

# CHICAGO DEFERRED EXCHANGE COMPANY

## MULTI-ASSET EXCHANGES AND EXCHANGES OF PERSONAL PROPERTY

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The Regulations, effective April 11, 1991, contain amendments and additions to the Income Tax Regulations under Section 1031. The amendments and additions provide additional rules for determining the applicability of Section 1031 in an exchange of personal property, as well as rules for determining gain recognized and the basis of property received in an exchange of multiple properties under Section 1031.

Most exchanges of improved real estate include some amounts of personal property. In many transactions there may be only minor amounts of personal property, and it is even sometimes ignored by the Taxpayer. In other transactions (e.g., a hotel) there may be significant amounts of personal property. Most exchanges of improved property will fall somewhere in between.

There is significant uncertainty in the existing law in applying the like-kind test to personal property. The Regulations provide a safe harbor whereby depreciable tangible personal property held for productive use in a trade or business will be considered exchanged for like-kind property if it is exchanged for property of a "like-class". Properties are of a "like-class" if they are either within the same "General Business Asset Class" or the same "Product Class."

As a general rule, the application of Section 1031 requires a property-by-property comparison for computing the gain recognized and basis of property received in a like-kind exchange. The Regulations provide an exception to this general rule in the case of an exchange of multiple properties. An exchange is an exchange of multiple properties if the properties transferred by the Taxpayer in the exchange can be separated into more than one exchange group (as described below). For example, an exchange of an apartment building for another apartment building may be an exchange of multiple properties if, in addition to real property, personal property is transferred and received by the Taxpayer in the exchange. Exchanges of entire businesses are also exchanges of multiple properties.

An exchange group consists of all properties transferred and received in the exchange which are of a "like-kind". The separation of the properties transferred and the properties received by the Taxpayer in the exchange into exchange groups requires a matching up of properties of a like-kind or like class to the extent possible. For example, all properties within the same General Business Asset Class would be in the same exchange group. Thus, in an exchange of real estate and personal property for other real and personal property, two exchange groups would be created - one consisting of the real estate transferred and received as part of the exchange and the other consisting of the personalty transferred and received as part of the exchange.

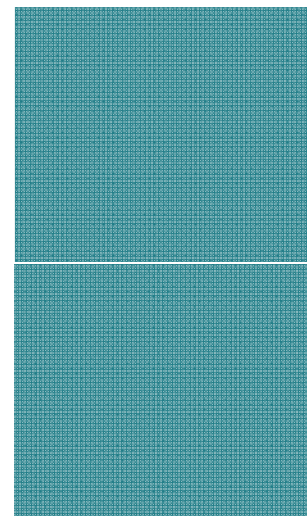
To the extent the aggregate fair market value of the properties transferred and the properties received in each exchange group are not equal, a portion of the "other property or money" received as part of the exchange is allocated among the exchange groups in order to equalize the aggregate fair market value of the properties transferred and the aggregate fair market value of the properties received in each exchange group. For this purpose, "other property or money" received as part of the exchange includes property described in Section 1031(a)(2) (i.e., stock in trade or other property held primarily for sale, stocks, bonds, notes, other securities or evidence of indebtedness or interest, interest in a partnership, certificates of trust or beneficial interests, or choses in action), property received that is not of like-kind with any property transferred, and money. If in an exchange group the aggregate fair market value of the property received exceeds the aggregate fair market value of the like-kind property transferred, the excess is allocated to other exchange groups where it is treated as "other property or money" received in the exchange. Once exchange groups are created, the rules of Section 1031 and the Regulations thereunder are applied separately to each exchange group to determine the amount of gain recognized and the basis of the property received in the exchange.

**Explanation of Provisions: Exchanges of Personal Property:** Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business, or for investment, if the property is exchanged solely for property of a "like-kind" that is to be held either for productive use in a trade or business or for investment. Section 1.1031(a)-1(b) of the Regulations provides that the non-recognition rules of Section 1031 do not apply to an exchange of one kind or class of property for property of a different kind or class. The Regulations set forth additional rules for determining whether personal property has been exchanged for property of a "like-kind".

Under the Regulations, depreciable tangible personal property held for productive use in a business is exchanged for property of a "like-kind" under Section 1031 if the property is exchanged for property that is either of a like-kind or of a like class. An exchange of properties of a like-kind may qualify for non-recognition of gain or loss under Section 1031 regardless of whether such properties are also of a like-class. In addition, the Regulations provide that an exchange of properties of a like-class may similarly qualify for non-recognition of gain or loss under Section 1031.

In general, depreciable tangible personal property held by the Taxpayer for productive use in its business is of a like-class to other depreciable tangible personal property to be held by the Taxpayer for productive use in its business if the exchanged properties are either within the same "General Business Asset Class" or within the same "Product Class". For purposes of the Regulations, property may not be classified within more than one General Business Asset Class or more than one Product Class. Further, property within any General Business Asset Class may not be classified within a Product Class. Reg. §1.1031(a)-2, (e)-1, (j)-1.

**General Business Asset Classes:** There are 13 General Business Asset Classes, which consist of depreciable tangible personal property described in asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87-56, 1987-2 C.B. 674, as modified. Rev. Proc. 87-56 provides a classification system for property for the purpose of determining depreciation deductions under Section 168 of the Code. These General Business Asset Classes describe types of depreciable tangible personal property that are frequently used in many businesses. For example, the first three General Business Asset Classes are office furniture, fixtures, and equipment; information systems; and data handling equipment.



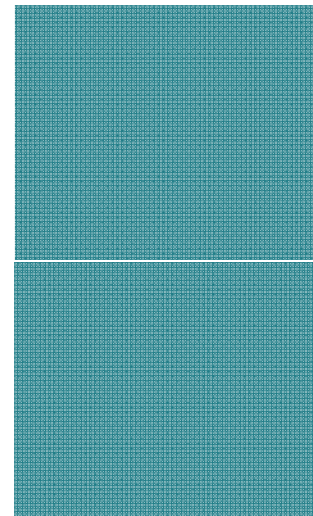
- (i) Office furniture, fixtures, and equipment (asset class 00.11),
- (ii) Information systems (computers and peripheral equipment) (asset class 00.12),
- (iii) Data handling equipment, except computers (asset class 00.13),
- (iv) Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21),
- (v) Automobiles, taxis (asset class 00.22),
- (vi) Buses (asset class 00.23),
- (vii) Light general purpose trucks (asset class 00.241),
- (viii) Heavy general purpose trucks (asset class 00.242),
- (ix) Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25),
- (x) Tractor units for use over-the-road (asset class 00.26),
- (xi) Trailers and trailer-mounted containers (asset class 00.27),
- (xii) Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28), and
- (xiii) Industrial steam and electric generation and/or distribution systems (asset class 00.4).

Reg. §1.1031(a)-2(b)(2).

**Product Classes:** Product Classes consist of depreciable tangible personal property listed in a Product Code. A property's Product Code, ("SIC") is its four-digit product class under the product coding system of the Standard Industrial Classification codes set forth in Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (1987), which is indexed and available in most libraries. Reg. §1.1031(a)-2(b)(3). On August 12, 2004, the Service issued regulations replacing the use of product classes based upon the SIC system with the North American Industry classification system, ("NAICS") for determining what properties are of like class under section 1031.

**Other Personal Property:** Under the Regulations, an exchange of intangible personal property, non-depreciable personal property, or personal property held for investment may qualify for non-recognition of gain or loss under Section 1031 only if the exchanged properties are of a like-kind. These types of property have not been divided into like classes because of the variety of such personal property and the lack of generally available classification systems. For example, the nature or character of intangible personal property is generally dependent not only on the type of right involved (e.g., a patent or a copyright) but also on the type of underlying property to which the intangible personal property relates.

Thus, although the differences between copyrights on different novels may best be described as differences of grade or quality, the differences between a copyright on a novel and a copyright on a song may best be described as differences of nature or character. For these reasons, no like classes are provided in the Regulations for intangible personal property, non-depreciable personal property, and personal property held for investment and this determination will presumably have to be made on an individual basis. Reg. §1.1031(a)-2(c).



**Treatment of Liabilities:** Section 1.1031(b)-1(c) of the existing Regulations provides that consideration received in the form of an assumption of liabilities (or a transfer subject to a liability) is to be treated as "other property or money" for purposes of Section 1031(b). Where each party to the exchange either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of "other property or money" for purposes of Section 1031(b), consideration given in the form of an assumption of liabilities (or a receipt of property subject to a liability) is offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability). Additional rules are provided in 1.1031(d)-2, examples (1) and (2). Reg. §1.1031(b)-1, (d)-2.

**Exchange of Multiple Properties:** The Regulations adopt an "exchange group" approach to multi-asset exchanges. No gain will be recognized if the aggregate value of the properties in each group transferred equals the aggregate value of the properties received in the same exchange group. If the aggregate fair market values are not identical, gain will be recognized. While this approach is not as restrictive as the pro-rata approach, it does require that Taxpayers determine the fair market value of each asset transferred, and will almost certainly result in some recognized gain. Reg. §1.1031(j)-1.

**Treatment of Liabilities: Multi-Asset Exchanges:** All liabilities of which the Taxpayer is relieved in the exchange are offset against all liabilities assumed by the Taxpayer in the exchange, regardless of whether the liabilities are recourse or non-recourse and regardless of whether the liabilities are secured by or otherwise related to specific property transferred or received as part of the exchange. If there are excess liabilities assumed by the Taxpayer as part of the exchange (i.e., the amount of liabilities assumed by the Taxpayer exceeds the amount of the liabilities of which the Taxpayer is relieved), the excess is allocated to the properties received in all the exchange groups, based on their fair market values and to the extent of their fair market values. The same rules apply if the exchange is part of a larger transaction (e.g., a transaction described in Section 1060(a)), except that all liabilities assumed or relieved as part of such larger transaction are offset against each other. Under certain circumstances, the allocation of excess liabilities assumed to property received in the exchange groups may result in more gain recognized under Section 1031 than if the excess liabilities assumed were allocated under another method. For example, this may be the result in the case of a purchase or sale of a business which in part consists of an exchange of multiple properties where there are excess liabilities assumed as part of the overall transaction. On the other hand, the effect of offsetting all liabilities assumed by the Taxpayer against all liabilities of which the Taxpayer is relieved is generally to decrease the amount of gain recognized. Reg. §1.1031(j)-1(b)(2)(ii).

**Goodwill/Going Concern Value:** The Regulations state that goodwill and/or going concern value of a business activity are not like-kind to goodwill or going concern value of another business activity, regardless of whether the business activities are similar. Considering recent legislative changes allowing for the amortization of intangibles, this regulatory prohibition is probably a good candidate for litigation. Reg. §1.1031(a)-2(c)(2).

