

# CHICAGO DEFERRED EXCHANGE COMPANY

## DEFERRED (DELAYED) EXCHANGES

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**Like-Kind Exchanges:** Final Regulations to Section 1031 (generally effective for transfers occurring after June 10, 1991) provide long overdue guidance on the application of amendments to Section 1031 made by Section 77 of the Tax Reform Act of 1984. Section 77 of the Act limited the application of Section 1031 to non-simultaneous exchanges by providing specific time limits for the identification and receipt of replacement property. In addition, Section 77 of the Act provided that Section 1031(a) does not apply to any exchange of interests in a partnership.

**Background:** An exchange of property, like a sale, generally results in the current recognition of gain or loss. Section 1031(a) provides an exception to this general rule. Under Section 1031(a), no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of like-kind that is to be held either for productive use in a trade or business or for investment. Section 1031(a) specifically does not apply to exchanges of stock in trade or other property held primarily for sale, stocks, bonds, notes, other securities or evidences of indebtedness or interest, certificates of trust or beneficial interest, choses in action, or interests in a partnership. Code §1031(a).

**Explanation of Provisions: Deferred Exchanges In General:** Section 1031(a)(3) was added by Section 77 of the Tax Reform Act of 1984. Section 1031(a)(3) provides that any property received by the Taxpayer in a deferred exchange is treated as property which is not like-kind property if (a) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the Taxpayer transfers the property relinquished in the exchange, or (b) such property is received after the earlier of (1) the day which is 180 days after the date on which the Taxpayer transfers the property relinquished in the exchange, or (2) the due date (including extensions) of the Taxpayer's tax return for the taxable year in which the transfer of the relinquished property occurs. Code §1031(a)(3).

Although Section 1031(a)(3) is limited to the identification and receipt requirements of a deferred exchange, other issues important to the application of Section 1031 to deferred exchanges require clarification. In particular, the use of various security arrangements, guarantees, and intermediaries in deferred exchanges raise questions concerning the definition of a deferred exchange and concerning how the rules of actual or constructive receipt apply in the case of a deferred exchange. Questions have also been raised concerning the computation of gain or loss to be recognized and the basis of property received in a deferred exchange.

**Definition of Deferred Exchange:** The Regulations define a deferred exchange as an exchange in which, pursuant to an agreement, the Taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property").

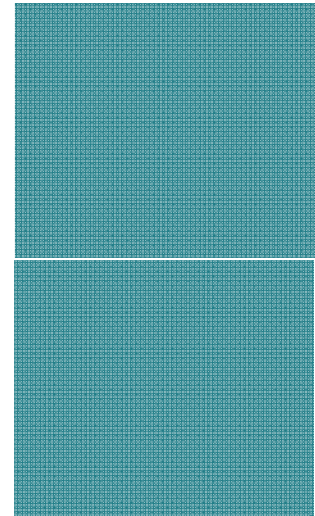
In order to constitute a deferred exchange, the transaction must be an exchange (i.e., a transfer of property for property, as distinguished from a transfer of property for money). For example, a sale of property followed by a purchase of property of a like-kind to the property sold does not qualify for non-recognition of gain or loss under Section 1031 regardless of whether the other requirements of Section 1031 are satisfied.

The Regulations do not apply if the Taxpayer received the replacement property prior to the date on which the Taxpayer transfers the relinquished property. The IRS has requested comments concerning whether Section 1031 applies to so-called "Reverse-Starkers". After reviewing the comments and applicable law, the Service determined that the deferred exchange rules of Section 1031(a)(3) do not apply to "Reverse-Starker" transactions. However, the Service will continue to study the applicability of the general rule of Section 1031(a)(1) to these transactions. See Revenue Procedure 2000-37 on Reverse Exchanges.

**Identification and Receipt Requirements:** The Regulations provide that, in the case of a deferred exchange, any replacement property received by the Taxpayer will be treated as property which is not of a like-kind to the relinquished property if (a) the replacement property is not "identified" before the end of the "identification period", and (b) the identified replacement property is not received before the end of the "exchange period." This general rule follows directly from the provisions of Section 1031(a)(3). The identification period begins on the date the Taxpayer transfers the relinquished property and ends 45 days thereafter. The exchange period begins on the date the Taxpayer transfers the relinquished property and ends on the earlier of 180 days thereafter or the due date (including extensions) for the Taxpayer's tax return for the taxable year in which the transfer of the relinquished property occurs. Because the timing requirements relating to the identification and exchange periods are statutory, requests for extensions of the identification and exchange periods will not be granted. Reg. §1.1031(k)-1(b).

Under the Regulations, replacement property is treated as identified for purposes of Section 1031(a)(3) only if it is designated as replacement property in a written document signed by the Taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to a person involved in the exchange other than the Taxpayer or a related party. The identification may also be made in a written agreement for the exchange of properties. The replacement property must be unambiguously described in the written document or agreement. For example, real property generally is unambiguously described if it is described by a legal description or street address. Reg. §1.1031(k)-1(c).

**Methods of Identification:** Replacement property is identified only if it is designated as replacement property in a written document signed by the Taxpayer and (i) hand delivered, (ii) sent by certified mail, (iii) telecopied or (iv) otherwise delivered, before the end of the identification period, to a person involved in the exchange who is not a "disqualified person". Reg. §1.1031(k)-1(c)(2).



**Three Property or 200 Percent Rule:** The Taxpayer may identify more than one property as replacement property. However, regardless of the number of relinquished properties transferred by the Taxpayer as part of the same deferred exchange, the maximum number of replacement properties that the Taxpayer may identify is (a) three properties of any fair market value, or (b) any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties. With certain exceptions, if, as of the end of the identification period, the Taxpayer has identified more properties as replacement properties than is permitted, the Taxpayer is treated as if no replacement property had been identified. Reg. §1.1031(k)-1(c)(4).

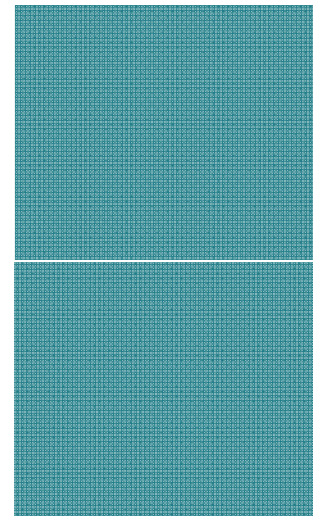
**Exceptions to Three Property or 200 Percent Rule:** Any replacement property received by the Taxpayer before the end of the identification period does not have to be formally identified as replacement property. Any replacement property identified within 45 days and received within the exchange period if the Taxpayer received at least **95 percent of ALL identified properties** before the end of the exchange period. Reg. §1.1031(k)-1(c)(4).

**Revocation of Identification:** An identification of property as a replacement property may be revoked at any time prior to the end of the identification period. The revocation must be made in a written document that is signed by the Taxpayer and hand delivered, sent by certified mail, or telecopied before the end of the identification period to the person to whom the identification was sent. Reg. §1.1031(k)-1(c)(4)(iii), (k)-1(c)(6). It is interesting to note that the Regulations completely ignore certain elements of the legislative history of Section 1031, i.e., the requirement that alternative identifications of replacement property be subject to contingencies beyond the control of the Taxpayer. Furthermore, the formula for identification of more than three replacement properties is based on gross value, not net value. The effect of this provision restricts a Taxpayer's previously unfettered right to trade up in value by contributing his own equity to the exchange. For example, a Taxpayer who transfers property with a fair market value of \$1 million with no mortgages would not be able to identify five replacement properties each having a fair market value of \$500,000 and each being subject to a \$300,000 mortgage. There does not appear to be any public policy served by this seemingly arbitrary departure from the legislative history of Section 1031, rather, the decision was based on administrative concerns. Reg. §1.1031(k)-1(m).

**De Minimis Rule: Incidental Property Disregarded for Purposes of Identification:** Property that is incidental to a larger item of property is not treated as separate property for purposes of identification if:

1. In standard commercial transactions, the property is typically transferred together with the larger item of property, **and**
2. The aggregate fair market value of all such property does not exceed 15 percent of the aggregate fair market value of the larger item of property.

Incidental property, such as personal property, is disregarded in determining whether property has been properly identified. Apparently, the IRS has, in these Regulations, developed what they think is a workable incidental property rule. It is unfortunate that such a rule could not be utilized in the multi-asset Regulations discussed above.



The Regulations also provide rules for determining whether the identified replacement property is received before the end of the exchange period. In the case of a deferred exchange, the replacement property received must be substantially the same property as was identified. If the Taxpayer identifies more than one property as replacement property, the receipt rules are applied separately to each identified replacement property. Reg. §1.1031(k)-1(c)(5).

**Constructed Property Real Estate/Services:** The transfer of real estate in exchange for services rendered in the construction of replacement property will not fall within the non-recognition provisions of Section 1031.

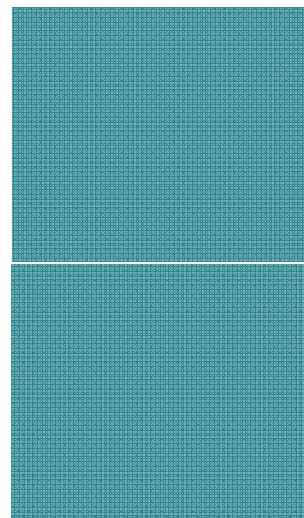
Any construction occurring after the property is received by the Taxpayer will not be treated as property of a like-kind.

1. The replacement property received must constitute real property when it is received.
2. The replacement property received must be substantially the same as the property identified when construction is completed.
3. The 200 percent rule applies to the fair market value of replacement property on the date it is received by the Taxpayer.

The Regulations provide special rules for the identification and receipt of replacement property where the replacement property is not in existence or is being produced or constructed at the time the identification is made. Constructed property will be treated as identified if a legal description of the land is provided and "as much detail as is practicable" for construction of the improvements. The definition of "as much detail as is practicable" is unclear in its application and will no doubt be subject to a wide range of interpretation. Constructed property must constitute real property at the time of receipt by the Taxpayer. This determination should be made under local law. Reg. §1.1031(k)-1(e).

**Constructed Property: Personality** If identified replacement property is personal property to be produced, production must be completed on or before the date the property is received by the Taxpayer. Reg. §1.1031(k)-1(e)(3)(ii).

**Deferred Exchange Safe Harbors:** In an attempt to provide clear rules for "typical" deferred exchange transactions, the Regulations provide four safe harbor tests. These safe harbors define the edges of the envelope of safety. Transactions structured within the safe harbors will result in a determination that the Taxpayer is not in actual or constructive receipt of money or other property for purposes of the Regulations. It should be noted that even if a transaction is within the safe harbors, to the extent the Taxpayer has the ability or unrestricted right to receive money or other property before the Taxpayer actually receives replacement property, the exchange will not qualify for non-recognition treatment under Section 1031(a). **Exchanges structured in a manner which is not sanctioned by the safe harbors will not automatically be non-qualifying, but will be carefully scrutinized, which means the auditing agent will likely disallow the purported exchange and leave resolution of the issues to the appellate conference.**



**The Regs. define four distinct Safe Harbors:**

**1. Transferee's exchange obligation secured by a mortgage, a standby letter of credit, or a guarantee of a third party:** Under the first safe harbor, the obligation of the Taxpayer's transferee to transfer the replacement property to the Taxpayer is permitted to be secured or guaranteed by (a) a mortgage, deed of trust, or other security interest in property (other than cash or a cash equivalent), (b) a standby letter of credit which satisfies all of the requirements of Section 15A.453-1(b)(3)(iii) and which does not allow the Taxpayer to draw on such standby letter of credit except upon a default of such transferee's obligation to transfer like-kind replacement property, or (c) a guarantee of a third party. Reg. §1.1031(k)-1(g)(2).

**2. Qualified Exchange Trust:** Under the second safe harbor, the obligation of the Taxpayer's transferee to transfer the replacement property is permitted to be secured by cash or a cash equivalent if such cash or cash equivalent is held in a qualified trust. In order for a trust to be "qualified" the trustee must not be the Taxpayer or a "disqualified person", and the Taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in escrow or trust must be limited to certain specified circumstances described at Reg. §1.1031(k)-1(g)(6). Reg. §1.1031(k)-1(g)(3), (k)-1(g)(6), (k)-1(g)(7).

**Definition of a "disqualified person" for purposes of this Section - a person is a "disqualified person" if:**

- (i) such person is the agent of the Taxpayer, or
- (ii) such person acts as the Taxpayer's attorney, accountant, broker, investment banker or real estate agent, or
- (iii) such person bears a relationship to the Taxpayer described in either Section 267(b) or 707(b) of the I.R.C. determined by substituting "10 percent" for "50 percent" each place it appears, or
- (iv) such person bears a relationship to a person described in (iii) above.

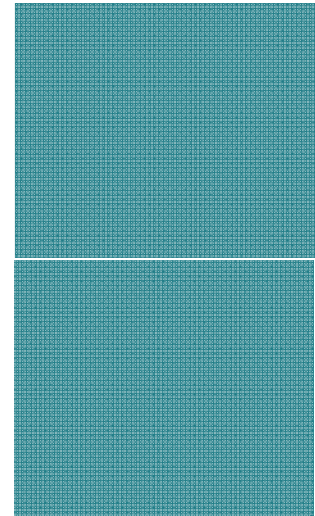
Reg. §1.1031(k)-1(k).

**3. Qualified Intermediary:** Under the third safe harbor, deferred exchanges are permitted to be facilitated by the use of a qualified intermediary if the Taxpayer's rights to receive money or other property are limited to certain specified circumstances. A qualified intermediary is a person who is not the Taxpayer or a disqualified person and who, for a fee, acts to facilitate a deferred exchange by entering into an agreement with the Taxpayer for the exchange of properties pursuant to which such person acquires the relinquished property from the Taxpayer, transfers the relinquished property to a purchaser, acquires the replacement property, and transfers the replacement property to the Taxpayer. The qualified intermediary is considered to have acquired property even if such acquisition is subject to a binding commitment to re-transfer the property. Consistent with Rev. Rul. 90-34, I.R.C. 1990-16 (April 16, 1990), the transfer of property in a deferred exchange that is facilitated by the use of a qualified intermediary may occur via a "direct deed" of legal title by the current owner of the property to its ultimate owner. Reg. §1.1031(k)-1(g)(4), (k)-1(g)(6), (k)-1(g)(7).

**Definition of Qualified Intermediary**

A Qualified Intermediary is a person who:

- (A) Is not the Taxpayer or a Disqualified Person



(B) Enters into a written Exchange Agreement with the Taxpayer and as required by the Exchange Agreement:

1. Acquires the relinquished property from the Taxpayer,
2. Transfers the relinquished property,
3. Acquires the replacement property, and
4. Transfers the replacement property to the Taxpayer.

Reg. §1.1031(k)-1(g)(4)(iii).

**An Intermediary is treated as acquiring and transferring property if the Intermediary:**

(A) Acquires and transfers legal title to that property.

(B) Either on its own behalf or as the agent of any party enters into an agreement with a person other than the Taxpayer for the transfer of property to that person.

(C) Either on its own behalf or as the agent of any party enters into an agreement with the Owner of property for the transfer of that property and pursuant to that agreement the property is transferred to the Taxpayer.

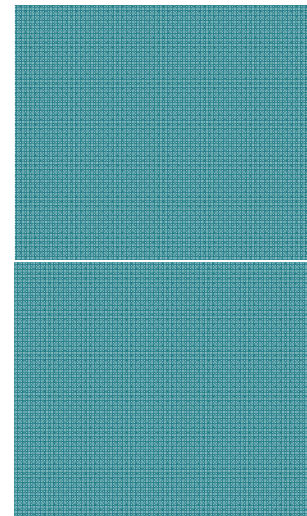
(D) Accepts the assignment of the rights to an agreement and all parties to the agreement are notified in writing of the assignment on or before the date of the relevant transfer of property.

\*On August 1, 1995, Jody J. Brewster, Assistant Chief Counsel (Income Tax & Accounting) Department of the Treasury, Internal Revenue Service confirmed there is no requirement that the Taxpayer must also assign the obligation to sell the property, nor is there any requirement that the intermediary must assume any of the obligations under the contract. Doc 95-7555 Reg. §1.1031(k)-1(g)(4)(iv).

**4. Investment Income:** Under the fourth safe harbor, the Taxpayer is permitted to receive interest or a growth factor with respect to the deferred exchange provided that the Taxpayer's rights to receive such interest or growth factor are limited to certain specified circumstances (see below). Such interest or growth factor will be treated as interest regardless of whether it is paid in cash or in property (including property of a like-kind). The Regulations do not address the proper manner for reporting interest income earned on money held in a qualified escrow account or a qualified trust. It is also unclear in which year the interest income is reportable.

Reg. §1.1031(k)-1(g)(5), (k)-1(g)(6), (k)-1(g)(7), (k)-1(h).

The final Regulations on deferred exchanges at Section 1.1031(k)-1(g)(5) provide that interest or a "growth factor" must be treated as interest and included in income according to the Taxpayers' method of accounting. However, the Regulations do not address the proper manner for reporting interest income earned on money held in a qualified trust or qualified escrow account. The Service indicated that it planned to issue Regulations under Section 468B(g), "Qualified Settlement Funds," including treatment of interest earned on deferred exchanges. The recently published proposed Regulations under Code Section 468B(g), in fact, failed to address this issue and it is therefore unclear as to how the information reporting should work. For example, if the exchange is facilitated by an intermediary, it is unclear whether the financial institution should send the form 1099-INT to the intermediary or to the ultimate recipient of the interest. Presumably, the intermediary would be entitled to



an interest deduction if it receives the form 1099 from the financial institution and then issues a matching 1099 to the Taxpayer, but this is also unclear. The author argued at the public hearing on May 27, 1992 that it should be permissible for the financial institution to send the form 1099-INT directly to the person entitled under the exchange agreement to the interest earned on the exchange balance. The issues surrounding reporting of interest income in a §1031 exchange assume greater importance when the relinquished property is transferred in year one, proceeds are invested by an intermediary with a financial institution, and replacement property is acquired in year two.

**Restrictions on Safe Harbors – the “(g)(6)” Restrictions:** The Taxpayer must not have the right to receive money or other property until:

1. After the end of the identification period if no replacement property is identified, or
2. After the Taxpayer has received all of the identified replacement property to which the Taxpayer is entitled, or
3. If replacement property has been identified but not received, after the later of the end of the identification period and the occurrence of a material and substantial contingency that
  - A. Relates to the exchange,
  - B. Is provided for in writing, and
  - C. Is beyond the control of the Taxpayer or a related party, or
4. The end of the exchange period.

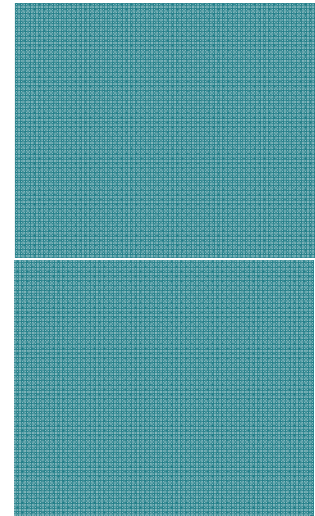
Reg. §1.1031(k)-1(g)(6).

**Items Disregarded in Applying Safe Harbors:** The Taxpayer's receipt of or right to receive any of the following will be disregarded in determining whether a safe harbor applies:

1. Items that a seller may receive as a consequence of the disposition of property that are not included in the amount realized from the disposition of property (e.g., prorated rents), and
2. Transactional items that relate to the disposition or acquisition of property, appear on the closing statement, and under local practice are the responsibilities of a buyer or seller, (e.g., commissions, prorated taxes, recording charges, transfer taxes, and title company fees). Reg. §1.1031(k)-1(g)(7).

**Gain or Loss and Basis Computation for Deferred Exchanges:** As a general rule, the amount of gain or loss recognized and the basis of property received in a deferred exchange is determined by applying the existing rules of Section 1031 and the Regulations thereunder. For example, in a deferred exchange, consideration given in the form of an assumption of liabilities (or the receipt of property subject to a liability) may be offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability).

Reg. §1.1031(k)-1(j).



**Interests in a Partnership:** Section 77 of the Tax Reform Act of 1984 amended Section 1031 to provide that Section 1031(a) does not apply to any exchange of interests in a partnership. Under the proposed Regulation, an exchange of partnership interests will not qualify for non-recognition of gain or loss under Section 1031(a) regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or in different partnerships. NOTE: see *Magneson v. Commissioner*, and *Maloney v. Commissioner*. The Service has not acquiesced on the issues raised when partnerships are dissolved and partners enter into exchange agreements for their purported undivided interests in real estate and will continue to litigate in this area.

**CONCLUSION:** While the final Deferred Exchange Regulations are a model of simplicity, especially when contrast-ed with the final Regulations on Multi-Asset Exchanges and Exchanges of Personal Property, they are extremely technical in nature. Failure to meet the technical requirements of the safe harbors is likely to generate a number of malpractice claims in the future. The final Regulations provide tax planners with clear channels to safety, but the sides of these channels are steep and strewn with the potential to wreck. Stay inside the channel, and you will dispose of the issues of agency, constructive receipt, and the exchange requirement. Venture outside the channels, and you invite disaster.

