Tax Deferred Exchanges of Property - Mistakes, Misconceptions and Traps[1]

By

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Introduction:

Many tax deferred exchanges under section 1031 of the Internal Revenue Code result in an unexpected tax liability because of incorrect legal and/or tax advice (or in some cases no advice at all). With this in mind, this article focuses primarily on common misconceptions of taxpayers and their advisers concerning 1031 exchanges and the tax consequences thereof, the mistakes commonly made, and the many IRS traps in which taxpayers may fall absent a properly structured exchange.

Definition of "Exchange" and Concept of "Intermediary:"

There is no better place to start than with the definition of an "exchange," a simple yet often misunderstood concept which clarifies the necessity of using a qualified intermediary. An "exchange" occurs when a taxpayer conveys property (the "relinquished property") to the same party from whom such taxpayer acquires "replacement property." Contrary to what many taxpayers believe, if a taxpayer conveys relinquished property to a purchaser and acquires replacement property from someone other than the purchaser, an exchange has not occurred even if the sale and purchase close simultaneously. Absent an exchange section 1031 is inapplicable and the taxpayer must recognize gain for income tax purposes.

Prior to the 1990s the requirement of an "exchange" created problems in that a taxpayer desiring tax deferral under section 1031 was forced to require that the purchaser become a party to the taxpayer's acquisition of replacement property (as only then would the taxpayer be deemed to have conveyed property to the same party from whom the taxpayer acquired replacement property). The purchaser would get nervous and hire a lawyer (whose fees would often be borne by the taxpayer conducting the exchange), complex documents would be drafted, etc.

Fortunately these problems were alleviated when IRS regulations authorized the use of a "qualified intermediary" to accommodate a taxpayer's exchange.[2] Pursuant to 1031 regulations, if

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[2] Section 1.1031(k)-1(g)(4)(i) states as follows: "In the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange...." Section 1.1031(k)-1(g)(4)(iii) defines a "qualified

prior to a sale of relinquished property a taxpayer (i) executes an exchange agreement with an intermediary and (ii) assigns to the intermediary his "rights"[3] under a real estate sale agreement (such assignment accompanied by written notice thereof to all parties to the purchase agreement), then for income tax purposes the taxpayer will be "treated as if" he conveyed the relinquished property to the intermediary followed by the intermediary's conveyance of such property to the purchaser (although at the closing the taxpayer may simply deed the relinquished property directly to the purchaser).[4] Likewise if prior to the taxpayer's acquisition of replacement property the taxpayer assigns to the intermediary his "rights"[5] under a real estate purchase agreement (such assignment accompanied by written notice thereof to all parties to the purchase agreement), then for income tax purposes the taxpayer will be "treated as if" the intermediary acquired the replacement property and conveyed such property to the taxpayer (although at the closing the seller may simply deed the replacement property directly to the taxpayer).[6] In other words, by executing an exchange agreement and assigning to the intermediary rights under real estate sale/purchase agreements (with written notice thereof to all parties to the purchase agreement), the taxpayer is "treated as if" he conveyed relinquished property to the same party (the intermediary) from whom the taxpayer acquired replacement property (i.e. an "exchange"). By following the 1031 regulations, no longer must a taxpayer request that a purchaser become a party to the taxpayer's acquisition of replacement property. Neither the purchaser's cooperation nor participation is required for purposes of the taxpayer's exchange and for this reason there is generally no need to insert language in the real estate sales agreement implying otherwise.[7]

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intermediary" as a person other than the taxpayer or a "disqualified person" who enters into an "exchange agreement" with the taxpayer and, as required by such agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer. Section 1.1031(k)-1(k) indicates that a "disqualified person" includes any related party, as well as an "agent" who, within the 2-year period prior to the taxpayer's conveyance of relinquished property, has acted as taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker (provided that "services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under section 1031" are disregarded).

[3] Only "rights" need be assigned. There is no requirement that the intermediary assume obligations under the real estate purchase agreement.

[4] See 1.1031(k)-1(g)(4)(iv-v).

[5] Again, only "rights" need be assigned. There is no requirement that the intermediary assume obligations under the real estate purchase agreement.

[6] See 1.1031(k)-1(g)(4)(iv-v).

[7] We often see real estate purchase agreements which indicate that the seller intends to conduct an exchange, that the purchaser will cooperate in this regard, that the seller will indemnify the purchaser against any loss or expense associated with seller's exchange, etc. This language is left over from the 1980s when there were no regulations authorizing the use of qualified intermediaries (i.e. when taxpayers needed the purchaser to participate in the taxpayer's exchange). There is nothing in section 1031 or the regulations thereunder requiring that the real estate purchase agreement address issues associated with the 1031 exchange, and with the advent of intermediaries, today there is no need for such language. One should be sure that there is nothing in the real estate purchase agreement

<u>Types of Exchanges</u>:

There are generally three major types of exchanges, a "simultaneous" exchange (taxpayer conveys relinquished property and simultaneously acquires replacement property), a "deferred" exchange (taxpayer conveys relinquished property and subsequently acquires replacement property), and a "reverse" exchange (taxpayer acquires replacement property and thereafter conveys relinquished property). Again, regardless of the type exchange being conducted, to use a qualified intermediary the taxpayer must execute an exchange agreement and assign to the intermediary rights under real estate sale/purchase agreements (generally with written notice of assignment to the purchaser/seller). With respect to deferred exchanges, the taxpayer must also (i) "identify" replacement property within the 45-day "identification period," (ii) acquire replacement property within the "exchange period," and (iii) avoid "constructive receipt"[8] of the sales proceeds in the meantime (which is accomplished by escrowing **<u>all</u>** net sales proceeds, including any earnest money which may have been delivered by the purchaser, with the intermediary pursuant to an exchange agreement which restricts the taxpayer's ability to receive, pledge, borrow or otherwise obtain such sale proceeds).[9]

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restricting the taxpayer's ability to assign rights to another party, as the taxpayer will need to assign rights under the agreement to the intermediary with written notice to the purchaser.

[8] Section 1.1031(k)-1(a) states as follows: "In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or property which does not meet the requirements of section 1031(a) before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or property which does not meet the requirements of section 1031(a) in the full amount of the consideration for the relinquished property, the transaction will constitute a sale, and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property." See also 1.1031(k)-1(f).

[9] Section 1.1031(k)-1(g)(4)(i-ii) states as follows: "(i) In the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer. (ii) Paragraph (g)(4)(i) of this section applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's right to receive, pledge, borrow, or otherwise the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in paragraph (g)(6) of this section."

Deferred Exchanges -- "Identification" of Replacement Property:

The "identification" rules can be tricky. Within 45 days after the sale,[10] the taxpayer must identify, in a writing signed by the taxpayer (usually a letter mailed or emailed to the intermediary),[11] one or more potential replacement properties for the exchange. A taxpayer may identify up to three properties without worrying about any additional restrictions (the "3-property rule"). If a taxpayer identifies more than three properties, then the total value of all identified property may not exceed twice the value of the relinquished property (the "200 percent rule") unless the taxpayer acquires 95% of everything identified (the "95 percent rule").[12] If an identification rule is violated, the exchange will fail and 100% of the gain must be recognized.[13]

Any property acquired during the 45-day period is deemed to be identified.[14] Thus the identification letter need only identify properties which may be acquired after the end of the 45-day period. However, for purposes of the 3-property rule and the 200 percent rule, any property acquired during the 45-day period counts. In other words, if a taxpayer acquires one property during the 45-day period and identifies three more properties, then the total value of the four properties cannot exceed twice the value of the relinquished property absent compliance with the 95 percent rule.

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[10] Section 1.1031(k)-1(b)(2)(i) states as follows: "The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th day thereafter." Section 1.1031(k)-1(b)(2)(iii) states as follows: "If, as part of the same deferred exchange, the taxpayer transfers more than one relinquished property and the relinquished properties are transferred on different dates, the identification period and the exchange period are determined by reference to the earliest date on which any of the properties are transferred."

[11] Section 1.1031(k)-1(c)(2) states as follows: "Replacement property is identified only if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either – (i) The person obligated to transfer the replacement property to the taxpayer..., (ii) Any other person involved in the exchange other than the taxpayer or a disqualified person.... Examples of persons involved in the exchange include any of the parties to the exchange, an intermediary, an escrow agent, and a title company. An identification of replacement property made in a written agreement for the exchange of properties signed by all parties thereto before the end of the identification period will be treated as satisfying the requirements of this paragraph (c)(2)."

[12] Section 1.1031(k)-1(c)(4)(i) states as follows: "The taxpayer may identify more than one replacement property. Regardless of the number of relinquished properties transferred by the taxpayer as part of the same deferred exchange, the maximum number of replacement properties that the taxpayer may identify is – (A) Three properties without regard to the fair market values of the properties (the "3-property rule"), 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 as of the date the relinquished properties were transferred by the taxpayer (the "200-percent rule")." For the "95-percent rule," see section 1.1031(k)-1(c)(4)(ii).

[13] Section 1.1031(k)-1(c)(4)(ii) states as follows: "If, as of the end of the identification period, the taxpayer has identified more properties as replacement properties than permitted by paragraph (c)(4)(i) of this section, the taxpayer is treated as if no replacement property had been identified."

[14] Section section 1.1031(k)-1(c).

The identification must be specific.[15] With respect to timberland for example, the taxpayer should utilize the legal description if available. An alternative is to attach a page from the applicable plat book with the identified property highlighted. If the property is within city limits, then the address may be used. If the property has a distinguishable name (such as the name of an apartment complex or the name of a commercial building), then such name may be used. If the property is a condominium unit, then a specific unit must be identified. Stating "a unit in Phoenix X" will not suffice.

Also, within the exchange period the taxpayer must acquire "substantially the same" property as identified.[16] If a taxpayer identifies a tract of timberland for example, but acquires only a half interest in such timberland (the other half being acquired by another buyer), the half interest may not be considered to be substantially the same property as identified. In this case regulations indicate that if a taxpayer acquires at least 75% (in size and value) of what was identified, then the acquired interest is substantially the same as what was identified.[17] Obviously if a taxpayer intends to acquire merely a half interest, a half interest (or at least no more than an undivided 66.67% interest) should be identified.

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[15] Section 1.1031(k)-1(c)(3) states as follows: "Replacement property is identified only if it is unambiguously described in the written document or agreement. Real property generally is unambiguously described if it is described by a legal description, street address, or distinguishable name...."

[16] Section 1.1031(k)-1(d) states as follows: "In the case of a deferred exchange, the identified replacement property is received before the end of the exchange period if – (i) The taxpayer receives the replacement property before the end of the exchange period, and (ii) The replacement property received is substantially the same property as identified."

[17] Example 4 of section 1.1031(k)-1(d)(2) states as follows: "(i) In the agreement, B identifies real property R as replacement property. Real property R consists of two acres of unimproved land and has a fair market value of $250,000. As of October 3, 1991, real property R remains unimproved and has a fair market value of $250,000. On that date, at B's direction, C purchases 1½ acres of real property R for $187,500 and transfers it to B, and B pays $87,500. (ii) The portion of real property R that B received does not differ from the basic nature or character of real property R as a whole. Moreover, the fair market value of the portion of real property R that B received ($187,500) is 75 percent of the fair market value of real property R as of the date of receipt. Accordingly, B is considered to have received substantially the same property as identified." Compare such result to Example 3 of section 1.1031(k)-1(d)(2), which states as follows: "(i) In the agreement, B identifies real property Q as replacement property. Real property Q consists of a barn on two acres of land and has a fair market value of $250,000 ($187,500 for the barn and underlying land and $87,500 for the remaining land). As of July 26, 1991, real property Q remains unchanged and has a fair market value of $250,000. On that date, at B's direction, C purchases the barn and underlying land for $187,500 and transfers it to B, and B pays $87,500 to C. (ii) The barn and underlying land differ in basic nature or character from real property Q as a whole. B is not considered to have received substantially the same property as identified."

Deferred Exchanges -- "Exchange Period:"

The "exchange period" can be tricky as well. Most taxpayers believe the exchange period is six months beginning with the date of the sale. Actually the exchange period ends on the earlier of the 180th day following the sale or the due date for the taxpayer's income tax return for the year in which the sale takes place.[18] Assume an individual taxpayer conveys relinquished property on December 15, 2024. His exchange period will end on April 15, 2025 (approximately two months earlier than the 180th day), absent an extension (approved by the IRS) of the due date for his 2024 income tax return. Individuals, trusts and C-corporations (using the calendar year for income tax purposes) must be cognizant of this rule with respect to any sale occurring after mid October (as the due date for their income tax return is April 15th of the following year). S-corporations and partnerships must be cognizant of this rule with respect to any sale occurring after mid September (as the due date for their income tax return is March 15th of the following year).

"Like-Kind" -- Real Property:

Within the exchange period the taxpayer must acquire replacement property (identified within the 45-day identification period) of "like kind" to the relinquished property.[19] Generally any real property is of like-kind to other real property.[20] As examples, a taxpayer may convey timberland and acquire a commercial building, or a taxpayer may convey a commercial building and acquire a vacant lot or any other real property.[21]

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[18] Section 1.1031(k)-1(b)(2)(ii-iii) states as follows: "(ii) The exchange period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the earlier of the 180th day thereafter or the due date (including extensions) for the taxpayer's return of the tax imposed by chapter 1 of subtitle A of the Code for the taxable year in which the transfer of the relinquished property occurs. (iii) If, as part of the same deferred exchange, the taxpayer transfers more than one relinquished property and the relinquished properties are transferred on different dates, the identification period and the exchange period are determined by reference to the earliest date on which any of the properties are transferred."

[19] See section 1031(a).

[20] See section 1.1031(a)-1(b-c). "The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class."

[21] Note, however, that if the relinquished realty is depreciable property (such as a commercial building), and if the replacement realty is non-depreciable property (such as timberland), then the taxpayer should seek advice as to whether any "recapture" issues are present. Generally, if the taxpayer has taken prior depreciation deductions with respect to relinquished realty, and if all such depreciation deductions were based on the "straight line" method, and if the amounts applied toward replacement realty exceed the net amount realized from the disposition of relinquished realty, then all gain may be deferred under section 1031 even if the replacement realty is non-depreciable. However, if all prior depreciation deductions were based on the "straight line" method, and if the amount applied toward replacement realty is less than net amount realized from the disposition of relinquished realty, then recognized gain will be considered "unrecaptured section 1250 gain" which is taxed at a maximum federal rate of 25% to the extent of prior depreciation deductions. Moreover, if any portion of relinquished property has been depreciated using an accelerated method of depreciation, such as components of realty subject to cost segregation, then to avoid recognition of ordinary income the taxpayer must apply toward depreciable replacement components as

“Like-Kind” -- Personal Property:

Effective for tax years commencing in 2018, personal property (such as aircraft, equipment, etc.) cannot be exchanged under section 1031. Only real property can be exchanged under section 1031.

“Held for Investment:”

Not only must the relinquished and replacement properties be of like-kind, the relinquished property must have been held “for investment” (or for use in a trade or business) and the replacement property must be acquired with an intent of holding such property “for investment” (or for use in a trade or business).[22]

Question: How long must the relinquished property have been held for investment in order for a taxpayer to conduct an exchange?

Answer: There is no specific period beyond which an exchange definitely works or short of which an exchange definitely fails.[23] A conservative approach would be to hold property for at least one year (the period which gives rise to long term capital gain treatment) prior to marketing such property for sale.[24] The longer the period, the safer the exchange will be in the event of an audit.

“Second Homes:”

On one end of the spectrum is “investment property,” and on the other end is a primary residence or “second” residence held for personal use rather than for investment. The words “second residence” and “section 1031" don’t need to be in the same sentence. A “second residence” cannot be exchanged under section 1031.

On February 19, 2008, the IRS issued Revenue Procedure 2008-16, which provides a safe harbor under which the IRS will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment for purposes of section 1031. To be within the safe harbor with respect to the relinquished property, for at least 24 months prior to the exchange

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much or more than the value of the relinquished components.

22 See section 1031(a).

23 In 124 Front Street, Inc. v. Comr., 65 T.C. 6 (1975), the Tax Court upheld a 1031 exchange where the relinquished property had been held by the taxpayer for approximately six months. See also Tax Free Exchanges Under 1031 by Jeremiah M. Long and Mary Foster (published by Clark, Boardman & Callaghan), section 2:13.

24 Once a property is put on the market for sale, it is being held “for sale” rather than held “for investment.”

(i) the property must have been owned by the taxpayer, (ii) the property must have been rented at fair rental value for 14 days or more per year, and (iii) the taxpayer's personal use of such property must not have exceeded the greater of 14 days per year or 10% of the number of days per year during which the property is rented at fair rental value. Likewise, to be within the safe harbor with respect to the replacement property, for at least 24 months after the exchange (i) the property must be owned by the taxpayer, (ii) the property must be rented at fair rental value for 14 days or more per year, and (iii) the taxpayer's personal use of such property must not exceed the greater of 14 days per year or 10% of the number of days per year during which the property is rented at fair rental value. The safe harbor applies for exchanges of dwelling units occurring on or after March 10, 2008. Obviously the conservative approach would be to comply with the provisions of this safe harbor when conveying or acquiring a residential property.

Often residential property is encumbered by a mortgage. If so, and if the taxpayer has been characterizing the interest as deductible "qualified home mortgage interest" (interest incurred on the primary residence and a second residence can be deducted as qualified home mortgage interest), then the property would not appear to constitute investment property. Deducting interest as qualified home mortgage interest is inconsistent with thereafter characterizing the property as investment property for purposes of 1031.

Often taxpayers obtain a mortgage through a mortgage company and represent to the mortgage company (for purposes of obtaining a lower interest rate) that replacement property will be a second residence, will be owner occupied and/or will not be rented to third parties. Such statements are inconsistent with taking the position the replacement property constitutes investment property under section 1031. When conducting an exchange (particularly reverse exchanges), it usually makes more sense to borrow through a bank as opposed to a mortgage company.

Gain Recognition:

An often misunderstood concept involves the amount of gain which must be recognized when less than 100% of the net sales proceeds is invested in replacement property. Assume a taxpayer purchases property for $100,000 and therefore has an income tax basis of $100,000 in such property. Further assume the property appreciates in value to $300,000. Two things are clear to most taxpayers. First, if the taxpayer sells the property for $300,000 and does not conduct an exchange, the taxpayer's "realized gain" would be $200,000, all of which must be "recognized" and reported on the taxpayer's income tax return. Second, if the taxpayer conducts an exchange and acquires one or more replacement properties of like kind at a cost of $300,000 or more, none of the $200,000 realized gain need be recognized as the entire gain is deferred under section 1031.[25] What many

[25] Note that gain is "deferred," not alleviated. Section 1.1031(d)-1 states as follows: "(a) If, in an exchange of property solely of the type described in section 1031 ..., no part of the gain or loss was recognized under the law applicable to the year in which the exchange was made, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with property adjustments to the date of the exchange. If additional consideration is given by the taxpayer in the exchange, the basis of the property acquired shall be the same as the property transferred increased by the amount of additional consideration given (see section 1016 and the

taxpayers and their advisers do not understand is the amount of realized gain which must be recognized if, in this example, the taxpayer acquires replacement property at a cost of $250,000. The answer -- $50,000. Realized gain must be recognized to the extent the net sales proceeds ($300,000) exceed the cost of the replacement property ($250,000).[26]

Take this concept a step further with the following question:

Question: Assuming the taxpayer sells relinquished property for $300,000 (with an income tax basis of $100,000), how much gain must be recognized if the taxpayer reinvests $100,000 in replacement property?

Answer: The entire gain of $200,000 must be recognized. <u>If the taxpayer does not reinvest in replacement property an amount which exceeds his income tax basis in the relinquished property, the tax consequences of an exchange are the same as the tax consequences of a sale</u>. In other words a taxpayer does not start deferring tax under section 1031 until he has reinvested in replacement property an amount which exceeds his income tax basis in the relinquished property.

The preceding rules apply even if the relinquished property is encumbered by a mortgage. To defer 100% of the realized gain taxpayers must reinvest in replacement property 100% of the net amount realized (sales price less closing costs), not just their "equity" in the relinquished property.

Question: If a taxpayer conveys relinquished property for $300,000, and $200,000 of the sales proceeds is used to pay off a mortgage on the relinquished property (leaving $100,000 of cash to be escrowed with the intermediary), how much must the taxpayer reinvest in replacement property to defer 100% of the gain?

Answer: To defer 100% of the gain the taxpayer must acquire replacement property at a cost of $300,000 or more. In other words, the taxpayer must not only reinvest the $100,000 of cash but must also either infuse $200,000 of cash

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regulations thereunder). (b) If, in an exchange of properties of the type indicated in section 1031 ..., gain to the taxpayer was recognized under the provisions of section 1031(b) or a similar provision of a prior revenue law, on account of the receipt of money in the transaction, the basis of the property acquired is the basis of the property acquired shall be the same as the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized on the exchange."

[26] Section 1.1031(b)-1(a) states as follows: "If the taxpayer receives other property (in addition to property permitted to be received without recognition of gain) or money ... in an exchange described in section 1031(a) of property held for investment or productive use in trade or business for property of like kind to be held either for productive use or for investment, ... the gain, if any, to the taxpayer will be recognized under section 1031(b) in an amount not in excess of the sum of the money and the fair market value of the other property ...."

or borrow at least $200,000 in connection with the acquisition of replacement property.[27]

"Taxpayer" Issues:

A related concept involves the "taxpayer" conducting the exchange. As a general rule, to defer 100% of the gain, whoever conveys the relinquished property must acquire the replacement property.

Question: What if H (husband) conveys relinquished property for $300,000, and H and W (wife) jointly acquire replacement property at a cost of $300,000?

Answer: A common mistake. H conveyed property worth $300,000 yet acquired property (a half interest) worth $150,000. Up to $150,000 of realized gain must be recognized by H.

Question: What if H and W convey jointly held relinquished property for $300,000, and W acquires replacement property for $300,000?

Answer: Another common mistake. Although W has a clean exchange, H conveyed property worth $150,000 and acquired no replacement property. H's entire gain must be recognized.

Question: What if H and W convey jointly held relinquished property for $300,000, and their family partnership acquires replacement property for $300,000?

Answer: Another common mistake. H and W conveyed property worth $300,000 and acquired no replacement property. Their entire gain must be recognized.

Question: In the preceding question, what if H and W acquired the replacement property but soon thereafter contributed such property to their family partnership?

Answer: Under the step transaction doctrine the IRS could argue that H and W have either (i) exchanged realty for a partnership interest in violation of section

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[27] If the taxpayer were to reinvest only his equity of $100,000, the debt relief of $200,000 would be considered "money received by the taxpayer" for purposes of recognizing gain. See section 1.1031(d)-2. In this regard, section 1.1031(b)-1(a) states as follows: "If the taxpayer receives other property (in addition to property permitted to be received without recognition of gain) or money ... in an exchange described in section 1031(a) of property held for investment or productive use in trade or business for property of like kind to be held either for productive use or for investment, ... the gain, if any, to the taxpayer will be recognized under section 1031(b) in an amount not in excess of the sum of the money and the fair market value of the other property ...."

1031(a)(2)(D),[28] or (ii) acquired replacement property with an intention of conveying such property to another party (their partnership) rather than with an intention of holding such property for investment as required by section 1031(a)(1).[29]

Seller Financed Exchanges:

Another related concept involves financing issues upon the conveyance of relinquished property or acquisition of replacement property. Assume a taxpayer conveys property for $300,000 but finances $200,000 of the sales price for the purchaser. In other words the purchase price is payable via $100,000 in cash at closing (properly escrowed with an intermediary) with the balance represented by the purchaser's promissory note (properly escrowed with an intermediary) secured by a vendor's lien or mortgage on the relinquished property. In this example many taxpayers believe they may then (i) acquire replacement property for $300,000, (ii) have the intermediary supply to the closing agent the $100,000 of cash derived from the sale, (iii) borrow the $200,000 balance from a bank, and (iv) have the intermediary thereafter return/assign to the taxpayer the purchaser's $200,000 promissory note. This is incorrect. In such an exchange, the taxpayer would be deemed to have conveyed (i) relinquished property worth $300,000 and (ii) a $200,000 note to the bank in exchange for (i) replacement property worth $300,000 and (ii) the purchaser's $200,000 promissory note. The purchaser's promissory note of $200,000 constitutes "boot" (i.e. something other than real estate of like kind to the relinquished property). Generally taxpayers must recognize gain to the extent of the "boot." The question becomes whether the taxpayer may offset the receipt of such boot by executing a note to the bank. The answer is no, leaving the taxpayer with up to $200,000 of realized gain to

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[28] Section 1.1031(a)-1(a)(1) states as follows: "Section 1031(a)(1) does not apply to any exchange of interests in a partnership regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or in different partnerships. An interest in a partnership that has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K is treated as an interest in each of the assets of the partnership and not as an interest in a partnership for purposes of section 1031(a)(2)(D) and paragraph (a)(1)(iv) of this section."

[29] The American Bar Association has taken the position that replacement property may be contributed to a partnership without violating the requirement that replacement property be acquired with an intent of holding such property for investment. See the American Bar Association's "Joint Report on Section 1031 Open Issues Involving Partnerships," BNA Tax Management Memorandum, January 29, 2001. For holdings consistent with this position, see Maloney v. Commissioner, 93 T.C. 89 (1989), Bolker v. Commissioner, 81 T.C. 782 (1983), aff'd 760 F.2d 1039 (9th Cir. 1985), and Magneson v. Commissioner, 81 T.C. 767 (1983), aff'd 753 F.2d 1490 (9th Cir. 1985). Note, however, that the IRS has added two questions to Form 1065 (partnership income tax return) which are designed to disclose whether there has been a "swap and drop" and/or "drop and swap" transaction. In connection with a "swap and drop," Question 13 of Schedule B states as follows: "Check this box if, during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (other than disregarded entities wholly owned by the partnership throughout the tax year)." In connection with a "drop and swap," Question 14 of Schedule B states as follows: "At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property?" The conservative approach would be to avoid these type transactions.

be recognized.[30] Taxpayers may not offset the receipt of boot by executing a note to a bank.[31] To defer 100% of the gain in this example, the taxpayer should consider "infusing" $200,000 into the exchange from a source other than a bank loan secured by the replacement property. If properly structured a cash infusion of $200,000 should offset the purchaser's promissory note and fully reduce the "boot" in this example.[32] Another way to salvage the exchange would be to find a seller of replacement property willing to accept the purchaser's promissory note as part of the sales price,[33] although finding such a seller is highly unlikely.

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[30] Although the purchaser's note would constitute "boot" for purposes of recognizing gain, the gain may be reported over time using the section 453 installment sale method of reporting gain. In this regard, section 1.1031(k)-1(j)(2)(vi) sets forth the following example:

Example 4. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange, B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is a qualified intermediary under paragraph (g)(4) of this section. On September 22, 1994, pursuant to the agreement, B transfers real property X to C who then transfers it to D for $80,000 in cash and D's 10-year installment obligation for $20,000. On that date B has a bona fide intent to enter into a deferred exchange. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property held by C until the earlier of the date the replacement property is delivered to B or the end of the exchange period. D's obligation bears adequate stated interest and is not payable on demand or readily tradable. On March 11, 1995, C acquires replacement property having a fair market value of $80,000 and delivers it, along with the $20,000 installment obligation, to B.

(ii) Under section 1031(b), $20,000 of B's gain (i.e., the amount of the installment obligation B receives in the exchange) does not qualify for nonrecognition under section 1031(a). Under paragraphs (j)(2)(ii) and (iii) of this section, B's receipt of D's obligation is treated as the receipt of an obligation of the person acquiring the property for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B's receipt of the obligation is not treated as a payment. Subject to the other requirements of sections 453 and 453A, B may report the $20,000 gain under the installment method on receiving payments from D on the obligation.

[31] "The taxpayer cannot offset the receipt of the buyer's note by the assumption of debt on the replacement property or probably even a note from the taxpayer to the seller of the replacement property because the buyer's note is "cash or other property" for the purposes of the boot offsetting rules and cannot be offset with mortgage liabilities assumed." See Tax Free Exchanges Under 1031 by Jeremiah M. Long and Mary Foster, section 9:15.

[32] Neither case law nor the regulations under section 1031 appear to have addressed the issue of offsetting a purchaser's note with a cash infusion for purposes of computing gain. Revenue Ruling 72-456 indicates that cash paid in connection with an exchange offsets all money subsequently received for purposes of computing gain, and section 1.1031(d)-2 indicates that cash paid in connection with an exchange offsets boot received in the form of an assumption of a liability or the transfer of property encumbered by a liability. There appears to be no reason why a cash infusion would offset boot in the form of cash subsequently received and boot in the form of debt relief, but not boot in the form of a purchaser's note received subsequent to the cash infusion.

[33] See Tax Free Exchanges Under 1031 by Jeremiah M. Long and Mary Foster, section 9:15.

All Cash Must Be Applied Toward Acquisition of Replacement Property:

To defer 100% of the realized gain, a taxpayer must apply toward the acquisition of replacement property 100% of the net cash proceeds derived from the conveyance of relinquished property.

Question: What if a taxpayer conveys relinquished property for $300,000 which is escrowed with an intermediary, but upon the taxpayer's acquisition of a $300,000 replacement property, the taxpayer obtains a $200,000 bank loan, such that the intermediary supplies only $100,000 to the closing agent and thereafter returns $200,000 to the taxpayer?

Answer: This doesn't work. In such an exchange the taxpayer would have conveyed relinquished property worth $300,000 and executed a $200,000 note to the bank in exchange for replacement property worth $300,000 and cash of $200,000. The $200,000 of cash constitutes "boot" for purposes of computing gain. Again the question is whether the taxpayer may offset the receipt of boot by executing a note to the bank. The answer is no. Taxpayers may not offset the receipt of boot by executing a note to a bank.[34]

Question: What if, in connection with a $300,000 sale of relinquished property, a taxpayer retains a $5,000 earnest money deposit and simply escrows $295,000 with the intermediary.

Answer: Even if the taxpayer acquires $300,000 or more of replacement property, the taxpayer must recognize $5,000 of gain, in that the retained earnest money deposit constitutes boot. To avoid this outcome, the taxpayer should turn deliver the earnest money to the closing agent so that 100% of the net sales proceeds may be escrowed with the intermediary in connection with the sale.

Related Party Issues:

Most advisers understand that as a general rule taxpayers may conduct a tax deferred exchange with a "related party" (such as the taxpayer's child or a corporation in which the taxpayer owns a majority of the outstanding stock). In other words a taxpayer may convey relinquished property to a related party in exchange for the related party's conveyance of replacement property to the taxpayer. The kicker is that for a period of two years following an exchange with a related

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[34] "Cash received by the taxpayer does not offset debt incurred by the taxpayer. Therefore, the taxpayer cannot take cash out of the exchange at closing by incurring a liability on the replacement property greater than the liability on the relinquished property." See Tax Free Exchanges Under 1031 by Jeremiah M. Long and Mary Foster, section 4:06.

party, both the taxpayer and the related party must refrain from disposing of their property acquired in the exchange. Why is this? Consider the following example:

> Father owns "Parcel A" worth $100,000 with an income tax basis of $10,000. Son owns "Parcel B" worth $100,000 with an income tax basis of $90,000. Purchaser desires to purchase Parcel A for $100,000. Father realizes that if he sells Parcel A to Purchaser, he must recognize a $90,000 gain. Thus Father instead conveys Parcel A to Son in exchange for Parcel B. Father then owns Parcel B with a substituted income tax basis of $10,000, and Son owns Parcel A with a substituted income tax basis of $90,000. Son then sells Parcel A to Purchaser for $100,000 and recognizes a $10,000 gain.

The proposed outcome is that by conducting a tax deferred exchange prior to the sale, and by shifting Son's high income tax basis to Parcel A prior to the sale, Father and Son, as a family unit, have reduced their gain from $90,000 to $10,000. To avoid this "shifting of basis" the Code imposes the two year holding period subsequent to an exchange between related parties. Generally if the taxpayer or the related party disposes of his exchange property within two years after the initial exchange, then the taxpayer's exchange with the related party will become taxable.[35]

Straight exchanges between two related parties are quite uncommon. What is common is a taxpayer's desire to (i) convey relinquished property to an unrelated party and (ii) acquire replacement property from a related party through the use of an intermediary. Many taxpayers (and many tax advisers) believe that this type of exchange will qualify for tax deferral under section 1031 provided the taxpayer holds the replacement property for two years following the exchange. This is incorrect. Consider the following example:

> Father owns "Parcel A" worth $100,000 with an income tax basis of $10,000. Son owns "Parcel B" worth $100,000 with an income tax basis of $90,000. Purchaser desires to purchase Parcel A for $100,000. Father realizes that if he sells Parcel A to Purchaser, he would need to recognize a $90,000 gain. Thus, as part of an exchange through the use of an intermediary, Father conveys Parcel A to Purchaser for $100,000 and acquires Parcel B from Son for $100,000.

The result of the second example is identical to the result in the first example. Purchaser ends up owning Parcel A. Father ends up owning Parcel B with a substituted income tax basis of $10,000. Son ends up with $100,000 and recognizes a $10,000 gain. For this reason, as a general rule[36] if a taxpayer (using a qualified intermediary) conveys relinquished property to an unrelated

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[35] See section 1031(f).

[36] An exception is where the related party conducts a tax deferred exchange upon his conveyance of the replacement property to the taxpayer (i.e. where the related party does not "cash out" upon the sale of replacement property to the taxpayer). Another exception may be a situation where there is no shifting of basis, such as where an acquisition from a related party would result in a taxable gain recognized by the related party which

party and acquires replacement property from a related party (who does not conduct an exchange), the IRS will treat the exchange as an immediately taxable "transaction structured to avoid the purposes of the related party rules"[37] (i.e. an immediate violation of the two year holding period applicable to related party exchanges). Generally a taxpayer may (using a qualified intermediary) convey relinquished property to a related party and acquire replacement property from an unrelated party,[38] but a taxpayer generally may not convey relinquished property to an unrelated party and acquire replacement property from a related party (unless the related party conducts a tax deferred exchange upon its conveyance of the replacement property to the taxpayer).[39]

Exchanges Involving Partnership Property:

I often receive calls from individuals who desire to conduct an exchange, yet soon learn the relinquished property is owned by a partnership or limited liability company having other owners with no desire to conduct an exchange. In other words one partner wants to conduct an exchange with "his share" of the sales proceeds while the other partners simply want cash. The problem relates to the basic requirements of section 1031(a) discussed above. To conduct an exchange a taxpayer must convey relinquished property which has been held for investment. Under these facts the partnership, not its partners, has held the relinquished property. Consider the following options:[40]

Option 1:

The partnership could be dissolved with its assets distributed to the individual partners. The individuals (who would then be tenants in common with respect to the distributed property) could then begin holding the relinquished property for investment. After the property has been held for investment, the owners could market the relinquished property for sale. At the closing any owner may conduct an exchange with his share of the net sales proceeds while other individuals simply cash out.

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equals or exceeds the amount of gain which the taxpayer would have recognized had the related party acquisition not taken place (i.e. an acquisition from a related party whose income tax basis in his property is less than or equal to the taxpayer's income tax basis in the relinquished property). See Tax Free Exchanges Under 1031 by Jeremiah M. Long and Mary Foster, section 2:47.

[37] Section 1031(f)(4); see also FSA 199931002 as well as Tax Free Exchanges Under 1031 by Jeremiah M. Long and Mary Foster, section 2:48.

[38] See Private Letter Ruling 200709036.

[39] See The Malulani Group, Limited and Subsidiary v. Commissioner, T.C. Memo 2016-209; see also Teruya Brothers, Ltd. & Subsidiaries v. Commissioner, 124 T.C. No. 4 (2005); see also Ocmulgee Fields, Inc. v. Commissioner, 132 T.C. No. 6. (2009).

[40] For options other than those presented in this article, including the use of special allocations of gain to those who do not conduct an exchange, see the American Bar Association's "Joint Report on Section 1031 Open Issues Involving Partnerships," BNA Tax Management Memorandum, January 29, 2001.

Option 2:

The partnership could distribute an undivided interest in the relinquished property to the partner who desires to conduct an exchange. The relinquished property (which would then be owned by the partnership and the distributee as tenants in common) could then be held for investment. After the property has been held for investment, the partnership and the distributee could market the relinquished property for sale. At the closing the distributee may conduct an exchange with his share of the net sales proceeds while the partnership simply cashes out.

Option 3:

The partnership could distribute an undivided interest in the relinquished property to the partners who do not desire to conduct an exchange. The partnership and the distributees could then market the property for sale. At the closing the partnership may conduct an exchange with its share of the net sales proceeds while the distributees simply cash out upon the sale of their undivided interest in the property.

Inevitably the problem with any such option is that the relinquished property is either already under contract or at least already on the market for sale. In either case if the partnership distributes the relinquished property or an interest therein to one or more partners desiring to conduct an exchange, the IRS could argue that such property was held "for sale" by the distributee(s) rather than having been held for investment as required by section 1031. Moreover, take note of the following lines 3 and 4 of the Form 8824:

3. Date like-kind property given up was originally acquired (month, day, year).

4. Date you actually transferred your property to other party (month, day, year).

Why is the IRS asking these questions? Obviously to determine how long the individual held the relinquished property for investment prior to conducting the exchange. If the sale takes place three weeks after the partnership's distribution, will the answer to line 3 be three weeks prior to the answer to line 4, or will the taxpayer "fudge" and take the position that he has held the property (via his interest in the partnership) since the date the partnership acquired such property? Under current law it appears the proper difference between lines 3 and 4 would be three weeks.[41]

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[41] The American Bar Association has taken the position that where an interest in relinquished property is distributed by a partnership (which has been holding such property for investment) to a partner, the partner should be treated as if he has held such interest for investment and should be allowed to thereafter conduct an exchange with his interest in such property. See the American Bar Association's "Joint Report on Section 1031 Open Issues Involving Partnerships," BNA Tax Management Memorandum, January 29, 2001. For holdings consistent with this position, see Maloney v. Commissioner, 93 T.C. 89 (1989), Bolker v. Commissioner, 81 T.C. 782 (1983), aff'd 760 F.2d 1039 (9th Cir. 1985), and Magneson v. Commissioner, 81 T.C. 767 (1983), aff'd 753 F.2d 1490 (9th Cir. 1985). Note, however, that the IRS has added two questions to Form 1065 (partnership income tax

Exchanges Which "Straddle" Year End -- Treatment as Section 453 Installment Sale:

Some exchanges "straddle" year end in that funds are escrowed in one taxable year, yet some or all of such funds are returned to the taxpayer in the following taxable year upon completion of a failed exchange or upon completion of an exchange successfully conducted by the taxpayer.

Question: What if a taxpayer conveys relinquished property during December of 2024, escrows his conveyance proceeds with an intermediary, successfully acquires replacement property, but less than all conveyance proceeds are applied toward such acquisition, such that the intermediary returns the balance of conveyance proceeds to the taxpayer during the year 2025 at the end of the 180-day exchange period?

Answer: Although the taxpayer recognizes gain to the extent of the balance of the conveyance proceeds returned to the taxpayer, the recognized gain may be "reported" on the taxpayer's year 2025 income tax return using the section 453 installment sale method of reporting recognized gain.

Question: What if a taxpayer conveys relinquished property during December of 2024, escrows his conveyance proceeds with an intermediary with a "bona fide"[42] intent of conducting an exchange, and identifies replacement property during the 45-day identification period, but the taxpayer fails to acquire any replacement property, such that the intermediary returns all conveyance proceeds to the taxpayer during the year 2025 at the end of the 180-day exchange period?

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return) which are designed to disclose whether there has been a "swap and drop" and/or "drop and swap" transaction. In connection with a "swap and drop," Question 13 of Schedule B states as follows: "Check this box if, during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (other than disregarded entities wholly owned by the partnership throughout the tax year)." In connection with a "drop and swap," Question 14 of Schedule B states as follows: "At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property?" The conservative approach would be to avoid these type transactions.

[42] Section 1.1031(k)-1(j)(2)(iv) states as follows: "The provisions of paragraphs (j)(2)(i) and (ii) of this section do not apply unless the taxpayer has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period. A taxpayer will be treated as having a bona fide intent only if it is reasonable to believe, based on all the facts and circumstances as of the beginning of the exchange period, that like-kind replacement property will be acquired before the end of the exchange period."

Answer: Although the taxpayer recognizes the entire gain, the recognized gain may be "reported" on the taxpayer's year 2025 income tax return using the section 453 installment sale method of reporting recognized gain.[43]

Question: What if a taxpayer conveys relinquished property during December of 2024, and escrows his conveyance proceeds with an intermediary with a "bona fide" intent of conducting an exchange, but the taxpayer fails to identify replacement property, such that the intermediary returns all conveyance proceeds to the taxpayer during the year 2025 at the end of the 45-day identification period?

Answer: Although the taxpayer recognizes the entire gain, the recognized gain may be "reported" on the taxpayer's year 2025 income tax return using the section 453 installment sale method of reporting recognized gain.[44]

Improvement Exchanges:

Assume a taxpayer (using an intermediary) conveys relinquished property for $300,000 and desires to acquire a vacant lot for $75,000 and construct improvements thereon at a cost of $225,000. There are three crucial requirements in connection with this type of exchange. First, not only must the lot be identified within the 45-day period, the improvements must be identified as well (generally by attaching the plans to the identification letter).[45] Second, amounts must be spent on the improvements prior to the date on which the taxpayer takes title to the replacement property. This

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[43] Section 1.1031(k)-1(j)(2)(ii) states as follows: "Subject to the limitations of (j)(2)(iv) and (v) of this section, in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the determination of whether the taxpayer has received a payment for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter is made as if the qualified intermediary is not the agent of the taxpayer. For purposes of this paragraph (j)(2)(ii), a person who otherwise satisfies the definition of a qualified intermediary is treated as a qualified intermediary even though that person ultimately fails to acquire identified replacement property and transfer it to the taxpayer. This paragraph (j)(2)(ii) ceases to apply at the earlier of – (A) The time described in paragraph (g)(4)(vi) of this section; or (B) The end of the exchange period."

[44] Section 1.1031(k)-1(j)(2)(ii) states as follows: "Subject to the limitations of (j)(2)(iv) and (v) of this section, in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the determination of whether the taxpayer has received a payment for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter is made as if the qualified intermediary is not the agent of the taxpayer. For purposes of this paragraph (j)(2)(ii), a person who otherwise satisfies the definition of a qualified intermediary is treated as a qualified intermediary even though that person ultimately fails to acquire identified replacement property and transfer it to the taxpayer. This paragraph (j)(2)(ii) ceases to apply at the earlier of – (A) The time described in paragraph (g)(4)(vi) of this section; or (B) The end of the exchange period."

[45] Section 1.1031(k)-1(e)(2) states as follows: "For example, if the identified replacement property consists of improved real property where the improvements are to be constructed, the description of the replacement property satisfies the requirements of paragraph (c)(3) of this section (relating to description of replacement property) if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time the identification is made."

is usually accomplished by "parking" the replacement property with a "qualified exchange accommodation titleholder" (discussed below) and having the improvements constructed prior to the date on which the titleholder conveys such property to the taxpayer. Third, regardless of whether the improvements are completed, the taxpayer must acquire the replacement property prior to the end of the 180-day exchange period.

Question: Under the preceding facts, what happens if the titleholder acquires the vacant lot for $75,000 but only $200,000 has been spent on improvements prior to the date on which the replacement property must be conveyed from the titleholder to the taxpayer?

Answer: In this case $275,000 has been applied toward the investment property, which is $25,000 less than the amount realized from the conveyance of relinquished property. The taxpayer must therefore recognize $25,000 of realized gain. Assuming the improvements are thereafter completed in a manner which substantially conforms to the identification of such improvements, the balance of the taxpayer's realized gain may be deferred under section 1031 even though the improvements were not completed within the 180-day exchange period.[46]

Question: What if the remaining $25,000 is spent at the site soon after the taxpayer takes title?

Answer: Amounts spent at the site subsequent to the date on which the taxpayer takes title will be deemed to have been spent on construction "services" (which are not of like kind to realty) and will not reduce the amount of gain which must be recognized.[47]

Question: Can the taxpayer and/or intermediary "prepay" for the improvements prior to the date on which the titleholder conveys the replacement property to the taxpayer?

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[46] Section 1.1031(k)-1(e)(3)(iii) states as follows: "If the identified replacement property is real property to be produced and the production of the property is not completed on or before the date the taxpayer receives the property, the property received will be considered to be substantially the same property as identified only if, had production been completed on or before the date the taxpayer receives the replacement property, the property received would have been considered to be substantially the same property as identified. Even so, the property received is considered to be substantially the same property as identified only to the extent the property received constitutes real property under local law."

[47] Section 1.1031(k)-1(e)(4) states as follows: "The transfer of relinquished property is not within the provisions of section 1031(a) if the relinquished property is transferred in exchange for services (including production services). Thus, any additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of a like kind."

Answer: No. This will not reduce the recognized gain, in that the prepayments would be deemed to have been spent on "services" rather than on realty.

Reverse Exchanges -- Revenue Procedure 2000-37:

The phrase "reverse exchange" refers to an exchange where the taxpayer acquires replacement property prior to having conveyed relinquished property. As a general rule, reverse exchanges are not authorized under section 1031. In other words, under section 1031 a taxpayer may not acquire replacement property prior to having conveyed the relinquished property. Thus, the goal of a reverse exchange is to structure the transaction such that the taxpayer is deemed to have conveyed the relinquished property prior to having acquired the replacement property.

In September of 2000 the IRS issued Revenue Procedure 2000-37 which sets forth a safe harbor for purposes of structuring what would otherwise constitute an invalid reverse exchange under section 1031. Under the safe harbor, there are two ways to structure a "reverse" exchange. The most common structure is referred to as an "exchange last" structure. Another approach is referred to as an "exchange first" structure. Under either structure, step one is to execute a "Qualified Exchange Accommodation Agreement" ("QEAA") with a "Qualified Exchange Accommodation Titleholder" (the "Titleholder").

Under a typical "exchange last" structure, a limited liability company (referred to as the "LLC" in this paragraph) is formed to acquire the replacement property, with the Titleholder as the sole member/owner of the LLC. The taxpayer (or a representative of the taxpayer) may be the manager of the LLC. If the taxpayer has sufficient cash to fully fund the LLC's acquisition of replacement property, then the Taxpayer may loan/advance such cash to the LLC. Otherwise a bank (not a mortgage company) may make a short term bridge loan to the LLC (with the taxpayer personally guaranteeing the loan) in order to fund the LLC's acquisition of the replacement property. The acquisition by the LLC begins a 45-day period in which the taxpayer must "identify" (to the Titleholder) the property which the taxpayer intends to sell in connection with the exchange. The acquisition by the Titleholder also begins a 180-day exchange period in which the Taxpayer must convey the relinquished property in order to successfully complete the exchange. Assuming the taxpayer finds a buyer for the relinquished property within the 180-day exchange period, the taxpayer executes an exchange agreement with a qualified intermediary, assigns his rights under the sales agreement to the intermediary with written notice to the purchaser, then conveys the relinquished property directly to the purchaser (with the conveyance proceeds passing to the intermediary). The taxpayer then (i) assigns his rights under the QEAA to the intermediary and (ii) acquires the replacement property via the Titleholder's assignment to the taxpayer of the 100% membership interest in the LLC. The conveyance proceeds are then applied by the intermediary as a pay down on any bridge loan incurred upon the LLC's initial acquisition of the replacement property, with any balance of conveyance proceeds being returned to the taxpayer. To the extent the conveyance proceeds are insufficient to fully pay off the bridge loan, then the taxpayer converts the balance of the bridge loan into permanent financing upon completion of the exchange.

Under a typical "exchange first" structure, a limited liability company (referred to in this paragraph as the "LLC") is formed with the Titleholder as the sole member. The taxpayer (or a representative of the taxpayer) may be the manager of the LLC. The taxpayer then executes an exchange agreement with an intermediary, assigns to the intermediary his rights under the QEAA, and sells/conveys the relinquished property to the LLC. Often a bank (not a mortgage company) makes a short term bridge loan to the LLC (with the taxpayer personally guaranteeing the loan), such that the LLC can close the acquisition of the relinquished property. The conveyance proceeds are temporarily escrowed with taxpayer's intermediary. The taxpayer then assigns to the intermediary his rights under the purchase agreement for the replacement property (with written notice to the seller), and the taxpayer acquires the replacement property via a direct deed from the seller, with the intermediary supplying the conveyance proceeds to the closing agent. At that point, the Titleholder then has 180-days to complete the sale of the relinquished property, and assuming such a sale takes place, the taxpayer will have successfully conducted a "reverse" exchange.

Under either structure, on the Form 8824 the transaction is usually reflected as a simultaneous exchange in that the taxpayer's conveyance of the relinquished property and acquisition of replacement property (from the Titleholder) usually occur simultaneously.

Of course there are multiple variations of exchange first or exchange last reverse exchanges. For example, the Titleholder can acquire title to the replacement property (or to the relinquished property as the case may be) "straight up" rather than via an LLC as described in the preceding two paragraphs. Also, as a means to avoid the necessity of structuring the transaction as a "reverse exchange," a Taxpayer may consider selling relinquished property to a related party in advance of the Taxpayer's acquisition of replacement property, all pursuant to a typical set of exchange documents with an intermediary.

Conclusion:

An article such as this cannot cover in detail all issues in connection with tax deferred exchanges. This article simply skimmed the surface with respect to issues which were discussed, and many areas which present risks were not discussed at all. For a much more detailed discussion of tax deferred exchanges, I suggest obtaining Tax Free Exchanges Under 1031 by Jeremiah M. Long and Mary B. Foster (published by Thomson Reuters-800-328-4880).