the Income Tax Regulations and Rev. Proc. 2000-37 creates safe harbors. Following the rules pertaining to these safe harbors allows an Exchanger to know the tax consequences of a transaction. Structuring a transaction outside the Safe Harbors creates some uncertainty regarding the tax consequences of the transaction.

SALES PRICE: The contract price of the property less closing costs. Also referred to as the net sales price.

SELLER FINANCING: A financing arrangement under which the seller of property provides the buyer with the financing needed to acquire the property. The financing is often a note from the buyer secured by the property without money changing hands.

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