

IRC §1031: LIKE-KIND EXCHANGES GENERAL STATUTORY REQUIREMENTS

- 1 Both the property surrendered and the property received must be held either for productive use in a trade or business, or for investment.
- 2 The property surrendered and the property received must be of "like-kind."
- 3 The exchange must be a reciprocal transfer of properties as distinguished from a sale and repurchase.

BUSINESS/INVESTMENT

Section 1031 does not define either the term "productive use in a trade or business" or "for investment". The Regulations provide that otherwise unproductive property held by a "non dealer" for future trade or business use or for future appreciation constitutes property held for investment. The relevant qualified use is the use of each property in the taxpayer's hands. The use of either property in the hands of the other party to the exchange is irrelevant.

Qualifying property must be used in a trade or business in which the taxpayer is engaged. The test is applied at the time of the exchange without regard to the taxpayer's motive prior to the exchange.

In Private Letter Ruling 8103117 the Service ruled that unimproved real estate qualified for a like-kind exchange where the taxpayer abandoned his original intention to construct a personal residence

on it and thereafter held it only for investment. A minimum amount of incidental personal use by a taxpayer will not taint qualifying investment property.

The language of Section 1031(a) states that an exchange of like-kind property will qualify provided the property received is "to be held for" productive use or investment. This reflects the continuity of ownership concept underlying nontaxable exchanges. (Reg. 1.1002-1(c)). How long the property received must be held by the taxpayer is uncertain. Depending on the facts and circumstances, the Service may construe subsequent dispositions, taxable or nontaxable, as evidence that the property was not acquired "to be held" so that the initial exchange would be taxable.

It is interesting to note that there have been two legislative initiatives in the last ten years attempting to modify the statute to impose a one-year holding period on property eligible for non-recognition treatment under Section 1031. Both proposals came out of the Treasury Department, and while neither initiative passed, it does give some indication of the administration's position on this issue.

LIKE KIND: GENERAL RULE

All property classified as realty under state law is "like-kind."

Refers to the nature or character of property, not to its grade or quality. The fact that the real estate is improved or unimproved is immaterial. The non-recognition rules of Section 1031 concern the dichotomy between realty and personalty rather than real estate which has dissimilar locations, characteristics or profit producing uses.

Improved real estate may be exchanged for unimproved real estate, and urban real estate may be exchanged for rural real estate. Mineral and non-mineral real property interests are like-kind to each other provided the mineral interests are considered real property under applicable state law. A leasehold interest of at least 30 years duration, including optional renewal periods, is like-kind to a fee.

The original version of Section 1031 premised non-recognition on the receipt of property of "like-kind or use". The "or use" limitation was quickly dropped because it was too difficult to determine if property received at the time of the exchange was to be held for productive use and not for investment. Subsequently, investment property was eligible to be exchanged for like-kind business property without recognition of gain.

PROPERTY FOR PROPERTY

The essence of an exchange is a reciprocal transfer of properties as distinguished from a sale for cash and reinvestment.

The Service initially took the position that the reciprocal transfer of property must be simultaneous. Under this view, a transfer of like-kind property in the future would not constitute an exchange.

In *Starker v. U.S.* 1975-1 USTC 8443 (D. Oregon 1975), the Ninth Circuit rejected this position. The Tax Reform Act of 1984 attempted to provide

more certainty in the area of delayed exchanges; however, this is not always the case.

The Tax Court will likely use the step transaction doctrine in its analysis of whether the non-recognition requirements under Section 1031 have been satisfied.

All the legs of the exchange must constitute an integrated, mutually dependent transaction. The Tax Court will look to interdependence, intent, timing, and commitment of the parties to the exchange.

Excluded Property

Section 1031(a)(2) denies non-recognition treatment to the transfer, or receipt of the following categories of property:

- Stock in trade or other property held primarily for sale
- Stocks, Bonds, or Notes
- Other securities or evidence of indebtedness or interest
- Interests in a Partnership
- Certificate of Trust or Beneficial Interest (see "Illinois Land Trusts" Revenue Ruling 92 -105)
- Choses in action

Partnership Problems in Like-kind Exchanges

Internal Revenue Code Section 1031(a)(2) excludes the exchange of a partnership interest, except where the partnership has in effect a valid election under Section 761(a) to be excluded from the application of subchapter K, in which case the interest shall be treated as an interest in each of the assets of the partnership, and not as an interest in a partnership.

A partnership includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business,

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financial operation or venture is carried on and which is not a corporation, trust or estate.

Tenants in common may be partners if they actively carry on a trade, business, financial operation or venture and divide the profits thereof. For example, a partnership does exist if co-owners of an apartment building lease space and, in addition, provide services to the occupants either directly or through an agent. (See Reg. § 1.761-1).

If an election under 761(a) is not feasible, partners may attempt to dissolve the partnership in front of the exchange - the "Drop and Swap" method - where each partner receives a tenancy in common interest in the property and decides individually to either sell or exchange their interest.

Alternatively, the partnership may complete the exchange at the partnership level and dissolve the partnership at some point in the future - the "Swap and Drop" method. In this scenario, the partnership dissolves and distributes tenancy in common interests to the individual partners. Each individual can then either sell or continue to hold their interest.

The "Drop and Swap" and "Swap and Drop" solutions are not without risk. The holding period of the partnership does not tack to the individuals when the partnership is dissolved which could lead the Service to conclude that the property was not held for the requisite intent.

Deferred (Delayed) Exchanges **Like Kind Exchanges**

The Final Regulations to Section 1031 (generally effective for transfers occurring after June 10, 1991) provided 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 addi-

tion, Section 77 of the Act provided that Section 1031(a) does not apply to any exchange of interests in a partnership.

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).

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 Service has determined that the deferred exchange rules of Section 1031(a)(3) do not apply to Reverse Starker transactions. In September of 2000 the Service did issue guidance in the form of Revenue Procedure 2000-37 to deal with "parking arrangements" in certain reverse exchange transactions.

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." 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.**

3 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.

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.

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.

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.

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.

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.

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.

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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).

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.

Acquisition by Intermediary

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.

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).

Revocation of Identification

In order for an escrow or trust account to be a "qualified" account for purposes of the Regulations, and to avoid the issue of constructive receipt of funds by the Taxpayer, the account must contain specific restrictions on the Taxpayer's rights to receive the cash. Specifically, the Regulations require that the Taxpayer 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.

Reverse Exchanges

Revenue Procedure 2000-37 like Kind Exchanges

The Internal Revenue Service issued guidance on Reverse Exchanges: Revenue Procedure 2000-37, (effective September 15, 2000). The Rev. Proc. provides a safe harbor under which the Internal Revenue Service will not challenge the qualification of relinquished property or replacement property in certain "Reverse Exchanges".

Practitioners will discover significant planning opportunities are available as a result of the new Revenue Procedure, including the ability to treat the Exchange Accommodation Titleholder as the owner of property for federal income tax purposes, and the Taxpayer as the owner of the property for financial reporting purposes.

The Rev. Proc. defines a safe harbor for structuring a reverse exchange under Section 1031 and, in brief, provides the following:

1 The IRS will not challenge the qualification of property as either "replacement property" or "relinquished property" as defined in the 1031 Treasury Regulations. In addition, the IRS will not challenge the treatment of an "Exchange Accommodation Titleholder" (EAT) as the beneficial owner of such property for federal income tax purposes, if the property is held in a "Qualified Exchange Accommodation Arrangement" pursuant to a "Qualified

Exchange Accommodation Agreement" (QEAA).

2 Property is deemed to be held in a QEAA if the following requirements are met:

i. Qualified indicia of ownership is held by someone other than the taxpayer or a disqualified person (i.e.: the Exchange Accommodation Titleholder) who is subject to federal income tax.

Qualified indicia of ownership can be demonstrated by: (a) legal title held by the EAT, (b) other indicia of ownership such that the EAT is treated as the beneficial owner of the property, as in a contract for deed, or (c) a single member LLC that holds legal title to the property (or some other entity that is disregarded for Federal income tax purposes), the membership interest of which is owned by the EAT.

ii. At the time the property is transferred to the EAT, the taxpayer must have bona fide intent that the property represents either replacement property or relinquished property that is intended to qualify for non-recognition of gain under Section 1031.

iii. No later than 5 business days after the EAT acquires the property, the taxpayer and the EAT must enter into a Qualified Exchange Accommodation Agreement. The QEAA must specify that the EAT is holding the property for the benefit of the taxpayer to facilitate an exchange under Section 1031. The QEAA must also specify that the EAT is the beneficial owner of the property, and all parties must report ownership of the Property as such for federal income tax purposes.

iv. No later than 45 days after the transfer of the replacement property to the EAT, the

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taxpayer must identify the relinquished property in a manner consistent with the 1031 Treasury Regulations (i.e.: the "3-property" or "200% rule").

- v. No later than 180 days after the property is transferred to the EAT, the property is transferred to the taxpayer as replacement property, or to a person who is not the taxpayer or a disqualified person, as relinquished property.
- vi. The combined period that the relinquished property or the replacement property is held in the QEAA does not exceed 180 days.

4 In addition, the Rev. Proc. provides the following:

- i. The Exchange Accommodation Titleholder may also act as Qualified Intermediary in the exchange (provided the EAT is not a disqualified person).
- ii. The taxpayer (or a disqualified person) can guarantee all of the obligations of the EAT, including a guarantee of the debt incurred by the EAT to acquire the replacement property, and can indemnify the EAT against costs and expenses.
- iii. The taxpayer (or a disqualified person) can loan funds to the EAT to acquire the replacement property.
- iv. The property can be leased by the EAT to the taxpayer.
- v. The taxpayer (or a disqualified person) can manage the property, oversee improvements to the property, act as contractor and provide services to the EAT.
- vi. The taxpayer and the EAT can enter into agreements arranging for the purchase or sale of the property, including puts and calls, effective for a period not to exceed

185 days from the date the EAT acquires the property.

- vii. The taxpayer and the EAT can enter into an agreement to deal with fluctuations in the price of the relinquished or replacement property during the period of time that the property is owned by the EAT.

In addition, the planning opportunities presented by Revenue Procedure 2000-37 afford significant flexibility in managing the timing of acquisitions and dispositions as tax deferred exchanges.

However, we quickly became aware of two potential problems which could impact the business decision of whether or not to take advantage of the tax savings opportunities.

The first was the potential assessment of duplicate transfer taxes at the state and local level. The second was the potential bankruptcy risk of an EAT. Both of these issues were addressed in two private letter rulings issued to Chicago Deferred Exchange Corporation.

To date, these are the only two rulings the IRS has issued in the context of reverse exchanges under the Revenue Procedure.

PLR 200148042 concludes that Chicago Deferred Exchange Corporation's Qualified Exchange Accommodation Agreement may contain an express declaration of agency for all purposes except federal income tax purposes. We are not aware of any jurisdiction where a transfer from an agent to a principal is a taxable event. We believe that it would be extremely unlikely that the Service would set up a deficiency in the event a customer of Chicago Deferred Exchange were to rely on this ruling.

PLR 200201024 takes the concept that a single member limited liability company is not treated as an entity separate from its owner one step further by creating a "hybrid" single member LLC. In this situation CDEC was concerned that a taxpay-

er may be reluctant to utilize the reverse exchange EAT structure because of risks arising from the potential bankruptcy of the EAT member of the LLC. The ruling concludes that the taxpayer (or taxpayer's lender) could hold a non-economic membership interest in the LLC without causing the LLC to be treated as something other than a disregarded entity. We believe this ruling provides an unprecedented level of security to our customers.

The full text of both of these rulings are available at our website: chicagodeferred.com



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