Section 1031 Tax-Deferred Exchange Reference Manual©

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LEGAL DISCLAIMER

Tax-deferred like-kind exchange transactions pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Department of the Treasury Regulations are complicated tax strategies for real estate and personal property that involve significant legal, tax and financial planning issues. Investors should always consult with competent legal, tax and financial advisors prior to entering into and completing a tax-deferred like-kind exchange transaction. This reference manual is intended as a brief overview of tax-deferred like-kind exchanges and is NOT intended to serve as specific legal, tax or financial advice.

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ABOUT EXETER 1031 EXCHANGE SERVICES, LLC

Exeter 1031 Exchange Services, LLC is a leading national provider of tax-deferred, like-kind exchange services pursuant to Section 1031 of the Internal Revenue Code ("1031 Exchanges") and Section 1.1031 of the Department of the Treasury Regulations ("1031 Regulations").

Tax-Deferred Exchange Strategies and Services

Our comprehensive tax-deferred exchange programs include forward ("delayed" or "starker"), reverse, and improvement ("build-to-suit" or "construction") tax-deferred like-kind exchange strategies for corporate, institutional and individual clients with investment real estate and personal property.

We provide superior Qualified Intermediary ("Accommodator") services, Exchange Accommodation Titleholder ("EAT") services, and technical advisory services combined with practical solutions for tax-deferred like-kind exchange transactions in all 50 states. We can also assist Investors with tax-deferred exchanges of foreign investment property as well.

Our tax-deferred exchange services are tailored to meet our clients' investment objectives while complying with all Federal and state income tax reporting and regulatory requirements. Meeting our clients' business objectives is our highest priority.

Exeter 1031 Exchange Services, LLC seeks long-term strategic partnerships with clients and their advisors, providing creative solutions for complex tax-deferred like-kind exchange transactions. A dedicated tax-deferred exchange administrative team will provide comprehensive and customized programs to meet clients' unique tax-deferred like-kind exchange needs.

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Exeter Performance Guarantee

Every tax-deferred like-kind exchange transaction administered by Exeter 1031 Exchange Services, LLC is backed by the Exeter Performance Guarantee. We will refund our entire 1031 exchange set-up fee if the Investor is not completely satisfied with our service for any reason – no questions asked.

It's our strong commitment to our clients' complete satisfaction.

Experience, Expertise, Financial Strength, and Stability

Significant Experience and Expertise

Our tax-deferred exchange specialists and advisors have over forty eight (48) years of extensive experience, expertise and technical depth in safely administering tax-deferred like-kind exchange transactions for corporate, institutional, and individual Investors.

Mr. William L. Exeter, President and Chief Executive Officer, Exeter 1031 Exchange Services, LLC, alone has over two (2) decades experience in senior executive management positions at Qualified Intermediary (Accommodator) operations.

Exeter 1031 Exchange Services, LLC can structure and customize a tax-deferred like-kind exchange solution to fit your specific investment strategy, and we have the financial strength, stability, insurance, bonding, and resources necessary to successfully and safely administer your tax-deferred like-kind exchange transaction.

Financial Strength and Insurance/Bonding

The Exeter Group, LLC has approximately $2 million in equity capital reserves and maintains $30 million in fidelity bond coverage (per occurrence) and $3 million in

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errors and omissions insurance coverage for the protection of Investors' funds and their tax-deferred like-kind exchange transactions.

Affiliate Companies

The Exeter Group, LLC

The Exeter Group, LLC is the holding and operating company for The Exeter Group of Companies, including Exeter 1031 Exchange Services, LLC, Exeter Reverse 1031 Exchange Services, LLC, Exeter Advanced Exchange Strategies, LLC, Exeter Consulting Group, LLC and Exeter Self-Directed IRA Services, LLC.

Exeter 1031 Exchange Services, LLC

Exeter 1031 Exchange Services, LLC, a California limited liability company, is a leading national provider of tax-deferred, like-kind exchange services, specifically functioning as the 1031 exchange Qualified Intermediary ("Accommodator" or "Facilitator") for tax-deferred like-kind transactions pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Department of the Treasury Regulations. Exeter 1031 Exchange Services, LLC, is a wholly owned subsidiary of The Exeter Group, LLC.

Exeter Reverse 1031 Exchange Services, LLC

Exeter Reverse 1031 Exchange Services, LLC, a California limited liability company, is a leading national provider of tax-deferred, like-kind exchange services specifically functioning as the Exchange Accommodation Titleholder ("EAT") for reverse and improvement ("build-to-suit" or "construction") tax-deferred like-kind exchange strategies utilizing the "parking arrangement" pursuant to Revenue Procedure 2000-37. Exeter Reverse 1031 Exchange Services, LLC is a wholly owned subsidiary of The Exeter Group, LLC.

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Exeter Advanced Exchange Strategies, LLC

Exeter Advanced Exchange Strategies, LLC, a California limited liability company, is a leading national provider of tax-deferred, like-kind exchange services for the administration of specialized tax-deferred like-kind exchange strategies with complex structural requirements such as non-safe harbor reverse or improvement (build-to-suit or construction) tax-deferred exchange transactions. Exeter Advanced Exchange Strategies, LLC, is a wholly owned subsidiary of The Exeter Group, LLC.

Exeter Consulting Group, LLC

Exeter Consulting Group, LLC, a California limited liability company, is a private consulting firm within The Exeter Group of Companies that assists Investors and their advisors in creating tax-deferral strategies in sophisticated, complex or cutting-edge transactions.

While the Exeter Consulting Group, LLC often works in conjunction with Exeter Advanced Exchange Strategies, LLC, the firm may be retained on an outside basis to consult on complicated transactions. Exeter Consulting Group, LLC is a wholly owned subsidiary of The Exeter Group, LLC.

Exeter Exchange Management Corporation

Exeter Exchange Management Corporation, a California corporation, was formed to facilitate certain management functions and corporate affairs on behalf of the affiliate companies within The Exeter Group of Companies.

Exeter Self-Directed IRA Services, LLC

Exeter Self-Directed IRA Services, LLC will administer self-directed individual retirement accounts ("IRAs"), including Traditional IRAs, Roth IRAs, SEP-IRAs, and SIMPLE IRAs where the investor can purchase real estate and real estate related investments such as notes secured by deeds of trusts or mortgages, tax lien

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certificates, tenant-in-common property interests, and more inside their IRA. Exeter Self-Directed IRA Services, LLC, is a wholly owned subsidiary of The Exeter Group, LLC. Our non-bank custodial IRA service is pending regulatory approval, which is expected in early 2007.

National Corporate Headquarters and Branch Offices

For more complete information about Exeter 1031 Exchange Services, LLC you can visit our web site at **www.exeterco.com**, call (866) 393-8377 to contact our branch office nearest you or contact us at any of our national offices listed below:

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INTRODUCTION TO SECTIONS 1031, 1033, 1034, 121 AND 721 OF THE INTERNAL REVENUE CODE

The sale, disposition or conversion of investment real estate or personal property may result in the recognition of ordinary income, depreciation recapture and/or capital gain income tax liabilities, so it is important for the Investor and his advisors to be familiar with the various tax-deferral and tax-exclusion strategies that are available today.

The majority of this Reference Manual will focus on tax-deferred like-kind exchange strategies pursuant to Section 1031 of the Internal Revenue Code ("1031 exchange") and Section 1.1031 of the Department of the Treasury Regulations since it is the most common real estate and personal property tax-deferral strategy in use today.

The tax-deferred like-kind exchange is not always the right or best fit for some Investors, so it is also important to have a basic understanding of the various and sundry tax-deferral and tax-exclusion strategies available today in order to make sure the most appropriate investment strategy is selected.

The first segment of this Reference Manual will briefly summarize, define, and explore the various tax-deferral and tax-exclusion strategies available to Investors who may be facing the sale, disposition or conversion of investment real estate or personal property. The remainder and majority of this Reference Manual will discuss and explore tax-deferred like-kind exchange transactions in much greater detail.

Investment real estate and/or personal property transactions should not be driven solely by income tax considerations. It is extremely important that an Investor consult with his competent legal, tax and financial advisors before completing any sale, disposition or conversion of investment property in order to determine whether a tax-deferral or tax-exclusion strategy may be appropriate.

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Section 1031 – Exchange of Investment Property or Property Used In a Business

Section 1031 of the Internal Revenue Code ("1031 exchange") provides that real estate or personal property held for investment or used in a business ("relinquished property") can be exchanged for "like-kind" property also held for investment or used in a business ("replacement property") thereby allowing the Investor to defer his Federal, and in most cases, state capital gain and/or depreciation recapture income tax liabilities.[1]

Tax-deferred like-kind exchanges are tax-deferred transactions and not tax-free transactions as many authors, speakers and advisors frequently refer to them. The Investor's capital gain and depreciation recapture income tax liabilities are continually and indefinitely deferred as long as the Investor continues to exchange into like-kind replacement properties through a series of tax-deferred like-kind exchange transactions. The Investor's capital gain and depreciation recapture income tax liabilities accumulate through out the series of tax-deferred like-kind exchanges as Investors exchange up into better, more productive and profitable assets. This is referred to in the industry as the "Swap Until You Drop" tax planning strategy, which will be discussed later in greater detail.

One of the benefits of indefinitely deferring income tax liabilities through a tax-deferred like-kind exchange is that an Investor may sell, dispose or convert real estate or personal property without reducing his cash position by paying capital gain or depreciation recapture income taxes. 100% of the Investor's cash proceeds, or equity, is available for reinvestment into like-kind replacement properties. This provides the Investor with the liquidity necessary to increase the overall value of his investment property portfolio by trading up in value, improving cash flow and capital appreciation opportunities from the portfolio, and ultimately increasing his net worth.

[1] Section 1031(a) of the Internal Revenue Code.

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The use of a Qualified Intermediary (Accommodator) is required when structuring a 1031 exchange transaction.

ALTERNATIVE TAX-DEFERRAL AND TAX-EXCLUSION STRATEGIES

The Internal Revenue Code contains a number of alternative provisions that allow Investors to defer, spread or exclude the recognition of income tax liabilities in particular circumstances.

The tax-deferred like-kind exchange is not always the right choice for Investors, so it is extremely important that Investors consult with their competent legal, tax and financial advisors before entering into a tax-deferred like-kind exchange to ensure they are selecting the right income tax strategy and solution that would best achieve their financial objectives.

Section 1033 – Involuntary Conversions by Eminent Domain or Natural Disaster

Section 1033 of the Internal Revenue Code ("1033 Exchange") provides that property that is or will be the subject of a compulsorily or involuntary conversion either from an Eminent Domain proceeding (condemnation by local, state or Federal government)[2] or destruction by a natural disaster such as an earthquake, hurricane, fire, flood, or other natural disaster[3], in whole or in part, can be exchanged on a tax-deferred basis for like-kind replacement property that is either like-kind pursuant to Section 1033(g) or is similar or related in service or use to the property that was involuntarily converted pursuant to Section 1033(a).

Investors have up to two (2) years to replace property destroyed due to natural disasters[4] and up to three (3) years to replace property converted due to Eminent Domain proceedings[5].

[2] Section 1033G of the Internal Revenue Code.
[3] Section 1033A of the Internal Revenue Code.
[4] Section 1033A of the Internal Revenue Code.

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Strategic tax planning opportunities are available to the Investor when the buyer of the Investor's property is a government agency with Eminent Domain powers. Although the property may not be the subject of an Eminent Domain proceeding, the Investor may want to request the government agency to threaten a condemnation action in order to take advantage of the extended time frames involved with a 1033 tax-deferred like-kind exchange.

The definition of like-kind for replacement property purposes is not the same for 1033 exchanges, so care needs to be taken to ensure that the Investor complies with the applicable like-kind replacement property standard. Essentially, the like-kind replacement property standard used in 1031 exchanges is applied to 1033 exchanges involving Eminent Domain Proceedings. But, a "similar or related in service or use" standard is used for 1033 exchanges that result from natural disasters.

The use of a Qualified Intermediary (Accommodator) is not required when completing a 1033 Exchange transaction.

Section 1034 – Rollover of Gain on the Sale of a Primary Residence (REPEALED)

The Taxpayer Relief Act of 1997 repealed and replaced the tax-deferral provisions contained within Section 1034 of the Internal Revenue Code ("1034 exchange") with Section 121 of the Internal Revenue Code ("121 exclusion").

Section 1034 of the Internal Revenue Code allowed an owner of real property that was owned and used as his primary residence to sell or otherwise dispose of his primary residence and defer or rollover 100% of his capital gain income tax liability by acquiring another primary residence of equal or greater value.

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[5] Section 1033G of the Internal Revenue Code.

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Although it was repealed, it is still important to understand what the 1034 exchange was all about and what the differences are between the old and new income tax laws. The 1034 exchange merely deferred or rolled over the capital gain tax into the future, while the 121 exclusion is a permanent tax-free exclusion of capital gains. Tax–free is always significantly better than tax-deferred.

The use of a Qualified Intermediary (Accommodator) was never required for 1034 exchange transactions.

Section 121 – Exclusion of Gain on Sale of Primary Residence

Generally, an Investor can sell real property that he has owned and lived in as his primary residence and exclude from his taxable gross income up to $250,000 in capital gains ($500,000 for a married couple; $250,000 for each taxpayer/domestic partner) pursuant to Section 121 of the Internal Revenue Code.

The Investor must have owned and lived in the property as his primary residence for at least 24 months out of the last 60 months (at least two out of the last five years). The 24 months do not have to be consecutive and there are certain exceptions to the 24 month requirement if the Investor lived in the primary residence for less than 24 months due to a change of employment, health, military service, or other unforeseen circumstances has occurred.

121 Exclusions only apply to sales or dispositions of real property occurring after May 7, 1997 that were held and used as a primary residence. Primary residences sold prior to May 8, 1997 would qualify for tax-deferral pursuant to Section 1034 of the Internal Revenue Code. Investors can take advantage of the 121 Exclusion once every two years.

Investors should carefully monitor the amount of accumulated or built-up capital gain in their primary residence and may want to think about selling their primary residence before the capital gain amount exceeds the maximum $250,000/$500,000 exclusion

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limitation as any capital gain in excess of the maximum limitation is taxable. The sale of the primary residence will preserve the tax-free exclusion of the capital gain, and would allow the Investor to start fresh by acquiring another primary residence with no accumulated or built-up capital gain. This can be a powerful and smart wealth management strategy, but it does not take into consideration quality of life issues involved with a decision to buy, sell or hold onto a primary residence. Remember, an Investor's decision should not be based solely on income tax considerations. Investors must weight the financial and income tax benefits with quality of life issues before making a decision to sell or dispose of their primary residence.

Special legal, tax and financial planning is needed in circumstances where an Investor's primary residence already has a significant capital gain that exceeds the $250,000/$500,000 maximum exclusion limitation.

In these circumstances, the Investor may want to consider combining the benefits of Sections 121 and 1031[6]. Under this strategy, the requirements for the 121 exclusion have been met if the Investor has owned and lived in the property as his primary residence for at least 24 months out of the last 60 months, and the tax-deferred like-kind exchange can be used when the primary residence has been converted to investment property, has been held as investment property for a sufficient amount of time in order to demonstrate the Investor's intent to hold the property as investment property, and is investment property at the time of sale or disposition.

This strategy allows the Investor to dispose of his primary residence, exclude or defer all of the capital gain tax liability, including the depreciation recapture if the 1031 exchange is utilized. The Investor can also use the strategy to diversify into multiple replacement properties, which would allocate the capital gain and depreciation recapture tax liability proratably over a number of rental properties clearing the way for further financial, tax and estate planning opportunities.

[6] Department of the Treasury Revenue Procedure 2005-14

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Special rules[7] apply when the real property was acquired previously as replacement property through a tax-deferred like-kind exchange transaction and then subsequently converted to the Investor's primary residence and sold pursuant to Section 121 of the Internal Revenue Code. (See Section entitled Other Issues: Section 1031 and Section 121 Combined).

Section 721 – Exchange of Investment Property For An Interest In A REIT

Section 721 of the Internal Revenue Code ("721 Exchange") allows an Investor to defer his capital gain and depreciation recapture income tax liabilities by exchanging out of rental or investment real property and into an ownership interest in a Real Estate Investment Trust (REIT). This transaction is most commonly referred to as a 721 Exchange, an "upREIT," or a "Section 1031/721 exchange," depending on the actual structure utilized.

Investors would typically utilize the upREIT or Section 1031/721 exchange structure in conjunction with the sale of relinquished property and the acquisition of like-kind replacement property as part of a tax-deferred like-kind exchange transaction. The 721 exchange does not have to be used in conjunction with a tax-deferred like-kind exchange, however. The Investor could simply contribute his rental or investment property already owned by the Investor directly to the "Umbrella Partnership" in the Real Estate Investment Trust (REIT) as part of a 721 Exchange. However, in most cases, the Real Estate Investment Trust (REIT) does not want the specific property owned by the Investor, so the Investor must first complete a tax-deferred like-kind exchange into property that the Real Estate Investment Trust (REIT) does wish to own or acquire. When used in conjunction with a tax-deferred like-kind exchange, the REIT will direct the Investor as to what property the Investor will identify and acquire. Once the replacement property has been acquired and held as rental or investment property for at least 12 to 18 months in order to demonstrate the Investors intent to hold the property for investment purposes, thereby qualifying them for tax-deferred

[7] Investor Relief Act of 2004 signed into law on October 22, 2004.

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like-kind exchange treatment, the replacement property is contributed into an "Umbrella Partnership" as part of the Real Estate Investment Trust (REIT) in exchange for an ownership interest in the "Umbrella Partnership" as part of the Real Estate Investment Trust (REIT) pursuant to a 721 exchange. The "**U**mbrella **P**artnership" is the "up" in "upREIT."

The 721 exchange can provide an Investor with a tremendous real estate exit strategy by exchanging out of his investment real estate portfolio and into an ownership interest in a Real Estate Investment Trust (REIT) that should provide more liquidity once the Real Estate Investment Trust (REIT) becomes publicly traded and listed on a securities exchange. The Investor also gains complete control and flexibility over the recognition of the capital gain and depreciation recapture income tax liabilities by determining the timing and percentage of the ownership interest converted from the "Umbrella Partnership" and into the Real Estate Investment Trust (REIT) and subsequently sold.

However, it is important to note that the 721 exchange eliminates the ability of the Investor to exchange back into real estate and defer his capital gain and depreciation recapture income tax liabilities by using a tax-deferred like-kind exchange because the Investor now owns a security interest instead of a real estate interest, and security interests are specifically excluded from tax-deferred like-kind exchange treatment.

It is also important to note that once the replacement property has been contributed into the umbrella partnership via the 721 exchange, the sponsor has the ability to dispose of the property, which in some cases can trigger the Investors' deferred capital gain and depreciation recapture income tax liabilities. The Private Placement Memorandum should therefore be carefully reviewed by the Investor and his legal, tax and financial advisors for a thorough and complete understanding of this risk.

Other Alternatives

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There are numerous other tax-deferral and/or tax exclusion options available that Investors should review with their legal, tax and financial advisors, including Installment Sales[8], Private Annuity Trusts ("PATs"), Charitable Remainder Trusts ("CRTs"), Self-Cancelling Notes, etc.

These are outside the scope of this Reference Manual, but should not be ignored or disregarded until evaluated by the Investor and his legal, tax and financial advisors.

HISTORY OF SECTION 1031 AND THE TAX-DEFERRED EXCHANGE

Section 1031 of the Internal Revenue Code has a very long and somewhat complicated history dating back to 1921. The first income tax code was adopted by the United States Congress in 1918 as part of The Revenue Act of 1918, and did not provide for any type of tax-deferred exchange. The first tax-deferred exchange was authorized as part of The Revenue Act of 1921, when the United States Congress created Section 202(c) of the Internal Revenue Code, allowing Investors to exchange securities and non-like-kind property unless the property acquired had a "readily realizable market value." These non-like-kind property provisions were quickly eliminated with the adoption of The Revenue Act of 1924. The Section number applicable to tax-deferred like-kind exchanges was changed to Section 112(b)(1) with the passage of The Revenue Act of 1928. In 1935, the Board of Tax Appeals approved the first modern tax-deferred like-kind exchange[9] using a Qualified Intermediary and the "cash in lieu of" clause was upheld so that it would not invalidate the tax-deferred like-kind exchange.

The 1954 Amendment to the Federal Tax Code changed the Section 112(b)(1) number to Section 1031 of the Internal Revenue Code and adopted the present day definition and description of a tax-deferred like-kind exchange, laying the groundwork for the current day structure of the tax-deferred like-kind exchange transaction.

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[8] Section 453 of the Internal Revenue Code.
[9] Mercantile Trust Co. of Baltimore et. al. v. Commissioner.

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The tax court cases and corresponding decisions, including an appellate decision from the 9th Circuit Court of Appeals resulting from the now famous Starker family tax-deferred like-kind exchange transactions, changed the tax-deferred like-kind exchange industry forever[10]. The Starker family litigation stemmed from two tax-deferred, delayed exchange transactions where T.J. Starker and his son Bruce Starker sold timberland to Crown Zellerback, Inc. in exchange for a contractual promise to acquire and transfer title to properties identified by T.J. Starker and Bruce Starker within five (5) years. The Internal Revenue Service disallowed this arrangement, contending, among other things, that a delayed exchange did not qualify for non-recognition treatment (i.e. deferral of income tax liabilities).

These tax court decisions were significant in numerous ways and set the precedent for our present day tax-deferred, non-simultaneous, delayed like-kind exchange transactions.

The Starker family cases demonstrated to the investment community that non-simultaneous, delayed tax-deferred like-kind exchange will qualify for non-recognition treatment, which provided Investors with significantly more flexibility in the structuring of tax-deferred like-kind exchange transactions.

In addition, the concept of a “growth factor” was introduced. The Starker family’s tax-deferred like-kind exchange transactions were structured so that Crown Zellerback would compensate the Starker family with a “growth factor.” This growth factor was essentially designed compensate the Starker family with interest income for the lost use of their timberland and was based on the assumption that timber grew by a certain annual percentage, or annual growth rate, each year, and since the Starker family had conveyed or transferred their property to Crown Zellerback with out any immediate compensation they should be compensated for the lost growth rate in timber until their like-kind replacement property had been acquired by Crown Zellerback and conveyed or transferred to them. The courts ruled that the “growth

[10] 1975 Starker I; 1977 Starker II; 1979 Starker III (appeal of Starker II).

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factor" or "disguised interest" was interest income and must be treated and reported as ordinary income (interest income).

The Starker family tax-deferred like-kind exchange tax court decisions established the need for regulations regarding delayed tax-deferred like-kind exchanges and prompted the United States Congress to eventually adopt the 45 *calendar* day Identification Deadline and the 180 *calendar* day Exchange Period as part of The Deficit Reduction Act of 1984, which also "codified" or adopted the delayed tax-deferred like-kind exchange provisions that we have today. The Deficit Reduction Act of 1984 also amended Section 1031(a)(2) of the Internal Revenue Code to specifically disallow exchanges of partnership interests (See Section on Partnership Issues).

The Tax Reform Act of 1986 is responsible for the tremendous explosion in the number of 1031 exchange transactions administered today. The Tax Reform Act of 1986 eliminated preferential capital gain treatment so that all capital gains were taxed as ordinary income, enacted "passive loss" and "at risk" rules, and eliminated accelerated depreciation methods in favor of straight line depreciation consisting of 39 years for commercial property and 27.5 years for residential property. These changes significantly restricted the tax benefits of owning real estate and catapulted the tax-deferred like-kind exchange into the lime light as being one of the few income tax benefits left for real property Investors.

The Revenue Reconciliation Act of 1989 resulted in a few changes to the tax-deferred like-kind exchange arena, including the disqualification of tax-deferred like-kind exchange transactions between domestic (United States) and non-domestic (foreign) property and placed restrictions on related party tax-deferred like-kind exchange transactions in the form of a two year holding period requirement.

The long awaited proposed tax-deferred like-kind exchange rules and regulations were issued by the Department of the Treasury effective July 2, 1990. The proposed rules and regulations specifically clarified the 45 *calendar* day identification period and the

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180 *calendar* day exchange period rules, provided guidance on how to deal with actual and constructive receipt issues in the form of safe harbor provisions, reaffirmed that partnership interests do not qualify as like-kind property in a tax-deferred like-kind exchange transaction, and further clarified the related party rules.

The proposed tax-deferred like-kind exchange rules and regulations were issued as final rules and regulations effective June 10, 1991 with only a few minor adjustments, including the further clarification and definition of what constitutes a "simultaneous exchange" and an "improvement exchange," and which parties were disqualified from serving as a Qualified Intermediary (Accommodator).

The Tax Relief Act of 1997 attempted to significantly change Section 1031 of the Internal Revenue Code, but failed. There have been a number of attempts to alter portions of the 1031 exchange code and regulations ever since, but none have been successful to date.

The final issuance of Revenue Procedure 2000-37 gave Investors and Qualified Intermediaries guidelines on how to structure reverse tax-deferred like-kind exchange transactions where the Investor's like-kind replacement property can be acquired before he disposes of his relinquished property. This reduced the risk associated with the 45 *calendar* day identification period.

The introduction of Revenue Procedure 2002-22 has arguably had the most significant impact on the tax-deferred like-kind exchange industry since the Tax Reform Act of 1986. It provided Investors with an additional like-kind replacement property option that had not existed before – Co-Ownership of Real Estate (CORE) – and is partially responsible for the explosive growth in the number of tax-deferred like-kind exchange transactions between 2002 and 2005.

OVERVIEW OF SECTION 1031 OF THE INTERNAL REVENUE CODE

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The tax-deferred like-kind exchange allows an Investor to sell his existing property (relinquished property) that has been held for rental, investment or productive use in a trade or business and purchase other like-kind property (replacement property) to be held for rental, investment or productive use in a trade for business in order to defer his Federal, and in most cases state, capital gain and depreciation income tax liabilities.[11]

This transaction is most commonly referred to as a 1031 exchange but is also known as a delayed exchange, deferred exchange, starker exchange, like-kind exchange, or tax-deferred exchange. Technically speaking, it is a tax-deferred, like-kind exchange pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Department of the Treasury Regulations.

BENEFITS TO THE INVESTOR

The tax-deferred like-kind exchange transaction is an exceptional tax planning tool or strategy that can assist Investors in repositioning or rebalancing their investment real estate portfolio in order to accomplish a number of financial, tax and/or estate planning goals and objectives.

These objectives may include diversifying or consolidating the Investor's investment real estate portfolio, increasing the cash flow from a specific property or the overall portfolio, implementing a change in the leverage (financing) strategy for a specific property or the overall portfolio, managing the depreciation benefits available to the Investor, and changing, reducing or eliminating the property management burden and time commitment – often referred to as the terrible "T's" (tenants, toilets, taxes, trash, teenagers, etc.) – involved with the Investor's investment real estate portfolio.

Consolidation or Diversification of the Investment Real Estate Portfolio

[11] Section 1031(a)(1) of the Internal Revenue Code.

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The tax-deferred like-kind exchange is an extremely effective diversification tool: it allows an Investor to dispose of one relinquished property and ultimately diversify his investment real estate portfolio by acquiring **multiple** like-kind replacement properties in diverse **geographic** regions within different **asset classes** (commercial office, retail shopping, multi-family, industrial, land, etc.).

The tax-deferred like-kind exchange is also an effective consolidation tool: it allows an Investor to sell numerous relinquished properties and ultimately consolidate his investment real estate portfolio into one or fewer like-kind replacement properties in order to reduce the burdens of property ownership such as property management, debt servicing, and market exposure.

The Investor can also take advantage of the tax-deferred like-kind exchange in order to exchange out of non-productive investment property, such as vacant, unimproved property or obsolete equipment that is not producing any income (cash flow), and exchange into more productive, improved property, such as a commercial office building, or modern equipment that will produce a positive cash flow, better opportunity for capital appreciation, and possibly reduce or eliminate property management responsibilities (if desired).

Repositioning or rebalancing strategies such as this may also serve to increase the Investor's depreciation income tax deductions that can shelter some of the income (cash flow) from current taxation.

Finally, the tax-deferred like-kind exchange can be used as an integral part of a comprehensive estate plan that can eliminate capital gain and depreciation recapture income tax liabilities for the Investor and his heirs, and can minimize, if not eliminate, estate (inheritance) tax liabilities as well.

Multiple Properties

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The tax-deferred like-kind exchange is not limited to single property transactions. Investors can exchange out of multiple relinquished properties into multiple like-kind replacement properties. Exchanging out of or into multiple properties can complicate the tax-deferred like-kind exchange structure, administration burdens and like-kind replacement property identification processes, so the Investor should consult with his Qualified Intermediary and legal or tax advisor for expert guidance.

Further, the relinquished and/or replacement property can involve a fractional or partial interest in the property commonly referred to "Co-Ownership Real Estate (CORE)" or "Tenant-In-Common Properties (TIC)". In other words, the Investor does not have to acquire and/or own 100% of either the relinquished property or the replacement property in order for it to qualify for tax-deferred like-kind exchange treatment.

THE ROLE OF THE QUALIFIED INTERMEDIARY ("ACCOMMODATOR")

The use of a professional, experienced, institutional Qualified Intermediary, such as Exeter 1031 Exchange Services, LLC, is critical in the structuring and completion of a successful tax-deferred like-kind exchange. The Qualified Intermediary (often referred to in the real estate industry as an Exchange Accommodator or Exchange Facilitator) is authorized under Section 1.1031 of the Department of the Treasury Regulations[12] and is the central component in a tax-deferred like-kind exchange transaction.

A Qualified Intermediary is responsible for a number of important elements in the administration of a successful tax-deferred like-kind exchange transaction, including (1) preparing the tax-deferred like-kind exchange agreements and related transactional documents in order to properly structure the tax-deferred like-kind exchange transaction; and (2) receiving, holding and safeguarding the Investor's tax-deferred like-kind exchange funds throughout the transaction; and (3) advising or consulting with the Investor and their professional advisors regarding the implementation of the

[12] Section 1.1031(b)-1(g)(4) of the Department of the Treasury Regulations.

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Investor's tax-deferred like-kind exchange transaction to ensure compliance with all applicable Internal Revenue Codes, Department of the Treasury Regulations and related Revenue Rulings and Revenue Procedures.

It is important to note that Qualified Intermediaries are not licensed, regulated, audited or otherwise monitored by any governmental regulatory agency, and Qualified Intermediaries are not required to be bonded, insured or maintain any other form of minimum equity capitalization. Investors should therefore exercise significant care when choosing their Qualified Intermediary because of the crucial role it will play in administering the tax-deferred like-kind exchange. Investors should review the information provided later in this Reference Manual under the Section entitled Evaluating and Selecting a SAFE Qualified Intermediary, which was written to assist them in the careful evaluation, analysis and selection process.

Preparation of Legal Documentation

The drafting of the tax-deferred like-kind exchange agreements and related transactional documents is crucial in the proper structuring of a successful tax-deferred like-kind exchange transaction. A single mistake in the preparation of the legal documentation could result in the disallowance of the Investor's tax-deferred like-kind exchange transaction by the Internal Revenue Service, and the subsequent recognition by the Investor of the depreciation recapture and capital gain income tax liabilities along with interest and penalty assessments by the Service.

The Qualified Intermediary must possess the necessary experience and expertise to ensure a thorough review of the related transactional documents and a complete understanding of the Investor's tax-deferred like-kind exchange transaction. This in depth understanding of the Investor's transaction by the Qualified Intermediary will ensure the tax-deferred like-kind exchange agreements and related documents will be completed accurately.

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Holding and Safeguarding Investor's Funds

Another important responsibility that is arguably just as critical as the rest is the Qualified Intermediary's fiduciary duty of receiving, holding and safeguarding the Investor's tax-deferred like-kind exchange funds. Qualified Intermediaries hold significant amounts of tax-deferred like-kind exchange funds on behalf of numerous Investors and therefore have a tremendous fiduciary responsibility to protect the funds under its custody.

Technical Ability: Providing Guidance

Perhaps the most frustrating element for Investors is preparing and planning for a tax-deferred like-kind exchange. The Investor speaks to one Qualified Intermediary and gets one answer and speaks to another and gets a completely different answer. They consult with their legal, tax and financial advisors and get three more completely different answers. The tax-deferred like-kind exchange industry has many gray areas because there are many unanswered questions in Section 1031 of the Internal Revenue Code and Section 1.1031 of the Treasury Regulations, which explains why Investors often receive so many different answers (which really represent opinions and not true answers).

Therefore, perhaps the most important role of all is for the Qualified Intermediary to ensure that its 1031 exchange specialists are sufficiently trained and have sufficient experience and expertise in order to provide the necessary guidance and advisory services to help guide the Investor through the confusing tax-deferred like-kind exchange arena.

Disqualified Persons Can Not Act as Qualified Intermediary

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Certain persons are specifically prohibited from serving as the Qualified Intermediary ("Accommodator"). The Qualified Intermediary cannot be the Investor, an agent of the Investor or an otherwise disqualified person under Section 267(b) and 707(b) of the Internal Revenue Code.[13]

Further, although an individual may serve as a Qualified Intermediary, it is not recommended because the death, divorce or bankruptcy of the individual may have a catastrophic effect on the Investor's tax-deferred like-kind exchange transaction and/or otherwise compromise the tax-deferred like-kind exchange funds.

EXCHANGE REQUIREMENTS

Intent to Hold and Integration Issues

In order to qualify for a tax-deferred like-kind exchange, the Investor must intend[14] to complete a tax-deferred like-kind exchange and must ensure the transaction is structured, reported and documented as a tax-deferred, like-kind exchange[15] pursuant to Section 1031 of the Internal Revenue Code and not a sale and subsequent purchase.[16]

Furthermore, both the relinquished property and the like-kind replacement property transactions must be part of an integrated contractual plan or transaction. An experienced Qualified Intermediary (Accommodator) can assist you with the structuring of your tax-deferred like-kind exchange transaction.

Qualifying Use Requirement

[13] Sections 267(b) and 707(b) of the Internal Revenue Code.
[14] Starker v. United States, 602 F.2d 1341 (CA9 1979).
[15] Section 1.1031(k)-1(a) of the Department of the Treasury Regulations.
[16] Meadows v. Commissioner, TC Memo 1981-417.

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To qualify for tax-deferred like-kind exchange treatment, the Investor must have held the relinquished property for rental, investment or use in his business, and must have the **INTENT** to **HOLD** the like-kind replacement property for rental, investment or use in his business.[17]

The terms INTENT and HOLD can not be overemphasized enough and are critical in planning and defending a tax-deferred like-kind exchange transaction.

Real Property not held for rental, investment or use in a trade or business is not considered to be qualified use property and will technically not qualify for tax-deferred like-kind exchange treatment.

This typically includes real property held and used as the Investor's primary residence, second home or vacation home. None of these will technically qualify for 1031 exchange treatment.

However, it should be noted that the Internal Revenue Service did issue a Private Letter Ruling[18] ("PLR") which allowed the Investor to structure a tax-deferred like-kind exchange transaction on property held for investment and for "personal enjoyment". Investors should be extremely careful when evaluating whether to structure a tax-deferred like-kind exchange transaction based on this PLR. The subject PLR is an old PLR issued in 1981, and there are no other Sections of the Internal Revenue Code or the Department of the Treasury Regulations, nor any rulings or court decisions that support this position. In addition, Section 1.1031 of the Department of the Treasury Regulations governing 1031 exchange transactions were issued in 1991 well after this PLR was issued. It is possible that the Department of the Treasury and/or the Internal Revenue Service could reverse their position if they were to reconsider this transactional structure in the future. However, the Internal Revenue Service did in

[17] Section 1.1031(a)-1(a) of the Department of the Treasury Regulations
[18] Private Letter Ruling 8103117

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fact take the position with this PLR that an Investor could in fact exchange out of a vacation property.

Property held specifically for sale will not qualify for tax-deferred like-kind exchange treatment. For example, property acquired by the Investor with the intent to fix-up and/or improve and then sell is actually held for sale, not held for investment, and will therefore not qualify for tax-deferred like-kind exchange treatment. Similarly, an apartment complex acquired by an Investor with the intent to convert to condominiums and then sold are actually held for sale, not held for investment, and therefore also will not qualify for tax-deferred like-kind exchange treatment. There may be more aggressive tax-deferred like-kind exchange strategies that could be designed in order to position these types of transactions for tax-deferred like-kind exchange treatment. Investors should discuss their options with their Qualified Intermediary and legal and tax advisors.

The key to qualifying for tax-deferred like-kind exchange treatment is the Investor's intent to hold the property for rental, investment or productive use in a trade or business, as opposed to holding the property for sale (inventory). The Investor must be in a position to prove under audit that he did in fact have the requisite intent to hold the property for rental, investment or use in a trade or business, and the best way to establish that intent is to in fact hold the property for the recommended period of time of at least 12 to 18 months. (See Section entitled Holding Requirements).

Like-Kind Replacement Property Requirement

The relinquished and the replacement properties must be of like-kind[19] in order to qualify for tax-deferred like-kind exchange treatment. There is a lot of information and it is often incorrectly reported as to what real property qualifies as "like-kind" property, such as an Investor that sells a condominium must acquire a condominium

[19] The term "Like-Kind" refers to the "nature" or "character" of the real property and not to its grade or quality. Section 1.1031(a)-2 of the Department of the Treasury Regulations.

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or an Investor that sells an apartment complex must acquire an apartment complex. This is not correct. In regards to real estate, ANY type of real property is considered to be like-kind to ANY other type of real property, so long as the Qualifying Use Requirements referenced above have been met.

An Investor can sell vacant land and acquire commercial or industrial property. He could sell an apartment complex and purchase a commercial office building or sell a retail center and acquire multiple single family dwellings. Leases with remaining terms of 30 years or more, including options to extend, qualify as like-kind property.[20] Tenant-in-common interests structured pursuant to Revenue Procedure 2002-22[21] are considered to be like-kind replacement property for real estate purposes. Again, any kind of real property is like-kind as long as the Qualifying Use Requirements have been met.

Further, property sold in one state may be exchanged for property located in another state, provided they are located with the United States of America.[22] Only domestic (United States) property can be exchanged for domestic property and non-domestic (foreign) property can be exchanged for non-domestic property.[23] Domestic property can not be exchanged for non-domestic property. For example, a United States Investor can sell his investment property in Canada and exchange it for like-kind replacement property located in Canada. Similarly, a Mexican National that owns investment property in the United States can sell and exchange the United States property for like-kind replacement property located in the United States.

Certain types of properties are specifically excluded as like-kind replacement properties under Section 1.1031 of the Department of the Treasury Regulations. These properties include those held for personal use such as a primary residence, second home or vacation home, as well as cash, stocks, bonds, notes, real estate

[20] Section 1.1031(2)-1(c) of the Department of the Treasury Regulations.
[21] Revenue Procedure 2002-22 issued by the Department of the Treasury.
[22] Certain state and/or local exceptions may apply, so consult with your local legal and tax advisor.
[23] Section 1.1031(h)(1) of the Department of the Treasury Regulations.

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investment trust interests (REITS), and partnership interests, and other securities or evidences of indebtedness or interest, such as a deed of trust or mortgage, a payoff of a deed of trust or mortgage, certificates of trust or beneficial interests in a trust, or choses in action[24].

In addition to real property, personal property may also qualify for tax-deferred like-kind exchange treatment if the Qualified Use Requirements and Like-Kind Property Tests are met. To meet the "like-kind" property test to exchange personal property, the Investor must exchange personal property for like-kind personal property. An Investor cannot exchange personal property for real property.[25] State law generally governs the determination as to whether property is classified as real or personal property.[26] It is important to note that the definition of "like-kind" is much more restrictive[27] for personal property than the standard applied to real property, and that the Investor's legal and tax advisors should be consulted immediately if personal property may be involved in a tax-deferred like-kind exchange transaction, so as to make sure the personal property relinquished, identified and ultimately acquired meets the personal property tax-deferred like-kind exchange requirements.

The extremely favorable and broad definition of "like-kind" as applied to real property allows Investors to change and/or reposition existing investment real estate portfolios in order to accomplish a number of strategic goals and objectives, including the repositioning or rebalancing of the real estate investment portfolio in order to satisfy any number of risk management issues. In addition, Investors can diversify or consolidate their real estate portfolio to meet changing investment needs and/or local, regional and national market conditions. Finally, the 1031 tax-deferred exchange transactions allow Investors to exchange out of their existing investment property

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[24] Section 1031(a)(2) of the Internal Revenue Code.
[25] Revenue Ruling 72-151; Oregon Lumber Co. v. Comm., 20 TC 192 (1953) and Revenue Ruling 59-229, 1959 CB 180.
[26] Section 1.1031(2)-1(b)(c) of the Department of the Treasury Regulations; Aquilino v. U.S., 363 US 509, 4 L. Ed. 2d 1365, 1371, 80 S. Ct. 1277, 1285 (1960).
[27] Section 1.1031(a)(2) of the Department of the Treasury Regulations.

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portfolio and diversify into new replacement properties by asset class (office vs. retail vs. apartments, etc.), by geographic area, and by quantity of properties.

Cost Segregation Analysis and Like-Kind Replacement Property

Cost segregation studies have become increasing popular on larger commercial transactions. Generally, performing a cost segregation analysis on property can provide the Investor with significant depreciation benefits that can shelter a higher percentage of the Investor's cash flow. However, the cost segregation study can create complicated problems when the transaction involves a tax-deferred like-kind exchange.

A simple example will demonstrate the issues involved. An Investor sells commercial real property for $10 million and acquires like-kind replacement property for $10 million and then has a cost segregation study completed on the like-kind replacement property, which subsequently segregates and allocates $1 million to personal property in order to obtain increased depreciation benefits. The Investor has now sold $10 million in real property and acquired $9 million in real estate and $1 million in personal property and has created a taxable boot problem.

Deferring 100% of Capital Gain and Depreciation Recapture Taxes

Investors must meet certain requirements in order to defer 100% of their Federal, and in most cases state, capital gain and depreciation recapture taxes on the sale of investment property. Generally, for full tax deferral, the Investor must (1) acquire replacement property that is equal to or greater in value than the relinquished property (based on net sales price, not equity); (2) must reinvest all of the net proceeds (net equity) from the sale of the relinquished property into the replacement property; and, (3) must replace the outstanding debt or mortgage value[28] on the relinquished property with new debt on the

[28] Section 1.1031(d)-2 of the Department of the Treasury Regulations.

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replacement property, although the Investor may elect to replace the debt with an additional cash contribution instead.

As a general rule, the Investor can always put more cash into the transaction, but cannot pull any cash out of the transaction without creating a potential taxable event referred to as boot. For example, if the Investor acquired property with a $60,000 cash down payment and is now selling the property and is doing a 1031 exchange transaction, even the $60,000 initial cash investment must be reinvested in order to defer 100% of his income taxes; the initial down payment can not be pulled out of the 1031 exchange transaction without creating boot. Boot can be generated in a number of ways and can be avoided with careful tax planning and proper review by the Investor's tax adviser.

In order to avoid unanticipated boot, the Investor should always have the estimated settlement or closing statement reviewed by his tax advisor before the transaction actually closes to make sure that the 1031 exchange values have been met and to make sure that there will be no taxable boot. Cash received by the Investor at the close of the 1031 exchange transaction is termed "cash boot" and a net reduction in debt is termed "mortgage boot" or "mortgage relief."

Partial Tax Deferral and Taxable Boot

An Investor may only be able to defer a portion of the capital gain and/or depreciation recapture income tax liabilities (and must therefore recognize the remainder) when a tax-deferred like-kind exchange transaction does not meet the previously discussed exchange requirements and has generated taxable boot.

When it is determined that the Investor has incurred income tax liability from the receipt of boot, two initial calculations are necessary. The first is to determine the amount of boot that has been generated and the second is to determine the actual amounts of the depreciation recapture and/or capital gain from the sale of the relinquished property(ies).

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The boot generated from the tax-deferred like-kind exchange transaction is merely the total amount that may result in an income tax liability. The actual income tax liability will depend on the actual depreciation recapture and/or capital gain amounts.

Incurring Boot may be desirable and in some circumstances may be a strategic and desirable result in a tax-deferred like-kind exchange. This is particularly true where an Investor has offsetting tax losses or wishes to rebalance part of his investment portfolio by taking part of his investments out of the real estate market all together.

OVERVIEW OF EXCHANGE STRUCTURES

Simultaneous Exchanges

A simultaneous transaction is one where the closing of both the relinquished property and the replacement property take place on the same day. These exchanges may be referred to as a simultaneous or concurrent tax-deferred like-kind exchanges, and virtually eliminate the risks associated with the exchange deadlines (See Section entitled Exchange Deadlines).

Two-Party Exchanges

A two party tax-deferred like-kind exchange is structured in the same manner as a simultaneous transaction: two property owners trade or swap properties and then balance the difference in equities (values) by making a payment either with cash or other non-like-kind property to the participant with less equity.

While two-party tax-deferred like-kind exchange transactions are not common today, they were the standard transactional structure for the period of time after Congress introduced tax-deferred like-kind exchanges in 1921 until the Starker family cases in the 1970s. (See the Section entitled History of Section 1031 and the Tax-Deferred Like-Kind Exchange).

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The qualifications for tax deferral in a two-party tax-deferred like-kind exchange are applied to each Investor separately and independently of one another. Thus, one Investor may be deferring his income tax liabilities pursuant to Section 1031 of the Internal Revenue Code while the other Investor may qualify for a tax free exclusion on the sale of his primary residence pursuant to Section 121 of the Internal Revenue Code.

The use of a Qualified Intermediary is not required in a two-party tax-deferred like-kind exchange since the two parties are merely "swapping' deeds or bills of sale with each other to the respective property interests. However, the use of a Qualified Intermediary in a two party transaction is still advisable and preferable as a precautionary measure just in case the tax-deferred like-kind exchange cannot close simultaneously at the last minute as planned.

For example, two party tax-deferred like-kind exchange transactions can be relatively easy to structure when both properties are handled by the same closing officer, settlement agent, escrow officer, or title insurance company, and both properties are located in the same jurisdiction and/or county. However, when the transactions are being administered, closed or settled by different closing agents and/or are located in different jurisdictions such as county recorders offices or county assessor offices, there is always the possibility that the transactions do not close concurrently and result in an accidental failed tax-deferred like-kind exchange transaction.

Property values and respective equities may not equal and an equalization payment may be required. The Investor receiving the equity balancing payment (cash boot or other non-like-kind property) may wish to acquire additional replacement properties under a delayed tax-deferred like-kind exchange transaction in order to defer the residual amount.

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The replacement property transaction may be delayed for any number of reasons making it impossible for both transactions to close simultaneously.

These are just a few of the reasons for which the use of a Qualified Intermediary in a two party transaction is highly recommended and advisable in order to prevent the inadvertent constructive receipt of funds.

Using a Qualified Intermediary also assists in the structuring of the tax-deferred like-kind exchange transaction and will help to demonstrate and document the Investors' mutual intent to complete tax-deferred like-kind exchange transactions and to ensure compliance with Section 1031 of the Internal Revenue Code and Section 1.1031 of the Treasury Regulations.

Three Party Exchanges

Three party tax-deferred like-kind exchanges were initially structured as simultaneous transactions and either the buyer of the relinquished property or the seller of the replacement property functioned as the Qualified Intermediary (Accommodator) on behalf of the Investor in order to defer the income tax consequences.[29]

There were certain risks associated with this simultaneous three party exchange: the Investor's tax-deferred like-kind exchange could be disallowed if the documentation was not prepared and/or completed correctly and the Investor was deemed to be in constructive receipt of the tax-deferred like-kind exchange funds. The party acting as the Qualified Intermediary was also exposed to certain risks and liabilities in conjunction with their brief acquisition and subsequent conveyance of title to one of the properties. Three-party tax-deferred like-kind exchange transactions become very complicated when it is necessary for the parties to cooperate with each other in coordinating a simultaneous closing on the relinquished property and the replacement

[29] Alderson v. Commissioner; 1963.

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property transactions, especially if there are multiple relinquished properties and/or replacement properties involved in different geographic areas.

Delayed Exchanges

The Deficit Reduction Act of 1984 created and codified the present day delayed tax-deferred like-kind exchange transaction, under which Investors can sell their relinquished property first and acquire their replacement property later.

The three-party transaction can be structured as a simultaneous tax-deferred like-kind exchange where the relinquished property and the replacement property transactions close simultaneously or concurrently, or it can be structured as a delayed tax-deferred like-kind exchange transaction where the relinquished property closes first and the replacement property closes in the future (See Section entitled Exchange Deadlines).

Prior to the Deficit Reduction Act of 1984 and the *Starker* family case decisions, tax-deferred like-kind exchange transactions were almost exclusively structured as simultaneous transactions. Today, however, virtually all tax-deferred like-kind exchange transactions today are structured as three party transactions: the Investor completes a tax-deferred like-kind exchange sale to one party (the buyer) and acquires his replacement property from a separate, unrelated party (the seller) on a delayed basis. This delayed exchange option provides significantly greater flexibility for the Investor when structuring a tax-deferred like-kind exchange transaction than those previously utilized and eliminates the complexities, difficulties and risks involved in structuring a simultaneous or concurrent transactional structure.

There are at least five parties involved in each delayed tax-deferred like-kind exchange transaction. These five parties include, but are not limited to: (1) the Investor doing the tax-deferred like-kind exchange; the (2) Buyer of the relinquished property; the (3) Seller of the replacement property; the (4) Escrow Officer of the Closing

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Agent/Attorney handling the real estate transaction settlement and closing process; the closing agent can be the same or different party for the relinquished property and replacement property transaction; and the (5) Qualified Intermediary (See Section entitled Use of A Qualified Intermediary and Section entitled Evaluating and Selecting the Qualified Intermediary).

Forward Exchanges

The simultaneous and/or delayed tax-deferred like-kind exchange may also be referred to as a forward 1031 exchange, regular 1031 exchange, or a Starker 1031 exchange (after the Starker family case decisions). For the sake of clarity the delayed tax-deferred like-kind exchange will be referred to as a forward tax-deferred like-kind exchange in order to help differentiate it from a Reverse tax-deferred like-kind exchange (See Section entitled Reverse Exchange).

A forward tax-deferred like-kind exchange structure may include either the simultaneous or the delayed transactional structures, But the majority of discussion will be placed on the forward tax-deferred like-kind exchange transaction since this is the most common tax-deferred like-kind exchange transactional structure.

Reverse Exchanges

A reverse tax-deferred like-kind exchange transaction allows the Investor to acquire like-kind replacement property prior to the sale of his relinquished property. This strategy is particularly beneficial in markets where demand for property is greater than the inventory. The reverse exchange also eliminates the risks involved with the identification deadline involved with forward tax-deferred like-kind exchanges: although it does have its own 45 calendar day identification and 180 calendar day exchange deadlines (See Section entitled Exchange Deadlines). Reverse tax-deferred like-kind exchanges give the Investor the flexibility to take all the time they need to

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locate the ideal replacement property, without the pressure of the forward tax-deferred like-kind exchange deadlines.

EXCHANGE DEADLINES

Section 1031 of the Internal Revenue Code

tax-deferred like-kind exchanges are subject to very specific time restrictions contained in Section 1031 of the Internal Revenue Code. These restrictions cannot be extended, waived or altered for any reason, except in special circumstances where the President of the United States has declared certain areas federal disaster areas and has expressly authorized the extension of these time periods.

45 Calendar Day Identification Period

In a forward tax-deferred like-kind exchange, the Investor has 45 *calendar* days from the close of his sale transaction, defined as the transfer or conveyance of the title to his relinquished property to the buyer to identify potential replacement property(ies) to be acquired as part of his tax-deferred like-kind exchange transaction.

It is important to note that the 45 *calendar* day deadline can not be extended for any reason, even if the deadline falls on a Saturday, Sunday or legal holiday. . If the deadline does fall on a Saturday, Sunday or a legal holiday, the deadline does not get extended to the following business day as in other parts of the income tax code and regulations, so the Investor must ensure that the identification is made no later than midnight of the 45th *calendar* day. (See Section entitled Identification and Receipt of Replacement Property Requirements).

The 45 *calendar* day identification period begins with the closing of the first relinquished property in a forward exchange. For tax-deferred like-kind exchange transactions that involve more than one relinquished property as part of the same tax-

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deferred like-kind exchange transaction (same tax-deferred like-kind exchange file), the rule remains the same: the clock begins to run with the closing of the first relinquished property regardless of when the other relinquished properties close. Investor's should consider opening separate tax-deferred like-kind exchange transactions for each relinquished property so they are not restricted to one set of tax-deferred like-kind exchange deadlines.

The Investor can change his mind as often as he wishes within the 45 *calendar* days by revoking any prior identifications and submitting a new identification to the Qualified Intermediary. Past the 45th day however, the identification cannot be changed or altered in any manner.

The 45 *calendar* day identification deadline is a very short timeframe, goes by very fast, and accordingly can be very stressful for Investor's still trying to locate suitable replacement property(ies). The search for replacement property should begin as soon as the Investor has decided to sell his property and enter into a tax-deferred like-kind exchange transaction. In cases where finding replacement property is expected to be difficult, the Investor should consider approaching the buyer of the relinquished property and requesting an extension of time to the closing of escrow; if this is not initially received positively, the Investor may consider offering an extension fee. Extending the close of the transaction will provide more time to look for suitable replacement property and ease the Investor's stress slightly.

180 Calendar Day Exchange Period

In order to successfully complete a tax-deferred like-kind exchange, the Investor must complete the acquisition of one or more his identified replacement property(ies) no later than either (1) 180 *calendar* days from the close of his sale transaction, OR (2) by the due date (including extensions) of his Federal income tax return.

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This means that in a situation where a sale transaction closes before October 17th of any given tax year, the Investor must close on the acquisition of the replacement property within the 180 *calendar* day exchange period. If however, the Investor's sale transaction were to close on or after October 17th and on or before December 31st, of any given tax year, then the 180 *calendar* day exchange period would end after the taxpayer's deadline to file his Federal income return (April 15th for individuals). An extension of time to file would be required for the Investor to have the full and complete 180 *calendar* days to complete the tax-deferred like-kind exchange transaction. The Investor would then file his Federal income tax return after the tax-deferred like-kind exchange transaction has been completed, but within the extended filing period.

DELAYED EXCHANGE PROCESS

Treatment of Deferred Exchanges

Generally, no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind to be held either for productive use in a trade or business or for investment.

Section 1.1031 of the Department of the Treasury Regulations, numerous rulings, pronouncements, and legal precedent have provided us with additional guidance on how to properly structure a tax-deferred like-kind exchange transaction.

It is often recommended that certain language be included in the Purchase and Sale Agreement and Escrow Instructions, if applicable) to protect the Investors interests. This is not a requirement, but cooperation clause language may be a wise addition to the Agreement. Here are suggested clauses that can be used.

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Cooperation Clause and Disclosure Language

Relinquished Property (Sale): Buyer acknowledges that Seller intends to perform an IRC Section 1031 Tax-Deferred exchange and that Seller's rights, title and interest (but not obligations) pursuant to this [Purchase and Sale Agreement or Sales Contract or Escrow Instructions] may be assigned to [Qualified Intermediary] for the purpose of completing said exchange. Buyer agrees to cooperate with Seller and [Qualified Intermediary], at no additional cost or liability to Buyer, by executing the documents necessary to complete Seller's IRC Section 1031 Tax-Deferred exchange transaction.

Replacement Property (Purchase): Seller acknowledges that Buyer is completing an IRC Section 1031 Tax-Deferred exchange and that Buyer's rights, title and interest (but not obligations) pursuant to this [Purchase and Sale Agreement or Purchase Contract or Escrow Instructions] may be assigned to [Qualified Intermediary] for the purpose of completing said exchange . Seller agrees to cooperate with Buyer and [Qualified Intermediary], at no additional cost or liability to Seller, by executing the documents necessary to complete Buyer's IRC Section 1031 Tax-Deferred exchange transaction.

Assignment of the Contract and Escrow Instructions Prior to Closing

The Qualified Intermediary must be assigned into the Purchase and Sale Agreement and the Escrow Instructions (if applicable) before the close of the transaction in order to defer the income tax consequences. Transactions that have closed without a Qualified Intermediary assigned into the transaction will be taxable because the Investor has the right to the net proceeds from the close of the transaction.

In order to protect the Investor from this presumptive receipt, it is important that the Purchase and Sale Agreement drafted for the relinquished property or replacement property contain language that allows an assignment of the contract, especially to a Qualified Intermediary.

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Identification and Receipt of Replacement Property Requirements

The identification process is the stage of the tax-deferred like-kind exchange transaction where the Investor identifies potential replacement properties during the 45 calendar day identification period that are being considered for acquisition as part of the tax-deferred like-kind exchange transaction. This is only an identification requirement and the properties do not need to be under contract or in escrow to qualify.

The Investor may change the properties identified as often as he wants during the 45 day identification period by revoking the previously identified properties and then identifying new potential replacement property(ies). It is essential however that on the 45th day the Investor has identified property in compliance with the three identification rules; if at the end of the identification period the Investor has identified more properties than are permitted, the Investor will be treated as having identified no potential replacement property(ies) and the tax-deferred like-kind exchange transaction will not qualify for tax deferral. These rules are not a bar where property is actually acquired during the identification period: replacement property actually acquired by the Investor before the end of the identification period will be considered identified and will qualify for tax deferral regardless of whether the Investor subsequently complies with the identification rules.

Identifications of replacement property(ies) should be made in writing and signed by the Investor and delivered by hand, facsimile, U.S. Mail, or other means to a person involved in the tax-deferred like-kind exchange transaction, typically the Qualified Intermediary (Accommodator).

There has been significant and lengthy debate within the tax-deferred like-kind exchange industry regarding the proper party to receive the identification of replacement property. The Department of the Treasury Regulations require that the

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identification be given or delivered to a "party involved in the tax-deferred like-kind exchange transaction", but do not directly specify which parties will safely qualify. A safe course of action is to look at the transaction itself for interpretation: the transaction is a like-kind exchange and is structured using a like-kind exchange agreement, so the only acceptable and safe definition of "a party involved in the tax-deferred like-kind exchange" are the parties to the like-kind exchange agreement (which generally means the taxpayer and the Qualified Intermediary). Therefore delivering the identification to the Qualified Intermediary is the safest course of action to prevent disqualification of the transaction for an invalid and/or untimely identification.

Regardless of who the Investor makes the identification to, the identified potential replacement properties must be unambiguously identified by listing the property address, the legal description, and the Assessor's Parcel Number, or all three. The ability to identify property is limited under the Code: there are three rules under which the Investor may identify property.

The Investor should use a method where by they can prove the identification was made within the prescribed time limits, or request a confirmation from the Qualified Intermediary that the identification was in fact made and received within the prescribed 45 calendar days time limit.

Investors acquiring an undivided percentage interest ("fractional interest") in a property should identify the specific percentage that will be acquired.

To qualify for a tax-deferred like-kind exchange, this step requires the Investor to comply with one (not all) of the following three identification requirements. (See Section entitled Exchange Deadlines for information on the deadlines regarding identification of potential replacement properties).

1) The Three Property Rule:

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The “three property” identification rule allows an Investor to identify up to, but not more than, three potential replacement properties. There is no limitation on the market value of the identified replacement properties under the three property rule; the only limitation is on the total number of potential replacement properties that the Investor may identify.

The “three property” rule allows an Investor to identify more than one property so they have back up properties identified in case their first choice cannot be acquired. This is the most common and the easiest of the identification rules to work with and virtually all Investors take advantage of this rule.

Although he could do so, the Investor is certainly not required to acquire all of the properties identified.

In the event an Investor needs to identify more than three potential replacement properties, he may choose to ignore the “three property” rule completely and opt to identify property in accordance with the 200% of fair market value rule.

2) The 200% of Fair Market Value Rule:

Unlike the three property rule, the 200% rule allows an Investor to identify more than three potential replacement properties as long as the total fair market value of all the potential replacement properties identified does not exceed 200% of the sales price of the relinquished property(ies). There is no limitation on the total number of potential replacement properties identified under this rule, only a limitation on the total fair market value of the potential replacement properties identified by the Investor.

This means that if an Investor sold relinquished property for $1,000,000 under the 200% rule, the Investor would be able to identify as many potential replacement properties as desired, provided that the total fair market value of all of the identified potential replacement properties combined did not exceed $2,000,000 (200% of the $1,000,000 sales price of the relinquished property).

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The fair market value used for each identified potential replacement property with the 200% rule is determined or valued as of the day actually acquired by the Investor or the last day of the exchange period.

If the Investor can not accomplish his objectives under either the three property rule or the 200% rule, the identification may still be held valid under the 95% exception.

3) The 95% Exception Rule:

In the event the Investor must identify replacement properties that exceed the three property rule and the 200% of fair market value rule, the identification will still be considered valid for tax-deferred like-kind exchange treatment if the Investor acquires at least 95% of the fair market value that was identified.

Investors should be very careful when using the 95% exception rule, as it is more difficult to qualify under and there is a much higher risk of the transaction failing. For example, assume that an Investor intends to identify and acquire 10 properties: the Investor would identify 10 properties, then list the fair market value by each of the respective properties. The Investor would then execute Purchase and Sale Agreements for all 10 properties, and begin closing on all of the properties. In the event that one property was not able to close with in the prescribed exchange period, the entire tax-deferred like-kind exchange will be disallowed if the Investor is not able to acquire and close on at least 95% of the fair market value identified. Extreme caution should be used when taking advantage of the 95% exception rule, and it should be utilized only when the other two rules will not meet the Investors objectives.

Other Identification Issues

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Property incidental to the transaction is disregarded for identification purposes.[30] Incidental property, such as washers, dryers, and dishwashers in an apartment building, must be typically transferred together with the larger property in standard commercial transactions. The total of the fair market value of the incidental property must not exceed fifteen percent of the total fair market value of the larger property.

Further, incidental property received that is not like-kind replacement property is still subject to capital gain recognition.

Avoiding Constructive and Actual Receipt of Funds – General

The Investor is considered to have actual or constructive receipt of the tax-deferred like-kind exchange funds whenever he has actual possession of the funds or receives any economic benefit from the funds or assets, including having the tax-deferred like-kind exchange funds credited to the Investor's account, set apart or aside for the Investor and under the Investor's control, or made available so that the Investor may draw upon them immediately or after giving notice. Constructive receipt also occurs when controls or restrictions on the tax-deferred like-kind exchange funds expire, lapse, or are waived and the Investor has the right to access or demand the funds.[31]

The Investor is not allowed to have any actual or constructive receipt of the tax-deferred like-kind exchange funds during the exchange period and the Qualified Intermediary is not permitted to disburse or release the tax-deferred like-kind exchange funds unless (1) the transaction has failed because the Investor's did not identify replacement property during the 45 calendar day identification period; or (2) all the identified replacement properties have been acquired and there are unused tax-deferred like-kind exchange funds; or (3) the tax-deferred like-kind exchange has been completed and there are unused tax-deferred like-kind exchange funds.[32]

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[30] Section 1.1031(k)-1(c)(5) of the Department of the Treasury Regulations.
[31] Section 1.1031(k)-1(f)(2) of the Department of the Treasury Regulations.
[32] Section 1.1031(k)-1(f)(1) of the Department of the Treasury Regulations.

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Actual or constructive receipt by the Investor of any portion of the tax-deferred like-kind exchange funds or assets during the exchange period may result in the complete disallowance of the entire tax-deferred like-kind exchange transaction and a taxable event for the Investor. In order to avoid constructive receipt of the funds, a Qualified Intermediary *must* be assigned into the purchase and sale agreements (and escrow instructions if applicable) of the relinquished property(ies) *and* the replacement property(ies). These assignments must be made *before* the transactions close and the properties are transferred or conveyed to the respective buyers. If either transaction should close before the Qualified Intermediary has been assigned into the transaction, the transaction will fail to qualify for tax-deferred like-kind exchange treatment.

There are some funds which may be disbursed from the tax-deferred like-kind exchange proceeds at the close of the transaction without resulting in the disqualification of the Investors tax-deferred like-kind exchange transaction. Investors may receive or have the right to receive items that a seller receives as a consequence of the sale that are not included in the amount realized from the disposition of the relinquished property, such as prorated rents or security deposits, without disqualifying the transaction for constructive and/or actual receipt. However, payment of these items out of the tax-deferred like-kind exchange funds may result in taxable boot to the Investor. The Investor should have his tax advisor review the estimated net settlement statement prior to the close of the transaction.

Further, while there is still little definitive authority in the Internal Revenue Code and the Department of the Treasury Regulations as to whether the Investor will incur a tax liability on amounts paid for certain and specific closing, financing and other routine transaction closing costs, most experts have concluded that routine closing costs typically involved in a sale or purchase of property (broker's commissions[33], title insurance premiums, escrow or closing agent's fees, prorated taxes, recording fees and costs, tax-deferred like-kind exchange Qualified Intermediary fees and costs, finder's fees, transfer fees and documentary transfer taxes, recording fees, and other related

[33] Revenue Ruling 72-456, 1972-2 CB 468 by the Department of the Treasury.

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items) can be paid from tax-deferred like-kind exchange proceeds at the close of the transaction without disqualifying the transaction.

Permissible and Non-Permissible Expenses and Closing Costs

Tax-deferred like-kind exchange proceeds can be used to pay for certain permissible transaction, settlement and closing costs related to the disposition of the relinquished property and/or the acquisition of the replacement property without creating an income tax liability for the taxpayer.

Other expenses, financing costs and settlement charges can be paid from the tax-deferred like-kind exchange proceeds as outlined above, but will be considered to be cash boot received by the taxpayer and may therefore result in an income tax liability (non-permissible expenses and closing costs). In certain situations, cash boot paid will offset cash boot received and will reduce the taxpayer's income tax liability.

Taxpayers should therefore always review their estimated settlement statement with their tax and/or legal advisors prior to approving the estimated expenses and closing costs to ensure they have a complete understanding of the income tax consequences from the transaction.

The more common permissible and non-permissible expenses and closing costs are listed below. Permissible and non-permissible expenses and closing costs can vary by geographic region based on common practices, local standards and customs.

Permissible Expenses and Closing Costs

- Owner's Title Insurance Premiums
- Escrow or Settlement Fees
- Broker's Commissions
- Finder/Referral fees
- 1031 Exchange Qualified Intermediary (Accommodator) Fees

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- Documentary Transfer Taxes
- Recording Fees
- Legal Counsel/Attorney Fees
- Tax Advisor/Accountant Fees

Non-Permissible Expenses and Closing Costs

- Financing activities such as loan fees, loan points, appraisal fees, mortgage insurance premiums, lender's title insurance policy premiums, and other loan processing fees and costs
- Property taxes
- Prorated rents
- Insurance premium payments
- Security Deposits
- Payoff of credit card balances

Further, financing costs and other costs not related to the direct acquisition of the replacement property(ies) can only be paid at the close of the replacement property(ies) when the Qualified Intermediary disburses all of the tax-deferred like-kind exchange funds it is holding to the closing agent.

Non-exchange expenses debited to the Investor and paid with exchange equity are taxable boot, but this boot may be offset (by other items, such as prepaid taxes or dues credited to the Investor).

Accrued interest or prorated property tax payments or security deposits paid to the buyer of the relinquished property can be treated by the Investor as non-recourse debt from which the Investor is relieved of and can be offset against debt assumed on the replacement property.[34]

[34] TAM 8328011 issued by the Department of the Treasury.

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The Investor should always consult with his legal, tax and financial advisor prior to completing the tax-deferred like-kind exchange transaction so these items can be addressed before it is too late. Advisors may recommend that Investors pay for certain costs at the close of the transaction with personal funds in order to avoid taxable boot.

Avoiding Constructive Receipt – Safe Harbor Provisions

There are other transactional and structural issues that come into play that would normally result in the constructive receipt of the tax-deferred like-kind exchange funds by the Investor. However, by complying with certain safe harbor provisions contained within the Department of the Treasury Regulations[35], Investors can avoid these constructive receipt issues while structuring the tax-deferred like-kind exchange transaction to his benefit. The safe harbor provisions are:

1. Safe Harbor Number One: Authorizes the use of one or more security or guarantee mechanisms to secure the Investor's tax-deferred like-kind exchange funds:
    a. Deed of trust, mortgage or other security interest granting a security interest or lien in a property to secure the Investor's tax-deferred like-kind exchange funds.
    b. Standby letter of credit under certain prescribed conditions and terms to secure the Investor's tax-deferred like-kind exchange funds.
    c. Guarantee of a third party.

    These security and/or guarantees are not always practical and in certain circumstances pose an unjustifiable expensive.

    It is generally more prudent and cost effective for the Investor to carefully evaluate and select a Qualified Intermediary by performing a thorough due diligence and background check on the Qualified Intermediary, and then using

[35] Section 1.1031(k)-1(g)(1) of the Department of the Treasury Regulations.

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the Qualified Intermediary to manage the risk of constructive receipt (See Section entitled Evaluating and Selecting YOUR Qualified Intermediary).

2. Safe Harbor Number Two: Authorizes the use of a Qualified Escrow Account or a Qualified Trust Account. These fiduciary accounts protect the Investor in the event of a voluntary or involuntary bankruptcy of the Qualified Intermediary ("Accommodator"). When the tax-deferred like-kind exchange funds are held in either type of account, the Qualified Intermediary merely administers the tax-deferred like-kind exchange transaction, rather than actually holding the tax-deferred like-kind exchange funds. Rather, the tax-deferred like-kind exchange funds are held by an entity that has either Escrow or Trust powers, which means the funds are legally defined as fiduciary funds instead of corporate funds, and excluded from the trustees estate in case the Qualified Intermediary elects or is forced into bankruptcy.

   Qualified Trust and Escrow accounts cannot be held by the Investor or a disqualified person[36]: these entities include anyone who acts as an agent of the Investor[37] because those parties are unable to effectively limit the Investor's right to receive, pledge, borrow, or otherwise obtain the benefits of the tax-deferred like-kind exchange funds or other property held in the tax-deferred like-kind exchange account before the end of the tax-deferred like-kind exchange period.

3. Safe Harbor Number Three: expressly authorizes the use of the Qualified Intermediary ("Accommodator") in the tax-deferred like-kind exchange transaction. The Qualified Intermediary ("Accommodator") serves as the facilitator or administrator of the tax-deferred like-kind exchange transaction. These responsibilities include:

[36] Sections 267(b) and 707(b) of the Internal Revenue Code.
[37] Section 1.1031(k)-1(k)(2) of the Department of the Treasury Regulations.

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a. Holding and safekeeping the tax-deferred like-kind exchange funds (See Safe Harbor Number Two) and preventing the Investor from having constructive receipt issues.

b. Preparing the tax-deferred like-kind exchange documents, including the Like Kind Exchange Agreement, the Qualified Escrow or Trust Agreements, the Assignment, Acceptance, Notice and Direction to Convey, and other related transactional documents required to properly structure the tax-deferred like-kind exchange transaction. These documents are particularly important to the transaction, as they limit the Investor's right to the funds as required to avoid constructive receipt issues, and to allow the Qualified Intermediary to acquire and transfer both the relinquished property and the replacement property in accordance with the Investor's objectives. These agreements must expressly limit the Investor's rights to receive, pledge, borrow, or otherwise obtain the benefits of the tax-deferred like-kind exchange funds as necessary to prevent an inference that the Qualified Intermediary itself is acting as the Investors agent and that the transaction should be disallowed by the Internal Revenue Service.

4. Safe Harbor Number Four: Allows Investors to accrue and receive interest or dividends on the tax-deferred like-kind exchange funds held by the Qualified Intermediary during the tax-deferred like-kind exchange period.[38]

   While the Investor can not receive the interest or dividends during the tax-deferred like-kind exchange period in order to avoid the constructive or actual receipt issues, they can be disbursed after the entire tax-deferred like-kind exchange transaction has been completed.

   It is important to note that the interest or dividends paid to the Investor are

[38] Section 1.1031(k)-1(h)(1) of the Department of the Treasury Regulations.

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taxable as ordinary income in the year paid, regardless of whether or not the Investor actually received the interest or dividends in the same tax year, regardless of whether or not the funds were used to acquire the like-kind replacement property.[39]

Restrictions on Exchange Proceeds

The Department of the Treasury Regulations only permit the Investor to access the tax-deferred like-kind exchange proceeds when certain stringent conditions have been satisfied.[40] No funds may be disbursed unless:

1. No replacement properties have been identified within the 45 calendar day identification period (the Investor can always revoke any and all identified replacement properties in the event they change their mind and want the tax-deferred like-kind exchange funds released on the 46th day); or
2. All identified replacement properties have been purchased and the 45 calendar day identification period has expired; or
3. The 180 calendar day exchange period has expired; or
4. A material and substantial contingency occurs after the end of the 45th calendar day identification period that relates to the tax-deferred like-kind exchange, has been provided for in writing, and the condition is beyond the control of the Investor (conditions such as a zoning or land use issues, etc.)

Holding Requirements for Exchange Property

While the Department of the Treasury Regulations[41] and numerous rulings make it very clear that the Investor must have the intent to hold his property for rental, investment or use in a trade or business, they fail to define exactly how long an Investor needs to hold his relinquished or replacement property in order to qualify for

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[39] Section 1.1031(k)-1(h)(2) of the Department of the Treasury Regulations.
[40] Section 1.1031(k)-1(g)(6) of the Department of the Treasury Regulations.
[41] Section 1.1031(a)-1(a) of the Department of the Treasury Regulations.

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a tax-deferred like-kind exchange. If the Investor's relinquished property was purchased just before the tax-deferred like-kind exchange transaction, the Internal Revenue Service has routinely taken the position that the Investor actually purchased the property for sale rather than holding it for investment.[42] Further, the Internal Revenue Service has also taken the position that if the replacement property is sold immediately after the tax-deferred like-kind exchange transaction then it was not HELD long enough to qualify for tax-deferred like-kind exchange treatment.[43] While there is little definitive authority on the holding period, in one private letter ruling,[44] the Internal Revenue Service has stated that a minimum holding period of two years would be sufficient to meet the Qualified Use test, and a number of court decisions have been handed down that have also taken the same position (although they have been somewhat more liberal than the Department of the Treasury and the Internal Revenue Service).[45]

The amount of time an Investor holds the property is not the only factor the Internal Revenue Service will use to determine whether the Investor had the appropriate intent to qualify for a tax-deferred like-kind exchange, but it is extremely important. The easiest way to demonstrate the Investor's intent to hold a property is to do just that: actually hold the property. The longer the Investor holds the property the stronger his case will be if the Internal Revenue Service questions the sufficiency of the Investors intent.

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[42] Revenue Ruling 84-121, 1984-1 CB 168; Revenue Ruling 77-337, 1972 CB 305; and Revenue Ruling 57-244, 1957-1CB 247.

[43] Revenue Ruling 75-292, 1975-2 CB 333.

[44] Private Letter Ruling No. 8429039.

[45] Regals Realty Co. v. Commissioner of Internal Revenue, 127 F.2d 931 (C.C.A. 2d Cir. 1942) (replacement property listed for sale one month after 1031 Exchange transaction); Griffin v. Commissioner of Internal Revenue, 49 T.C. 253, 1967 WL 1261 (T.C. 1967) (replacement property sold under a contract executed before the 1031 Exchange transaction); Bernard v. Commissioner of Internal Revenue, T.C. Memo 1967-176, 1967 WL 1185 (T.C. 1967) (replacement property sold two weeks after the exchange); Black v. Commissioner of Internal Revenue, 35 T.C. 90, 1960 WL 1128 (T.C. 1960) (replacement property sold eight months after the 1031 Exchange transaction). See also Boise Cascade Corp. v. Commissioner of Internal Revenue, T.C. Memo. 1974-315, 1974 WL 2404 (1974) (replacement property sold within a year after the 1031 Exchange transaction, but 1031 Exchange upheld).

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Tax advisors frequently recommend that Investors hold the subject property for at least one year to prove intent. Holding the property for at least one year will give the Investor two income tax returns listing rental income, expenses and depreciation, all of which provide a solid argument that the Investor had the appropriate intent to hold the property. In addition, the United States Congress at one time considered a minimum holding requirement of 12 months for both relinquished and replacement property.[46] While the requirement was never enacted by Congress, it does provide a good indication of what sort of holding period Congress would consider sufficient to meet 1031 requirements.

If the Investor is considered a "dealer", he will typically not qualify for tax-deferred like-kind exchange treatment because technically the property is being held for sale as "inventory" and thus is NOT property held for investment purposes. In some cases, however, dealers may be able to qualify for tax-deferred like-kind exchange treatment by segregating assets intended to be held as rental, investment or productive use in a trade or business from those assets being held for sale. In these situations, some legal advisors have advised their clients to form a separate entity, such as a limited liability company, specifically to hold title to the segregated property in order to more easily qualify for tax-deferred like-kind exchange treatment in the future.

If however the Investor or dealer's intent is to buy, fix up and then sell ("Flip") the property, then he clearly does not have the intent to hold the property for investment purposes. Rather, the intent is to hold the property for sale, and accordingly does not meet the Qualified Use test and will not qualify for tax-deferred like-kind exchange treatment.

The holding issue becomes substantially more complicated when the Investor either holds legal title to the relinquished property, or intends to hold legal title to his replacement property in a partnership, corporation or multi-member limited liability company. The partnership, corporation or multi-member limited liability company

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[46] Section 11601 of HR 3150, 100th Congress, 1st Session (1989).

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can certainly sell relinquished property held in the entity's name and then purchase like-kind replacement property to be held by the same entity and still qualify for tax-deferred like-kind exchange treatment. The difficulties arise when some of the underlying shareholders, partners or members of the multi-member entity wish to go separate ways and attempt to exchange their interests in that entity as part of a tax-deferred like-kind exchange. (See Section entitled Partnership Issues under Other Issues).

Only the Investor can determine how aggressive or conservative he wants to be in structuring and undertaking a tax-deferred like-kind exchange. The longer an Investor holds a property prior to an exchange, the more conservative the course of action is and the easier it will be to prove the Investor has satisfied the Qualified Intent requirement.. Conversely, the shorter the holding period, the more aggressive the transaction is considered and the more difficult it will be to demonstrate that the Investor's intent was to hold the property for rental, investment or use in a trade or business.

Refinancing and Exchanges

A common concern among investors conducting a tax-deferred like-kind exchange is the ability to withdraw equity from the investment property without incurring any income tax liability. Since cash or debt relief constitutes taxable boot, the concern is that pulling cash equity out of a property before, during or after a tax-deferred like-kind exchange transaction would result in the disallowance of the tax-deferred like-kind exchange transaction and full tax liability for the Investor.

It is possible for the Internal Revenue Service to take the position that the refinance transaction has been structured specifically to evade payment of income taxes, collapse the exchange as a "step" transaction, and complete disallow the tax-deferred like-kind exchange transaction. The preamble to the Department of the Treasury Regulations contains language stating that refinancing immediately prior to a tax-

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deferred like-kind exchange transaction will result in the disallowance of the tax-deferred like-kind exchange, so the Investor is best advised to refinance at least six months prior to execution of an exchange, or waiting until the completion of the exchange to refinance.

While there is limited guidance in the form of regulation or legal precedent, all available information seems to indicate that refinancing well before the property is disposed of in a structured tax-deferred like-kind exchange transaction is acceptable. This conclusion is also supported by a private letter ruling based on a scenario in which the Investor refinanced the property immediately after the completion of his tax-deferred like-kind exchange transaction and the exchange was not disallowed by the Internal Revenue Service.

Evaluating and Selecting a SAFE Qualified Intermediary

The Qualified Intermediary often referred to as the Accommodator or Facilitator, is a central component in a tax-deferred like-kind exchange transaction. The Qualified Intermediary is the entity responsible for drafting the Like-Kind Exchange Agreements and other related legal documents necessary to properly structure the tax-deferred like-kind exchange. It is crucial that the tax-deferred like-kind exchange staff have sufficient technical knowledge to be able to identify potential problems with the tax-deferred like-kind exchange and undertake appropriate measures to advise the Investor, as well as correct and document the situation. Perhaps the most important function of the Qualified Intermediary is its fiduciary responsibility to receive, hold and safeguard the tax-deferred like-kind exchange funds during the transaction.

The Qualified Intermediary's critical role and responsibilities in the tax-deferred like-kind exchange process, particularly the safeguarding and management of the Investor’s tax-deferred like-kind exchange funds, make it crucial for Investors to carefully and thoroughly research and evaluate prospective Qualified Intermediaries.

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First and foremost, the Investor must realize that there are no regulatory, approval or licensing requirements placed on a Qualified Intermediary by any sort of regulatory body, and there are no capitalization, insurance or other financial restrictions placed on a Qualified Intermediary. Literally anyone can go into business as a Qualified Intermediary.

Given the amount of funds involved in even a modest routine exchange, this lack of regulation is a frightening proposition, especially given that Investors often contact prospective Qualified Intermediaries and ask them about fees, tax-deferred like-kind exchange transactional requirements and structures, location of the Qualified Intermediary, but rarely inquire into the Qualified Intermediary's financial strength, bonding, insurance, and methods used to safeguard the Investor's tax-deferred like-kind exchange funds. The safety of the funds should be the most important part of the Investor's due diligence process, and are characteristics of the Qualified Intermediary that should be investigated thoroughly by the Investor prior to initiating a tax-deferred like-kind exchange.

There are three primary risks that the Investor should be cognizant of when researching, evaluating and choosing his Qualified Intermediary.

(1) Theft or embezzlement of 1031 exchange funds
(2) Errors or omissions in the administration of a 1031 exchange
(3) Bankruptcy of the Qualified Intermediary

Experienced Qualified Intermediaries will understand your concerns. They will have analyzed and addressed these concerns and will have already implemented appropriate safeguards to protect your tax-deferred like-kind exchange funds.

Theft or Embezzlement of 1031 exchange Funds

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Institutional Qualified Intermediaries plan and implement sophisticated internal control systems, audit procedures and "checks and balances" to prevent misappropriation of client tax-deferred like-kind exchange funds. In addition, professional Qualified Intermediaries also maintain sufficient Fidelity Bond coverage to insure against a potential theft or embezzlement of client tax-deferred like-kind exchange funds, in case any of the control systems are corrupted or overcome.

When conducting his due diligence, the Investor must verify that the Qualified Intermediary does maintain sufficient Fidelity Bond coverage, and should request a copy of the insurance binder and the insurance agent's contact information in order to verify that the Fidelity Bond coverage is still in full force and effect and to verify the policy limits.

It is also important that the Investor determine whether the Fidelity Bond coverage is "per occurrence" or merely "in aggregate". The difference in the actual amount of coverage provided between these can be surprising. A policy written "In aggregate" means the policy limit is an annual coverage amount and limited to the annual policy limit regardless of the number of thefts during the year. A policy written "per occurrence" means that each incidence is covered up to the policy limit. The nature of the coverage is particularly important given the large nature of the sums involved in tax-deferred like-kind exchange transactions, and the ease with which the annual limit could be reached under a policy written in aggregate; it is not unreasonable to think that a single act of theft could utilize the maximum fidelity bond policy limit and that one Investor might not be covered for the entire loss and/or any other incidences of theft that may occur at the same time or later in the year.

Errors and Omissions in the Administration of a 1031 exchange

Even with superior quality control processes, tax-deferred like-kind exchange administrators are human and may occasionally make mistakes. To protect against harm incurred as a result of such an error, it is important to ensure the Qualified

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Intermediary has obtained Errors and Omissions (E&O) insurance coverage to insure against losses resulting from an employee's error or omission.

Errors & Omissions (E&O) insurance coverage is very difficult to qualify for, especially in the tax-deferred like-kind exchange industry, and is very expensive to obtain. For these reasons, many Qualified Intermediaries do not have Errors and Omissions Insurance coverage.

This coverage is perhaps even more important that other insurance coverage provided because human error is more likely than theft or embezzlement of funds.

As with the Fidelity Bond coverage, the Investor should verify that the Qualified Intermediary maintains sufficient Errors and Omissions Insurance coverage when conducting his due diligence, and should request a copy of the insurance binder and the insurance agent's contact information in order to verify that the Errors and Omissions Insurance coverage is still in full force and effect, as well as to verify the policy limits.

Bankruptcy of the Qualified Intermediary

Bankruptcy is a rare event within the tax-deferred like-kind exchange industry, but it is both possible and an important risk that must be considered and addressed. Bankruptcy can be voluntary or involuntary: While bankruptcy is often thought of in the context of financial and/or credit problems or as related to some form of theft or embezzlement of funds, it may also result from a catastrophic event such as an earthquake, fire, flood, hurricane, tornado, or act of terrorism, which may financially devastate the Qualified Intermediary and force it into involuntary bankruptcy. The 9/11 terrorism attacks against the United States of America are a perfect example: the terrorist attacks forced many well-reputed, financially stable companies into involuntary bankruptcy.

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To protect against the risk of a bankruptcy filing, the Investor must make sure his tax-deferred like-kind exchange funds are held by the Qualified Intermediary in such a manner that will protect his tax-deferred like-kind exchange funds from a bankruptcy filing, including the attachment of the tax-deferred like-kind exchange funds by the Qualified Intermediary's creditors. If the tax-deferred like-kind exchange funds are held by the Qualified Intermediary under its corporate name, then the funds are typically determined to be corporate funds by the bankruptcy court and included in the bankruptcy estate and will be subject to claims of the Qualified Intermediary's creditors.

The most effective method the Investor can adopt to protect against the inclusion of the tax-deferred like-kind exchange funds in a bankruptcy proceeding is to make sure that the tax-deferred like-kind exchange funds are held in Qualified Escrow Accounts or Qualified Trust Accounts.[47] With these accounts, the Qualified Intermediary never actually receives or holds the Investor's tax-deferred like-kind exchange funds, but has the tax-deferred like-kind exchange funds transferred directly into the Qualified Escrow Account or Qualified Trust Account held by the escrow agent or trustee of the account for the benefit of the Investor. tax-deferred like-kind exchange funds held in either of these vehicles are considered fiduciary funds, and therefore are not subject to being included in the bankruptcy estate and subject to creditor claims.

The Qualified Escrow Account or the Qualified Trust Account must meet the specific criteria outlined by the Department of the Treasury Regulations. These regulations prohibit tax-deferred like-kind exchange funds from being held by the Investor or by a disqualified person. Further, the Agreement must expressly limit the Investor's right to receive, pledge, borrow, or otherwise obtain the benefits of the tax-deferred like-kind exchange funds until after the Department of the Treasury Regulations so permit.

Suggested Due Diligence Questions

[47] Section 1.1031(k)-1(g)(3) of the Department of the Treasury Regulations.

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In order to make sure that tax-deferred like-kind exchange funds and the Investors interests will be adequately protected, the Investor should make sure to ask prospective Qualified Intermediaries:

- Whether the Qualified Intermediary maintains sufficient fidelity bond coverage to insure against employee theft or embezzlement of the exchange funds

- What is the policy limit of the fidelity bond coverage and is it sufficient (most of the large institutional Qualified Intermediaries carry fidelity bond coverage of $20 to $30 million or more)

- Whether the fidelity bond coverage is "per occurrence" or merely "in aggregate"

- Whether the Qualified Intermediary will provide the Investors with copies of the insurance binders and the contact information for the insurance agents to verify that the insurance coverage is still in full force and effect

- Whether the Qualified Intermediary has errors and omissions insurance, and if so, what is the coverage limit of the errors and omissions insurance policy

- Whether the fidelity bond and errors and omissions (E&O) insurance policies cover only the Qualified Intermediary's tax-deferred like-kind exchange operation or whether they include the numerous other related entity operations that could potentially diminish the overall protection to the Investor in the event of multiple losses throughout the consolidated entity

- Whether the tax-deferred like-kind exchange funds are held in separate, segregated Qualified Escrow or Qualified Trust Accounts to ensure that the

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tax-deferred like-kind exchange funds can not be attached by the Qualified Intermediary's creditors in the event of a voluntary or involuntary bankruptcy filing

- Whether the Qualified Intermediary's family of companies include regulated companies such as title insurance companies, banking organizations or trust companies, which provide regulatory oversight of the corresponding operations

- Whether the Qualified Intermediary is part of a family of companies with significant financial strength and equity capital

- Whether the Qualified Intermediary employs sophisticated internal controls, audit procedures and "checks and balances" to protect the tax-deferred like-kind exchange funds from risk of loss

- Whether the Qualified Intermediary is audited by an independent auditor and/or an internal audit group

- Whether there are any risk management or operational audits of the Qualified Intermediary performed by outside auditors and/or internal audit groups

Exchange Documentation

It is important that the Investor have a basic understanding of the contracts, agreements, forms and documents used to structure a tax-deferred like-kind exchange transaction. Although the form of the documents and language contained therein may vary slightly depending on the particular Qualified Intermediary, the following documents should be found in all tax-deferred like-kind exchange transactions:

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- Letter of Instruction to Client
- Letter of Instruction to Escrow/Closing Officer/Agent
- Like Kind Exchange Agreement
- Assignment, Acceptance, Notice and Direction to Convey
- Federal or state withholding documents (FIRPTA, CAL-FIRPTA, etc.)

Multi-Property and Mixed Use Property Exchanges

Investors have the option to exchange out of one or more (multiple) relinquished properties and into one or more (multiple) replacement properties.

Investors who live in a portion of their rental, investment or business use property as their primary residence may benefit from a split tax treatment allowed for mixed use properties when disposing of the property.[48] Investors may enter into a partial tax-deferred like-kind exchange transaction for the portion of the property that is allocated to rental or investment use[49] and can exclude a portion of the gain on the portion of the property that is allocated to their primary residence.[50]

Split Use Treatment

Property that is partially occupied by the Investor as his primary residence and partially treated as rental, investment or business use property can qualify for split use treatment under the Internal Revenue Code. The portion of the property that is occupied by the Investor may qualify for capital gain exclusion treatment pursuant to Section 121 of the Internal Revenue Code and the portion held as rental, investment or business use property can qualify for tax deferral treatment under Section 1031 of the Internal Revenue Code. The property value for split use tax treatment is typically allocated between the Section 121 Exclusion and the tax-deferred like-kind exchange based on the square footage used as a primary residence versus the square footage

[48] Revenue Ruling 59-229 by the Department of the Treasury.
[49] Pursuant to Section 1031 of the Internal Revenue Code.
[50] Pursuant to Section 121 of the Internal Revenue Code.

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held as rental, investment or business use property. A good tax advisor can assist the Investor with the proper allocation between each tax provision.

The Investor may elect to use the Section 121 Exclusion treatment for the entire property, including the portion held as rental, investment or business use property, if the property is one structure.

REVERSE 1031 EXCHANGES AND PARKING ARRANGEMENTS

Overview of Reverse 1031 Exchanges and Parking Arrangements

There are many situations where the Investor may find it necessary to acquire the like-kind replacement property prior to disposing of the relinquished property in a tax-deferred like-kind exchange transaction: the buyer of the relinquished property may need more time to arrange for financing or may completely back out of the transaction, or perhaps the seller of the replacement property is not willing to wait until the relinquished property closes and demands a short closing period on the replacement property.

By structuring a Reverse tax-deferred like-kind exchange[51] transaction, the Investor can acquire the like-kind replacement property prior to the sale of the relinquished property. This tax planning strategy is particularly beneficial in a "sellers" market, where the demand for property is high, but inventory is low so that properties move extremely fast and are difficult to identify/close on within the Forward tax-deferred like-kind exchange transaction guidelines.

The Reverse tax-deferred like-kind exchange allows the Investor all the time necessary to locate suitable like-kind replacement property, without the pressure of the forward tax-deferred like-kind exchange deadlines.

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[51] Revenue Procedure 2000-37 issued by the Department of the Treasury.

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Guidance from Revenue Procedure 2000-37

Even though Reverse tax-deferred like-kind exchanges have been structured by legal and tax advisors for many years, there has been little to no guidance from the Department of the Treasury or the Internal Revenue Service and legal precedent on the proper structure and documentation. Until September 2000, Investors had to rely on the educated guesses of their legal and tax advisors on how to properly structure a Reverse tax-deferred like-kind exchange transaction.

The Department of the Treasury finally provided guidance on the issue in the form of Revenue Procedure 2000-37 on September 15, 2000. Revenue Procedure 2000-37 provides a number of safe harbor rules for structuring Reverse tax-deferred like-kind exchange transactions, and has resulted in a significant increase in the number of Reverse tax-deferred like-kind exchange transactions since that time. These guidelines have clarified issues surrounding Reverse tax-deferred like-kind exchanges and provided a much higher comfort level than before.

It is important to point out that Revenue Procedure 2000-37 is not a Reverse tax-deferred like-kind exchange Revenue Procedure; it merely provides guidelines on how to properly structure a Reverse tax-deferred like-kind exchange using a "parking structure."

Safe Harbor versus Non-Safe Harbor Reverse Exchanges

Reverse tax-deferred like-kind exchange transactions structured pursuant to Revenue Procedure 2000-37 are referred to as "safe harbor" Reverse tax-deferred like-kind exchange transactions. It is possible to structure Reverse tax-deferred like-kind exchange transactions outside of these guidelines, which are referred to as "non-safe-harbor" Reverse tax-deferred like-kind exchange transactions.[52]

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[52] Private Letter Ruling 200111205.

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Investors should consult with their legal and tax advisors prior to structuring a Reverse tax-deferred like-kind exchange transaction to determine which strategy is best for them. The proper structure must be selected before proceeding: Reverse tax-deferred like-kind exchange transactions can not be converted from one structure to another once the form of the transaction has been selected.

Components of a Reverse Exchange

In a Reverse tax-deferred like-kind exchange, the legal title to either the Investors relinquished or replacement property is transferred to and held or "parked" by an Exchange Accommodation Titleholder (EAT) on behalf of the Investor. A Qualified Intermediary then facilitates the 1031 tax-deferred, like-kind exchange. While the Exchange Accommodation Titleholder and the Qualified Intermediary could be the same entity, it is not advisable: one entity should function as the Qualified Intermediary and a separate entity should function as the Exchange Accommodation Titleholder.

The easiest way to understand the structure of a Reverse tax-deferred like-kind exchange is to view it as two separate component parts: both stages of the transaction are distinct from each other, but both are then contractually integrated to complete a Reverse tax-deferred like-kind exchange.

A "Reverse tax-deferred like-kind exchange" is actually a misnomer: the transaction itself actually consists of a "parking" transaction, where legal title to either the relinquished or replacement property is acquired and "parked" by the Exchange Accommodation Titleholder, and then a simultaneous tax-deferred like-kind exchange occurs either at the beginning (Exchange First) or at the end (Exchange Last) of the Reverse tax-deferred like-kind exchange process. This parking/exchange scenario is commonly called a Reverse tax-deferred like-kind exchange because, as previously mentioned, it allows the Investor to acquire his like-kind replacement property first

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and then dispose of the relinquished property at a later date, not because it is the transactional opposite of a Forward tax-deferred like-kind exchange.

Exchange Accommodation Titleholder (EAT)

The Exchange Accomodation Titleholder is (or should be) a separate legal special purpose entity/limited liability company set up for the express purpose of conducting a Reverse tax-deferred like-kind exchange transaction in order to ensure proper liability protection for both the Qualified Intermediary and the Investor. Although it is possible for the Qualified Intermediary to function as the Exchange Accomodation Titleholder, it is highly undesirable: having the Qualified Intermediary hold thousands of Investors' tax-deferred like-kind exchange funds and hundreds of Investors' real property exposes the Qualified Intermediary and the Investor's assets to all of the real property held by the Qualified Intermediary to potential liability from liens, judgements, toxic waste contamination or other liabilities and risks involving real property.

In order for an entity to qualify and serve as the Exchange Accommodation Titleholder it must meet all of the following requirements:

- Hold Qualified Indicia of Ownership (customarily the legal title) at all times from the date of acquisition of the property until the property is transferred.
- May not be a disqualified entity or the Investor.
- Must be subject to federal, and if applicable, state income tax. If the Exchange Accommodation Titleholder is treated as a partnership or S corporation, more than 90% of its partnership interests or shareholders must be owned by partners or shareholders who are subject to federal income tax.
- Must report the acquisition, holding and ultimate disposition of the property on its Federal and state income tax returns.

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Qualified Indicia of Ownership

Qualified Indicia of Ownership are defined as any of the following:

- Legal title to the property.
- Other indicia of ownership of the property that are treated as beneficial ownership of the property under principles of commercial law (i.e. a contract for deed).
- Interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes, such as a single-member limited liability company, and this entity must hold either legal title to the property or other Qualified Indicia of Ownership.

Qualified Exchange Accommodation Agreement

In order to conduct a tax-deferred like-kind exchange, the Exchange Accommodation Titleholder and the Investor must enter into a written Qualified Exchange Accommodation Agreement (Qualified Exchange Accommodation Agreement). The terms of the Qualified Exchange Accommodation Agreement must include the following terms:

- The Exchange Accommodation Titleholder is holding the property for the Investor's benefit in order to facilitate an exchange pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Treasury Regulations and Revenue Procedure 2000-37.
- The Exchange Accommodation Titleholder and the Investor agree to report the acquisition, holding and disposition of the property on each of their respective income tax returns in a manner consistent with the agreement.
- The Exchange Accommodation Titleholder will be treated as the beneficial owner of the property for all federal and state income tax purposes.

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Legal and Contractual Arrangements

Revenue Procedure 2000-37 allows the Exchange Accommodation Titleholder and the Investor to enter into a number of operating agreements in order to complete a successful Reverse tax-deferred like-kind exchange transaction utilizing the parking structure while eliminating certain risks for both the Exchange Accommodation Titleholder and the Investor. These agreements may include:

- Loan, funds advanced or line of credit agreement
- Triple net lease back to investor
- Property management agreement
- Contractor and/or supervisor agreement
- Put and Call provisions are permissible

The Investor is responsible for any capital gains or losses incurred by the operating agreements and will receive any net operating profits or losses generated from the property during the parking or holding period. The Investor can retain control of the parked property either by leasing the property from the Exchange Accommodation Titleholder under a triple-net lease or by entering into a property management agreement, under which the Investor assumes all management responsibilities of the property, including the retention of an outside property management firm if they so desire.

Reverse Exchange Deadlines

Despite the difference in the structure of the transaction, the Reverse tax-deferred like-kind exchange transaction has the same transfer and identification requirements as a Forward tax-deferred like-kind exchange.

In an "Exchange Last" Reverse tax-deferred like-kind exchange parking arrangement the relinquished property must be identified within 45 *calendar* days after the transfer

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of the replacement property to the Exchange Accommodation Titleholder in a manner consistent with the principles of identifying property in a forward (delayed) 1031 tax-deferred, like-kind exchange.

In an Exchange First parking arrangement, no identification is required since the actual tax-deferred like-kind exchange is completed at the beginning of the transaction as a simultaneous exchange.

After a successful identification, the relinquished property must be sold and transferred to the buyer within 180 *calendar* days after the transfer of the parked property to the Exchange Accommodation Titleholder in either an Exchange First or Exchange Last structure.

Reverse Exchange Structures

The Exchange Accommodation Titleholder can park title to either the replacement property or relinquished property, depending on a number of complicated factors within each individual transaction.

The preferred and most common method involves havingthe Exchange Accommodation Titleholder acquiring and holding title to the Investor's replacement property in an Exchange Last structure. However, there are times when parking title to the replacement property with the Exchange Accommodation Titleholder is not practical and title to the relinquished property must be held by the Exchange Accommodation Titleholder in an Exchange First structure.

Exchange Last Structure: Replacement Property Parking

The "Exchange Last" structure is the most common form of Reverse tax-deferred like-kind exchange. In the "Exchange Last" structure, the Investor enters into a Qualified Exchange Accommodation Agreement with the Exchange Accommodation Titleholder. The Exchange Accommodation Titleholder then forms a limited liability company or

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other special purpose entity ("SPE"), into which the Investor assigns the Purchase Contract and/or the Escrow Instructions for the replacement property.

The Investor will then either loan funds to and/or arrange for third-party financing for the Exchange Accommodation Titleholder for the acquisition of the replacement property. Third-party lenders still base the decision to lend on the credit worthiness of the Investor, even though the Exchange Accommodation Titleholder is the entity executing the loan documents. After the financing is arranged, the Exchange Accommodation Titleholder acquires and parks title to the replacement property, and typically leases the replacement property to the Investor under an absolute triple net lease or enters into a property management agreement with the Investor, as authorized by the Qualified Exchange Accommodation Agreement. The lease payments to the Exchange Accommodation Titleholder are offset by the loan payments due from the Exchange Accommodation Titleholder, and may cover any debt service owed on outside financing, resulting in a tax neutral position for the Exchange Accommodation Titleholder.

An Investor in an "Exchange Last" scenario must identify the relinquished property or properties they intend to sell within 45 *calendar* days after the Exchange Accommodation Titleholder acquires title to the replacement property. Although the Investor will typically already know which relinquished property is going to be sold, it is important that the relinquished property be formally identified within the 45 calendar day deadline. After identifying the relinquished property, the Investor will then assign the Purchase and Sale Agreement and/or Escrow Instructions (if applicable) for their relinquished property to the Qualified Intermediary. Upon the sale of the relinquished property and transfer of title to the buyer, the Investor acquires title to the replacement property or the membership interest in the special purpose entity/limited liability company that holds title to the replacement property from the Exchange Accommodation Titleholder in a simultaneous exchange, and the Exchange Accommodation Titleholder uses the net proceeds received from the sale of the

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relinquished property to pay down the loan to the third-party lender and/or the Investor.

It is crucial that the Investor obtain the relinquished property lender's approval prior to entering into an "Exchange Last" Reverse tax-deferred like-kind exchange transaction if he needs to secure conventional financing in order to avoid any due on sale clauses. The special purpose entity/limited liability company is the borrower on the loan, as it is the entity that holds title to the property and typically signs the loan documents on a non-recourse basis. The Investor can then guarantee the loan on a recourse or non-recourse basis depending on the flexibility of the lender. If the Investor fails to obtain the Lenders approval prior to the conveyance of the relinquished property to the Exchange Accomodation Title Holder, the Lender may elect to view the transfer as triggering the due on sale clause and may call the loan. These financing issues are one of the more difficult aspects when structuring a Reverse tax-deferred like-kind exchange.

When to Use Exchange Last Parking Structure

Investors typically select the "Exchange Last" Reverse tax-deferred like-kind exchange structure when they have the ability to purchase the replacement property for cash or the seller is providing short-term financing (including seller-carry back financing).

Since the Investor's net equity is temporarily tied up in the relinquished property, an "Exchange Last" transaction typically presents a liquidity problem. The "Exchange Last" structure allows the Investor to structure the Reverse tax-deferred like-kind exchange transaction without worrying about the reinvestment of the net equity upfront: the net equity can be reinvested at the back-end of the transaction by paying down the financing used to acquire the replacement property.

The "Exchange Last" structure also allows the Investor to combine a forward tax-deferred like-kind exchange at the back-end of the Reverse tax-deferred like-kind

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exchange transaction in the event there are excess tax-deferred like-kind exchange funds from the disposition of the relinquished property.

The “Exchange Last” is the easier of the Reverse tax-deferred like-kind exchange structures to construct and administer, especially when there is little lead time prior to the close of the replacement property transaction. This structure also provides the Investor with the most flexibility at the back-end of the Reverse tax-deferred like-kind exchange transaction.

Issues and Problems with the Exchange Last Structure

Cash Boot Potential: If the amount of the down payment (the money loaned to the Exchange Accommodation Titleholder) used to acquire the replacement property is less than the equity generated from the sale of the relinquished property, there is potential liability for taxable boot. (Note: To qualify for 100% tax deferral in a tax-deferred like-kind exchange, the equity in the replacement property must be equal to or greater than the equity in the relinquished property). If the equity from the relinquished property is greater than the down payment on the replacement property, the Investor may contribute additional cash to the Exchange Accomodation Titleholder to avoid a tax liability.

Financing: If seller financing is not available, the Investor must pay cash for the replacement property and/or arrange conventional or other third-party financing. Obtaining outside financing is often difficult with this structure because the lender is not always willing to lend to the Exchange Accommodation Titleholder. If outside financing is available, the Exchange Accommodation Titleholder will typically execute a non-recourse loan in favor of the lender guaranteed by the Investor.

If the Investor does not have sufficient liquidity and/or available financing to acquire the replacement property pursuant to an “Exchange Last” Reverse tax-deferred like-kind exchange structure, the “Exchange First” structure will be required.

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Exchange First Structure: Relinquished Property Parking

In a Reverse tax-deferred like-kind exchange "Exchange First" transaction, the Investor completes a simultaneous exchange up front by conveying his relinquished property to the Exchange Accommodation Titleholder and acquiring and taking title to his replacement property.

The Investor then assigns the Purchase and Sale Agreement and/or Escrow Instructions (if applicable) for the relinquished property to the Qualified Intermediary, and enters into a Qualified Exchange Accommodation Agreement with the Exchange Accommodation Titleholder whereby the Exchange Accommodation Titleholder sets up a limited liability company or other special purpose entity to take title to the relinquished property. The Investor "sells" the relinquished property to the Exchange Accommodation Titleholder. A third party lender and/or the Investor will loan money to the Exchange Accommodation Titleholder and the Exchange Accommodation Titleholder executes a non-recourse note in favor of the lender or the Investor. The Exchange Accommodation Titleholder uses the "loan proceeds" to acquire the relinquished property from the Qualified Intermediary. The Qualified Intermediary uses the funds from the Exchange Accommodation Titleholder ("loan proceeds") to purchase the replacement property on behalf of the Investor. The replacement property is direct deeded to the Investor and the exchange is completed. Once a buyer for the relinquished property is found, the net proceeds from the sale of the relinquished property are used to payoff any notes due to an outside lender or the Investor.

When to Use Exchange First Parking

An "Exchange First" structure may be a more viable option than an "Exchange Last" structure when you need to obtain conventional financing to acquire the replacement property, as lenders may be uncomfortable lending on a property whose title is held by

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a party other than the borrower (in this case, the Exchange Accommodation Titleholder).

Issues and Problems with the Exchange First Structure

The "Exchange First" transaction has a high potential to yield cash boot: if the equity in the relinquished property is greater than the cash invested in the replacement property, then capital gain tax liability may be incurred. Since the replacement property has already been purchased, there is no opportunity to balance the equities within the exchange. For this reason, having the Exchange Accommodation Titleholder hold the replacement property ("Exchange Last") may be a more desirable option than the "Exchange First" structure.

The "Exchange First" transaction can also pose a risk to the loan on the relinquished property: by transferring the relinquished property to the Exchange Accommodation Titleholder, the Investor risks triggering the due-on-sale clause in the loan on the relinquished property. This is also one of the reasons that many Exchange Accommodation Titleholders will not hold qualified indicia of ownership to the relinquished property; holding indicia of ownership could be construed by the lender as proof of sale, thereby triggering the due-on-sale provisions.

Pre-Exchange Due Diligence

Before setting up a Reverse tax-deferred like-kind exchange, the Exchange Accommodation Titleholder will require the following:

- Financial statement or tax returns for the last two years to verify that you have the financial resources to indemnify the Exchange Accommodation Titleholder;
- Grant deed for the relinquished property when you originally took title to the relinquished property;

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- Binder providing proof of property, casualty and liability insurance and naming the special purpose entity/limited liability company as the insured and the Exchange Accommodation Titleholder and Investor as additional insureds;
- Phase I Environmental Assessment report issued within the last 6 months; the report must indicate that the property is free of contamination and be certified to the Exchange Accommodation Titleholder (commercial and industrial real property and vacant land); and
- Title insurance binder naming the Exchange Accommodation Titleholder as the insured (real property).

Issues with Reverse 1031 Exchanges

The costs surrounding Reverse tax-deferred like-kind exchanges are considerably more substantial than those for traditional forward tax-deferred like-kind exchange transactions.

Fees for Reverse Exchanges are higher than fees for forward tax-deferred like-kind exchange due to documentation and the risk the Exchange Accommodation Titleholder assumes by taking title to the "parked" property. The costs to establish the special purpose entity/limited liability company are added to the cost of the Reverse tax-deferred like-kind exchange transaction, and the Investor may also incur additional title insurance, environmental, loan, legal, property, casualty and liability insurance, documentary transfer taxes, escrow/closing fees and other costs. Investors should consult with legal, tax and closing professional for specific issues in the Reverse tax-deferred like-kind exchange transaction prior to closing.

The potential of incurring double taxation of state, county or local transfer taxes when a property is transferred to the Exchange Accommodation Titleholder and then transferred to the buyer ("Exchange First") or to the Investor ("Exchange Last") initially caused concern among investors and their advisors. However, in a Private Letter

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Ruling,[53] the Internal Revenue Service approved an express declaration of agency for all purposes except federal income tax purposes in an Exchange Accommodation Titleholder's Qualified Exchange Accommodation Agreement. As transferring property from an agent to a principal is not a taxable event in most jurisdictions, it is presumptively safe for similarly situated Investors to rely on this ruling when structuring their transaction.

The ability to depreciate the replacement property is not available until the Investor actually acquires title to the replacement property or once the Investor has transferred the relinquished property to the Exchange Accommodation Titleholder and the Reverse tax-deferred like-kind exchange has been completed. There are still some unanswered issues regarding depreciation from the Exchange Accommodation Titleholders perspective.

Property, casualty and liability insurance should be reviewed with a competent insurance broker to ensure that both the Exchange Accommodation Titleholder and the Investor are adequately insured during the Reverse tax-deferred like-kind exchange transaction.

Alternative Strategies

After reviewing the costs and complexities involved in a Reverse tax-deferred like-kind exchange transaction, the Investor may want to find a way to delay the closing of the replacement property until he finds a buyer for his relinquished property and can complete a Forward tax-deferred like-kind exchange, or a solution that will allow the Investor to delay the close of escrow and secure the replacement property, including using conditional or non-refundable earnest money deposits or an option or lease/option agreement.

[53] Private Letter Ruling No. 200148042.

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Incorporating a "Build-To-Suit" Component

The "Exchange Last" reverse tax-deferred like-kind exchange structure can be combined with an "improvement" tax-deferred like-kind exchange structure as well, which is also referred to as a "build-to-suit" or "construction" tax-deferred like-kind exchange. In this type of tax-deferred like-kind exchange, the Investor can build a new structure, improve an existing structure or retrofit the parked replacement property prior to the sale of the relinquished property and receipt of title to the replacement property.

The "Exchange First" reverse tax-deferred like-kind exchange structure can not be utilized with an improvement tax-deferred like-kind exchange.

IMPROVEMENT (BUILD-TO-SUIT OR CONSTRUCTION) EXCHANGES

Overview of Improvement (Build-To-Suit or Construction) Exchanges

The Improvement tax-deferred exchange – also referred to as a build-to-suit or construction – allows the Investor to build, construct, or make capital improvements to a replacement property before acquiring it as part of his tax-deferred exchange transaction. The Investor may use the exchange proceeds from the relinquished property to fund the construction or build-out on the replacement property, provided the necessary tax-deferred exchange guidelines are followed.[54]

The replacement property to be produced as part of the Investor's tax-deferred exchange can be constructed, built, installed, manufactured, developed, or improved.[55]

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[54] Section 1.1031(k)-1(e)(2)(i) of the Department of the Treasury Regulations.
[55] Section 263A(g)(1) of the Internal Revenue Code.

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While the replacement property does not need to be completed in order to qualify for tax-deferred exchange treatment[56] (unless the property is part of a personal property tax-deferred like-kind exchange transaction), the same requirements for deferring 100% of the income tax liabilities for a forward tax-deferred exchange transaction apply. The Investor must:

- Trade equal or up in value; and
- Reinvest all of the net equity (cash proceeds); and
- Replace the debt on the replacement property; and
- Receive substantially the same property as identified by the 45th *calendar* day identification period deadline.

Similarly, the tax-deferred like-kind exchange deadlines apply to the "Built-To-Suit" structure, and no extensions are available. The replacement property must be transferred to the Investor in order to complete the ""Build-To-Suit"" tax-deferred like-kind exchange transaction no later than the 180th calendar day.

This tax-deferred like-kind exchange strategy is appropriate specifically where the Investor wants to acquire a replacement property and construct a custom structure or make capital improvements to retrofit the property to meet his business operational needs or increase the value of the replacement property where there are excess tax-deferred like-kind exchange funds.

Using Parking Arrangements Pursuant to Revenue Procedure 2000-37

Parking Arrangements used in conjunction with Reverse tax-deferred like-kind exchange[57] transactions are ideal structures for forward or reverse "Build-To-Suit" tax-deferred like-kind exchange transactions.

[56] Section 1.1031(k)-1(e)(3)(iii) of the Department of the Treasury Regulations.
[57] Revenue Procedure 2000-37 by the Department of the Treasury.

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An Exchange Accommodation Titleholder may hold the replacement property during the construction as part of a Parking Arrangement, while the Qualified Intermediary controls the exchange funds for the acquisition of the replacement property and the payment of the construction costs. By the end of the 180 calendar day holding period for the exchange, the improved replacement property is transferred to the Investor to complete the Tax-Deferred Exchange.

Issues with Improvement (Build-To-Suit or Construction) Tax-Deferred Exchanges

Some of the same issues with Reverse tax-deferred like-kind exchange transaction apply to "Build-To-Suit" tax-deferred like-kind exchanges. For example, lenders may not be comfortable financing the construction because the Exchange Accommodation Titleholder is holding title to the property during the Build-To-Suit tax-deferred like-kind exchange process, but the actual borrower on the loan is the Investor.

Special Identification of Replacement Property Requirements

There are special identification requirements when identifying replacement property to be constructed as part of a Build-To-Suit tax-deferred like-kind exchange transaction as part of the asset does not exist at the time of identification. To meet the tax-deferred like-kind exchange identification requirements, the land or existing structures must be identified by using the legal description, the property address or the Assessor's Parcel Number and then the property to be produced or constructed must be identified with as much detail as is possible at the time of the identification.

Receipt of Replacement Property Requirements

The replacement property received by the Investor must be substantially the same as the property previously identified during the 45 *calendar* day identification period. The replacement property will not qualify as like-kind replacement property if there are substantial differences between what was actually received compared to what was originally identified.

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The value of certain constructed or improved property will only be considered like-kind property received if it has been completed within the tax-deferred like-kind exchange period and is defined as real property under the laws of the state in which the property is located at the time of receipt. The mere payment for lumber, concrete and the like will not qualify as like-kind property unless the materials have been constructed and made a permanent part or are permanently attached to the land in order to qualify as real property.

OTHER ISSUES

Partnership Issues

Partnerships can dispose of real property and defer the corresponding income tax liabilities by acquiring like-kind replacement property as part of a tax-deferred like-kind exchange transaction. However, extremely complex tax issues arise when the underlying partners each have different investment goals and decide to go separate directions. In this situation, advance legal and tax planning is crucial to prevent disallowance of the tax-deferred like-kind exchange.

The first consideration is whether or not the Investor truly does in fact own the real property as part of a formal partnership, or whether the Investor is misconstruing the nature of the interest: Investors are often familiar with the exact nature of their interests and can mistakenly refer to co-investors as partners when they are truly tenants-in-common.

If the property is truly held in a formal partnership, the partners' immediate solutions in this situation are somewhat limited. The partners may either sell their individual interests in the partnership, or the partnership can sell the real property and distribute the cash to the underlying partners so that each individual partner can go

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their separate way. Neither solution is particularly desirable, as both have undesirable income tax consequences.

If the property is held as part of a partnership, the exchange of interests in a partnership is specifically excluded from tax-deferred like-kind exchange treatment under the rationale that a partnership interest is a personal property interest and not a real property interest,[58] so more complicated solutions are required when partners desire to go their separate ways.

There are however other solutions available to the partners, provided the partners have sufficient time to properly implement these strategies. The various strategic solutions include the following:

- Dissolving the partnership pursuant to Section 708 of the Internal Revenue Code

- Having the partnership complete a tax-deferred like-kind exchange, then refinancing the replacement property and distributing the cash to partners who do not want to participate in the tax-deferred like-kind exchange transaction

- Having the partnership complete a tax-deferred like-kind exchange then reorganize under co-tenancy ownership, where two or more owners each hold an undivided fractional interest in property, then distributing property according to each co-tenants' pro-rata interest. The partnership should hold the replacement property for a sufficient length of time in order to prove the intent to hold the property as rental or investment property in order to qualify for tax-deferred like-kind exchange treatment (a recommended holding period of 12 months or more).

[58] Section 1031(a)(2)(D) of the Internal Revenue Code.

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- Having the partnership reorganize under co-tenancy ownership where each owner has an undivided fractional interest in property then allowing each co-owner pursues its individual investment goals. The tenants-in-common should hold the replacement property for a sufficient length of time in order to prove the intent to hold the replacement property as rental or investment property in order to qualify for tax-deferred like-kind exchange treatment (a recommended holding period of 12 months or more).

- Having the partnership submit a valid election pursuant to Section 761(a) to opt out of the application of Subchapter K. To do so, the partnership interests must be treated as interests in individual assets, as distinguished from an interest in a partnership.[59] Further, the partnership must be organized for investment purposes (as opposed to business purposes) and must not offer any auxiliary business services above and beyond those customarily associated with the investment either directly or through an agent.

- The individual Investors can dispose of relinquished property and acquire like-kind replacement property through a tax-deferred like-kind exchange transaction. After holding the replacement property for a sufficient length of time to ensure the transaction will qualify for tax-deferred like-kind exchange treatment, the Investors may contribute the replacement property into a partnership and receive an interest in the partnership in exchange for the replacement property on a Tax-Deferred basis pursuant to Section 721 of the Internal Revenue Code.[60]

If a partner or group of partners disposes of their partnership interests they can not defer their income tax liabilities by completing a tax-deferred like-kind exchange because interests in a partnership are personal property interests and can not be exchanged for an interest in real property.

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[59] Section 1031(a)(2)(D) of the Internal Revenue Code. Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.
[60] Sections 1031/Section 721 Tax-Deferred Exchange transaction.

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Related Party Issues

Tax-deferred, like-kind exchange transactions between related parties are acceptable, provided certain requirements are met, including the required minimum holding period of two years for both properties/parties.

Related parties include family members such as spouses, siblings, parents, children, grand children, (but more distant relations, such as cousins, uncles, aunts, in-laws, stepparents, nephews, nieces, or ex-spouses) or entities such as corporations that are members of a controlled group, a grantor and a fiduciary or a fiduciary and a beneficiary of the same trust, a partnership in which a person owns directly or indirectly more than 50% of the capital interest or profit interest, or a corporation and a partnership in which the same person owns more than 50% of the outstanding stock of the corporation and more than 50% of the capital or profit interest in the partnership.

The Doctrine of Rescission

Life moves extremely fast, and often an Investor finds that his relinquished property has closed before a Qualified Intermediary was assigned into the transaction and the necessary tax-deferred like-kind exchange documents were put into place. Once the transaction closes, the Investor has the right to the net proceeds and therefore has constructive receipt of the funds. This constructive receipt precludes the Investors ability to engage in a successful tax-deferred like-kind exchange transaction.

In a limited number of cases, the Doctrine of Rescission may be used to try to save the ability of the Investor to execute a tax-deferred like-kind exchange. In these circumstances, the Investor and the buyer of the relinquished property essentially rescind the transaction, placing themselves back in their respective positions prior to the first disqualifying transaction. The rescission must be completed by the original

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parties and must be in the same income tax year. Once both parties have been returned to their original positions, they are free to repeat the sale and take the steps necessary to properly structure the transaction as a tax-deferred like-kind exchange transaction.

There are practical issues involved with the use of the Doctrine of Rescission: the cost to complete such a rescission is prohibitively high, and the buyer is most likely not willing to cooperate. Further, the lenders for both parties would have to agree to reverse all lending transactions (the payoff of the Investor's debt on the relinquished property and the origination of the buyer's new debt on the acquisition of the replacement property) and then renew the obligations for the new sale. Accordingly, rescissions are not performed very often, but where the conditions can be met they may be extremely beneficial for the Investor.

Combining Section 1031 and Section 121

Combining these two tax strategies on multi-use property has been done for years and is a powerful tax-planning tool. By combining the benefits of Sections 1031 and 121, the Investor is in a sense creating the best of both tax worlds on single-use property: creating a *tax-free sale* as opposed to a *tax-deferred exchange*.

Combining Section 121 with Section 1031 within one transaction is actually a simple process provided the proper guidelines are followed. Presuming that an Investor had a single-family residence, the Investor could rent out the single-family residence for a period of at least 12 to 18 months in order to qualify for tax-deferred like-kind exchange treatment. Subsequent to the rental period, the Investor could move into the property and convert it to his primary residence. After living in the property for at least two years, (24 months, not necessarily consecutive) the Investor would qualify for the Section 121 Exclusion. Finally, once the Investor has owned (not lived in it, but owned it) the property for at least five years[61], he can sell the property and take

[61] House of Representatives Bill H.R. 4520 signed into law on October 22, 2004.

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advantage of the Section 121 Exclusion. (See copy of Section 121 with the changes from H.R. 4520 incorporated in the Appendix).

There has been a lot of misinformation regarding this transactional structure, so it is important to note the following three guidelines:

- The Investor must RENT the newly acquired replacement property for at least 12 to 18 months in order to qualify for tax-deferred like-kind exchange treatment.

- The Investor must LIVE in the property for at least two years in order to qualify for the Section 121 Exclusion.

- The Investor must OWN the property for at least five (5) years. This is the new requirement effective October 22, 2004 with the adoption of H.R. 4520 signed into law by President Bush.

Sections 1031 and 453 (Installment Sale Treatment for Failed 1031 Exchanges)

In the case of a failed or partial tax-deferred like-kind exchange transaction, an Investor may still be able to recognize the gain in the following year rather than the year in which the relinquished property was transferred, depending on when the Investor had the right to obtain the tax-deferred like-kind exchange funds.

If the Investor sold the relinquished property and the transaction closed on December 1st of any given tax year, the 45 and 180 *calendar* day deadlines would fall in the following tax year; in the event the Investor fails to identify any replacement property within the 45 *calendar* day identification period, the taxable gain would generally be recognized in the following tax year pursuant to the Installment Sale Rules[62] because the Investor did not have the right to the funds until the 46th *calendar* day. Likewise,

[62] Section 453 of the Internal Revenue Code.

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if the Investor failed to acquire some or all of the replacement property(ies) that were identified, and that failure resulted in excess tax-deferred like-kind exchange funds during the 180 *calendar* day exchange period, the taxable gain would also be recognized in the following tax year pursuant to the Installment Sale Rules, because the Investor did not have the right to access the unused tax-deferred like-kind exchange funds until after the 180th *calendar* day.

The Investor does have the right to elect recognition of the gain in the year in which the relinquished property closes, if they should choose to do so. This short-term tax deferral strategy provides an excellent tax planning opportunity when your tax-deferred like-kind exchange transaction fails unexpectedly. The Investor's tax advisor must carefully evaluate the tax-deferred like-kind exchange agreements and transaction to determine when the Investor had the right to the funds in order to determine whether the gain can be deferred into the following year pursuant to the Installment Sale Rules. Finally, the Qualified Intermediary cannot distribute the tax-deferred like-kind exchange funds if the disbursement would violate any early release provisions of the Like Kind Exchange Agreement and/or Treasury Regulations.

INTRODUCTION TO CO-OWNERSHIP OF REAL ESTATE (CORE) OR TENANT-IN-COMMON (TIC) INTERESTS IN REAL ESTATE UNDER DEPARTMENT OF THE TREASURY REVENUE PROCEDURE 2002-22

Overview of Tenant-In-Common Interests (TIC Interests)

One of the most common concerns and/or frustrations Investors face when structuring tax-deferred exchange transactions is the difficulty in locating, identifying and ultimately acquiring suitable like-kind replacement properties within the required tax-deferred exchange deadlines.

There are several practical problems that arise when Investors begin the difficult task of designating like-kind Replacement Properties. First, many Investors wait until the

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actual closing of the sale of their Relinquished Property to start looking for and evaluating potential like-kind replacement properties, so that the pressure of the tax-deferred exchange has already been triggered. Faced with these impending tax-deferred exchange deadlines, Investors start their search for suitable like-kind Replacement Properties already "under the gun," which increases the difficulty associated with finding suitable like-kind Replacement Properties. Under Section 1031, Investors ability to designate like-kind replacement properties is limited by the extremely short time constrictions and the rules of identification: Investors typically may designate no more than three (3) Replacement Properties, and because of the limited time available to locate and identify these properties, typically only evaluate local or regional properties. While it's possible that this manner of identification will meet the Investors goals, it is more likely that any replacement property chosen in this manner will be subject to the same problems and/or conditions that originally motivated the Investor to sell the Relinquished Property: inflated sales prices, poor cash flow, intensive property management requirements, etc. Although the tax benefits of completing a tax-deferred exchange transaction are important, the economic benefits should not be ignored simply to meet the tax-deferred exchange deadlines.

The second practical problem that arises with designation of like-kind replacement properties relates to the actual ability of the Investor to negotiate and close on the properties identified within the 180 calendar day Exchange Period. Even where the identification process has been relatively simple, where the Investor has had no difficultly finding properties that make economic sense within the forty-five calendar day (45) Identification Period, there is no guarantee that the Investor will actually be able to close on the properties in the time remaining. Real estate transactions fail to close for many reasons: problems discovered during the property inspection, defects in structure, tenant issues, environmental problems, particularly difficult third parties, etc. While these problems are difficult to redress in the context of a normal real estate closing, when they must be dealt with under the tight time constraints of a tax-deferred exchange, they can prove disastrous. Unless the Investor has taken specific

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steps to remediate the risk on closing to each particular transaction, it is quite possible that the Investor may find himself in a position where the property identified is not able to close, but the deadline to identify additional Replacement Properties has passed, so that their tax-deferred exchange transaction is doomed to failure. To address this risk, Investors must reorient themselves to think of the identification of replacement properties as a strategic process and to identify property not solely based on their preliminary assessment of it, but to identify property based on a number of factors: whether or not due diligence can be done in a timely manner, whether or not the property makes economic sense, whether or not the transaction has any inherent risks that might prevent and/or delay the closing within the deadlines, etc. Investors are best suited by viewing their identification of replacement properties as a strategic process, and identifying at least one (if not all) of their replacement properties with these risks in mind.

The strategic orientation towards identifying replacement property does make one large assumption: that replacement property that meets the Investors particular needs is available. In most cases however, it is the lack of quality property itself that belies the problem: properties that are available poses a risk to the investor in one capacity or another, or are simply not economically feasible. In response to this lack of suitable replacement properties, both for tax-deferred exchanges and real estate investors in general, an industry has sprung up to develop and offer syndicated property interests as alternative investment vehicles.

When choosing a replacement property, Investors should carefully consider and evaluate the merits of these co-ownership in real estate (CORE) or more commonly referred to as tenant-in-common property (TIC property) interests, or other forms of fractional ownership instead of rushing into a timely acquisition that does not ultimately make economic sense.

Tenant in common interests in real estate essentially were created by real estate entrepreneurs who saw the advantages in owning syndicated property interests in the

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form of "triple net leased" properties, but recognized that the size of the properties and the liquidity required to get into triple-net leased property precluded most investors from participating. To make these interests more marketable, these entrepreneurs began individually arranging the financing for and purchasing these large properties with triple net leases to large, credit-worthy tenants and dividing the properties into smaller deeded units, referred to as "tenant-in-common" interests. These smaller units are then offered for direct purchase to investors through private placement offerings, or offered as like-kind replacement properties for tax-deferred exchange transactions.

Tenant-in-common properties, because of the means by which they are packaged, distributed and sold; often times provide Investors struggling with tax-deferred exchange timing requirements a solution to their pending replacement property crisis. Simply stated, co-ownership or "TIC Interests" allow an Investor to acquire, together with other Investors, a percentage or fractional interest of a larger, institutional quality property that is potentially more stable, secure and profitable than what they could have otherwise acquired on their own. In addition, by acquiring tenant-in-common ownership interests in a number of different properties, the Investor can achieve far greater diversification, improved quality in their investment portfolio and can acquire an interest or value in the exact amount necessary to satisfy their tax-deferred exchange requirements. Finally, the TIC interests are in essence pre-packaged investment properties, so that the purchase of the interest may be arranged quickly to meet the timing requirements of Investors nearing the end of their forty-five (45) and/or one hundred and eighty (180) day deadlines.

There was some hesitation prior to investment in these syndicated TIC interests on the part of early Investors, because it was not clear precisely what tax implications these investments would have. In response to this uncertainty, the Department of the Treasury issued Revenue Procedure 2002-22 in March of 2002, which establishes the guidelines by which the Internal Revenue Service will consider issuing private letter rulings on tenant-in-common ownership interests acquired as replacement properties within an Investor's tax-deferred exchange transaction.

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It is important to point out in the onset that while Revenue Procedure 2002-22 does seem designed to address the specific concerns that arise with syndicated TIC properties, the guidelines promulgated by the procedure are not specifically limited to those investments; Revenue Procedure 2002-22 does apply to non-syndicated TIC interests, such as a single piece of property titled to two investors as "tenants-in-common", and arguably may have more affect in that area.

While these guidelines do not offer a "safe harbor" or "guaranteed" structure for tenant-in-common ownership interests they do provide guidance for TIC Sponsors or Syndicators involved in the structuring of tenant-in-common offerings as to what the characteristics/factors of a particular investment the Internal Revenue Service will use to determine whether the investment qualifies as a true co-tenancy arrangement for tax-deferred exchange treatment.

In the syndicated TIC investment arena, there are many TIC Brokers and TIC Sponsors that can work with Investors and provide them with guidance and advice regarding tenant-in-common ownership interests. TIC Brokers typically work with numerous TIC Sponsors and can assist the Investor in evaluating the various and sundry investment alternatives, options and in making the final investment decision as to whether a tenant-in-common ownership interest is right for them and their investment portfolio.

15 Guidelines for Tenant-In-Common Properties and Sponsors

The Internal Revenue Service will consider issuing a private letter ruling to the interested party if the following fifteen (15) conditions have been met and/or are present in the proposed tenant-in-common transaction.

1. Tenancy In Common Ownership: each of the co-owners must hold title to the property, either directly or through a disregarded entity, as tenants in common

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under local law. The title to the property as a whole may not be held by a single entity recognized under local law.

While the title to the Property as a whole is not typically held by a single entity, there is no restriction against the individual interests being held by a single member limited liability company (LLC), which is standard practice for most TIC offerings.

2. Number of Co-Owners: the number of co-owners or Investors is limited to no more than 35 people. For this purpose, a person is defined pursuant to IRC 7701(a)(1), except that both husband and wife and all persons who acquire interests from a co-owner by inheritance are treated as a single person.

   While this seems as if it would be highly restrictive for an individual offering, in practice there are very few tenancy-in-common ownership arrangements that have more than thirty-five (35) investors; in fact, it is common for offerings to have substantially less depending on the size of the initial investors' interests.

   The actual number of Investors permitted in each TIC Offering is actually controlled for all practical purposes by the lender and not the TIC Sponsor, as are many aspects of each TIC Offering.

3. No Treatment of Co-Ownership as an Entity: the co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity; the individual co-owners similarly may not hold themselves out as partners, shareholders, or members of a business entity.

   The Internal Revenue Service has stated that it generally will not issue a Private

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Letter Ruling under Revenue Procedure 2002-22 if the co-owners hold interests in the property through a partnership or corporation immediately prior to the formation of the co-ownership.

There are areas where this restriction is not as clear cut as we would like particularly where the members of the tenants-in-common arrangement have not held themselves out as an entity consistently, but rather have done so sporadically in the past, perhaps on the basis of bad tax advice. Revenue Procedure 2002-22 does not offer any guidance as to whether or not any evidence of "entity" characterization will operate to disqualify the present day tenants-in-common arrangement, and if so, how long that evidence remains effective to do so.

4. Co-Ownership Agreement: the co-owners may enter into a limited co-ownership agreement that runs with the land. Such an agreement may provide that a co-owner must offer their interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition (see Section 6.06 of Revenue Procedure 2002-22 for conditions relating to restrictions on alienation), or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the property (see section 6.05 of Revenue Procedure 2002-22 for conditions relating to voting).

   All participants in co-ownership property should seriously evaluate the tenancy-in-common arrangement which spells out the rights and responsibilities of each co-tenant, and look to see if the agreement is drafted to "run with the land", so that it will be effective against subsequent purchasers of the interest.

5. Voting: the co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the property, any leases of a portion or

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all of the property, or the creation or modification of a blanket lien. Any sale, lease, or release of a portion or all of the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the property. A co-owner who has consented to an action in conformance with section 6.05 may provide the manager or other person with a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a unlimited power of attorney.

Since most of the concerns Investors have regarding tenant-in-common offerings tends to revolve around the degree of participation individual investors will have in the operation of the property, the voting provisions are one area of the private placement memorandum ("PPM") that should be subject to close scrutiny. To be compliant with Revenue Procedure 2002-22, major decisions pertaining to the sale, lease or disposition of the property, as well as any decisions regarding any financing or re-financing secured by a blanket lien and/or any change or negotiation with the party designated as third-party property management or asset management, requires unanimity on the part of the co-tenants. While these events tend to be of such magnitude that deviate from the structure proposed in the private placement memorandum for the property tend to be rare, it is important the Investor consider the difficulties potentially created by the unanimity requirement as part of their due diligence. The unanimity requirement itself prohibits the co-tenants as a group from delegating certain powers to management, or from requiring less than a unanimous agreement for certain issues, so that absence of one or more co-tenants at any given time may severely interfere with the management of the investment. Fortunately, not all management decisions for tenancy-in-common

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investments must be made by unanimous decision: the guidelines permit other decisions to be made by a simply majority of the co-tenants.

One particularly difficult facet of the restrictions on delegation as they pertain to certain ownership functions are the restrictions on the use and/or delegation of powers by "Power of Attorney". Pursuant to Revenue Procedure 2002-22, a co-tenant who has already rendered consent to an action may provide the manager or other named individual with a power of attorney to execute a specific document on their behalf. This however is the full extent of delegation permissible: specific authority to execute documents to effectuate consent already rendered by the co-tenant, presumptively on a case by case basis. While it is not clear that Rev. Proc. 2002-22 was intended to be that restrictive, the I.R.S. has yet to clarify the matter. Further the risk is cognizable given the Rev. Proc. 2002-22's prohibition on the issuance of "an unlimited power of attorney". While most have read this to preclude any sort of broad grant of power to third party management with respect to the specific property held by the co-tenants, it is not clear what sort of grant of authority may be interpreted to fall into this context and so be prohibited under Rev. Proc. 2002-22; the Procedure could conceivably be read so narrowly as to find fault with delegation to a relative under durable power of attorney and until further clarification is issued by the I.R.S. as to what degree of delegation is permissible, it will continue to be the root of a good deal of uncertainty in tenant-in-common offerings.

6. Restrictions on Alienation: each co-owner must have the right to transfer, partition, and encumber their own undivided interest in the property without the agreement or approval of any person. Restrictions on the right to transfer, partition or encumber interests in the property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. (See section 6.14 of this revenue procedure for restrictions on who may be a lender). Moreover, the co-owners, the sponsor, or the lessee may demand the right of first offer (the right to have the first opportunity to offer to

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purchase the co-ownership interest) before any co-owner may exercise their right to transfer their interest in the property. In addition, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition.

The ability to sell TIC properties after the initial Offering is one of the issues that most concerns prospective investors. A common misperception is that because most major decisions concerning the TIC property tend to require unanimous consent of the tenants-in-common, that disposition of a property interest by one of the investors most likely does as well. Under Rev. Proc. 2002-22, this is clearly not the case: each individual investor's must have the ability to individually dispose of their respective interest without the consent of the other tenants-in-common in order for the arrangement to qualify. This is not to say that the Investors ability to transfer, partition or encumber their interest in the TIC property is completely unlimited however. Rev. Proc. 2002-22 does allow limited restrictions to be placed on the property where the action of the individual Investor may have repercussions to the other investors in the property.

Permissible restrictions on transfer, partition or encumbrance of TIC interests include the lender's ability to restrict such actions where consistent with customary lending practices, the co-tenants ability to include a provision in the operating agreement that gives them the right of first offer on any interest in the property prior to disposition, and the ability for the TIC operating agreement to require that an individual TIC Investor offer the entire interest for sale prior to exercising their right to partition. In any respect, where the TIC Investor does offer the property for sale, either to co-tenants in the property or to third parties, he is free to set whatever price for the interest that the market will bear.

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EXETER
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7. Sharing Proceeds and Liabilities upon Sale of Property: if the property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

8. Proportionate Sharing of Profits and Losses: each co-owner must share in all revenues generated by the property and all costs associated with the property in proportion with their undivided interest in the property. Neither the other co-owners, sponsor, or manager of the property may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the underlying member of the co-owned interest) and is for a period not to exceed 31 days.

   Under Rev. Proc. 2002-22, all valid co-tenancy agreements require that the profits and losses from an investment be distributed equally amongst the investors in accordance with their respective interests in the property. While the purpose of this provision may not be clear on its face, its purpose becomes obvious when contrasted with the allocation rules that typically apply to partnerships: special allocation of profits and losses among co-investors is one of the hallmarks of a partnership arrangement, whether express or in fact.

   The pro rata allocation rules under Rev. Proc. 2002-22 have the effect of severely limiting any creative financing arrangements that might otherwise arise between the co-tenants and/or sponsor of the property. Under this ruling, none of co-tenants, manager and/or sponsor may advance funds to a co-tenant to meet the expenses associated with their interest, or undertake any other arrangement which would in effect make them responsible for shares of the underlying financing to a greater extent than their ownership interest in the property.

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9. Proportionate Sharing of Debt: the co-owners must share in any indebtedness secured by the property by a blanket lien in proportion to their undivided interests.

10. Options: a co-owner may issue an option to purchase their undivided interest, referred to as a "call option", provided that the exercise price for the call option reflects the fair market value of the property determined at the time the option is exercised. For this purpose, the fair market value of an undivided interest in the property is equal to the co-owner's percentage interest in the property multiplied by the fair market value of the property as a whole. A co-owner may not acquire an option to sell an undivided interest, referred to as a "put option", to the sponsor, the lessee, another co-owner, the lender, or any person related to any of the parties.

    Under Rev. Proc. 2002-22, a co-tenant in the property may validly grant a call option to any third party, including co-tenants, so long as the exercise price associated with the call option reflects the fair market value of the property at the time the option is exercised. The method of determining the fair market value of an fractional interest in a property is subject to some dispute, but under the Revenue Procedure the value of any respective interest may be determined by multiplying the co-tenant's percentage interest in the property by the fair market value of the property as a whole when the option is exercised. While this may not determine the actual value of the TIC interest for income tax purposes, because it does not take into account the applicable fractional discounts and other offsets, it will be sufficient to determine whether or not the option was validly issued.

    Revenue Procedure 2002-22 also contemplates a restricted ability for co-tenant Investors to acquire a "put" option that allows them to sell their interest to third parties at a set price. The Investors' ability to acquire a "put" is substantially more limited than their ability to grant a "Call": a co-owner may not acquire a

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put option to sell an interest to the sponsor, co-owner, manager, lender, or any party "related" to the prohibited parties. While it seems that Investors should legitimately be able to acquire a "put" from any parties that do not fall into the prohibited categories, it is not clear how broadly the term "related" will be defined in this context.

11. No Business Activities: the co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities)[63]. Activities will be treated as customary for this purpose if they do not prevent an amount received by an organization described in 511(a)(2) from qualifying as rent under 512(b)(3)(A) and associated regulations. In determining what constitute the activities of the co-owners, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the property will be taken into account, regardless of the capacity in which the activities were actually performed. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the property will be taken into account in determining whether the co-owners activities are customary activities. However, activities of a co-owner or a related person with respect to the property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the property for less than 6 months.

The restriction on business activities amongst Investors is another provision of Revenue Procedure 2002-22 that attempts to distinguish true co-tenancy arrangements from entities classified as partnerships for income tax purposes; business activity in excess of "customary activities" is one of the Internal Revenue Service's most determinative means by which to recharacterize the nature of a tenancy-in-common investment.

[63] Revenue Ruling 75-374, 1975-2 C.B. 261

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The area of concern in relation to normal business activities typically does not involve the co-tenants activities directly, but that the "imputation" rules under Revenue Procedure 2002-22. Under the imputation rules, the activities of co-tenants, their agents and any and all related parties will be imputed to the other co-tenants of the investment for purposes of determining whether non-customary business activities are being performed. For practical purposes, this means that the majority of co-tenants need not be performing non-customary business activities with respect to the property to have the investment recharacterized as a partnership; rather, if even one co-tenant is performing such activities, that action will be imputed to the other co-tenants of the property, and be interpreted as the co-tenants as a whole engaging in outside business activities, providing valid grounds for re-characterization of the entity as a partnership.

12. Management and Brokerage Agreements: the co-owners may enter into management or brokerage agreements, which must be renewable at least once a year, with an agent. This agent may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but may not be a lessee. The management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the property against and revenues before disbursing each co-owner's share of net revenues. The manager must disburse to the co-owner's their shares of net revenues within 3 months from the date of receipt of those revenues irrespective of circumstances. Further, the management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the property, and to obtain or modify insurance on the property, and to negotiate modifications of the terms of any lease or any indebtedness encumbering the property (subject to the approval of the co-owners). (See section 6.05 of this revenue procedure for conditions relating to the approval of lease and debt modifications.) The determination of any fees paid by the co-ownership to the manager may not

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depend in whole or in part on the income or profits derived by any person from the property, and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to a broker for similar services.

13. Leasing Agreements: all leasing arrangements must be bona fide leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the property, and may not depend, in whole or in part, on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). (See section 856(d)(2)(A) and the regulations thereunder). This means that the amount of rent paid by a lessee may not be based on a percentage of net income from the property, cash flow, increases in equity, or similar arrangements.

14. Loan Agreements: the lender may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the property for any debt that encumbers the property or any debt incurred to acquire an undivided interest in the property.

15. Payments to Sponsor: except as otherwise provided, the amount of any payment to a sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to a sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the property.

The last guideline or provision under Revenue Procedure 2002-22 is directly solely at sponsors of syndicated TIC properties, and essentially is in place to prevent the sponsor's of properties from entering into profit sharing arrangements with co-tenants. Under the Revenue Procedure, the compensation received by the sponsor is

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specifically limited to the fair market value of the services the sponsor performs, and may not in any way be related to the performance of the property.

Regulatory and Security Requirements

Despite the issuance of Revenue Procedure 2002-22, the structure and sale of tenant-in-common interests in real estate is an area in which there is continual professional debate. Much of this debate centers on whether the TIC interests in real estate actually do constitute "investment contracts" for the purpose of Securities Laws, and the ramifications of that classification to the investments and other ancillary fields of law.

Securities Acts of 1933 and 1934

In order to understand the expansive nature of what qualify as "securities" under the Securities Act of 1933 and 1934, one must understand the need Congress intended to address with the legislation. The purpose behind the Securities Acts of 1933 and 1934 was "to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion."[64] As the primary aim of the legislation is consumer protection, the Acts must be construed liberally by the Courts and have the inherent flexibility to address new and novel investment opportunities that pose risks to consumer/investors. Accordingly, the definition of a security must "embody a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[65]

The defining case on what constitutes a "security" for the purposes of the Securities Act of 1933 is *Securities Exchange Commission v. Howey*, 328 U.S. 293 (1946), which

[64] Senate Committee on Banking and Currency, S.Rep. No. 47, 73d Cong., 1st Sess. 1 (1933)
[65] *Exchange Commission v. Howey*, 328 U.S. 293, 299 (1946)

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has become known as The Howey Test. The Court in *Howey* defined an investment contract as “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party, it being immaterial whether shares in the enterprise are evidenced by a certificate or by nominal interests in physical assets employed in the enterprise” (*Howey* at 299). The Court in *Howey* further pointed out that in determining whether or not an a particular investment falls within the regulatory scheme of the Securities Act of 1933, that form is to be disregarded for the economic realty of the transaction, which has the effect of widening the definition so as to arguably encompass any situation where individuals elect to invest money in a common enterprise where profit will be derived solely through the effort of a third party, rather than their own knowledge and capacity to manage the investment. "Congress' purpose in enacting the securities laws was to regulate “investments”, in whatever form they are made and by whatever name they are called."[66] To that end, it enacted a broad definition of "security," sufficient "to encompass virtually any instrument that might be sold as an investment."[67]

Since it is clear that under existing legal precedent what is construed to be an “investment contract” is broadly defined, and that the actual interests being sold as TIC investments most likely qualify as the types of investments the Act is perceived to address, the controlling part of the analysis in determining whether or not TIC interests do in fact qualify as securities is whether or not the investments as offering can be said to derive profit from the “efforts of others”. What constitutes sufficient “effort” on the part of a third party for purposes of making an investment contract a “passive investment” for the investing parties, and thus appropriately regulated as a security has been distilled over time by the courts. The Ninth Circuit in *Glen Turner Enterprises, Inc.* indicated that in order for an investment not to be said to rely on the “efforts of others” and hence avoid characterization as a security, the Investor’s themselves must be responsible for making the key managerial decisions. “Within

[66] *Reves v. Ernst & Young,* 494 U.S. 56 (1990)
[67] *S.E.C. v. Edwards*, 540 U.S. 389, 896 (2004)

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definition of 'investment contracts', which are 'securities' within the federal securities laws, as schemes which involve an investment of money in a common enterprise with profits to come solely from the efforts of others, word 'solely' should not be strictly construed; rather test is whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.[68]

In *Williamson,* the Court held that an Investor that retains control over their respective investment has not purchased an interest in a common venture "premised on the reasonable expectation of profits to be derived from the entrepreneurial and managerial efforts of others", so as to constitute an investment contract for purposes of the Securities Act of 1933 and the Securities Exchange Act of 1934, even if that Investor has outsourced the day to day management of the property to an outside vendor.[69] Under *Williamson*, the key in determining reliance on the "efforts of others" is dependence: only where investors are so dependent on a particular manager that the individual cannot be replaced or otherwise exercise ultimate control may it be said that the investors are truly passive investors. The Court in *Williamson* promulgated a three-part test to determine where there may be sufficient dependence on third-party efforts on the part of investors so as to characterize the investment as a security: (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or management ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers. In all three scenarios, the investors realistically have little or no control over their investment and the profitability and/or successful on the investment

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[68] *Securities and Exchange Commission v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973) *citing* the Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10)
[69] *Williamson v. Tucker*, 645 F.2d 404 (1981)

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accordingly must be attributable the efforts of a third party, and hence regulated as a security under the Securities Acts. Further, under *Williamson,* it is clear that for the purposes of determining whether or not a particular TIC interest constitutes a security interest, the analysis must consider both the actions of the sponsoring entity and the co-investors in each individual project. Where the sponsoring entity induces investment in the their projects by proclaiming some extraordinary expertise or capacity at managing investments of the particular nature of the offering, or requires the investors to utilize management companies the sponsoring entity is either related to or has a pre-existing relationship with, it can be argued that the sponsor has violated the third prong under *Williamson* and that co-tenants relied on these representations in making the investment, thus relying on the "efforts of others" for the purposes of the Securities Laws. Alternatively, where the co-tenants of the investment are so inexperienced and unknowledgeable in business affairs that they may be deemed incapable of intelligently exercising their rights under the project's Operating Agreement, or the co-tenants are so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that they can not replace the manager of the enterprise or otherwise meaningfully exercise the rights reserved to them under the Operating Agreement, then again the profitability of the investment is necessarily based on the management of a third party, and so may be validly said to be a security under the Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1) and the Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

In addition to elucidating what characteristics are necessary for an investment to be deemed a security, both *Howey* and *Williamson* indicate that there are truly some circumstances wherein a TIC investment will not be considered to be a security for the purposes of the 1933 and 1934 Securities Laws. Where the sponsoring entity structures a TIC offering so that the operating agreement provides the co-tenants with sufficient legal powers to actively participate in the management of the investment, and the co-tenants themselves are sophisticated investors capable of understanding the nature of the investment and exercising the rights reserved to them in the investment documents, the sponsor of the project may validly argue that the TIC

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investors are relying solely on their own expertise to render the project profitable and thus the investment contract fails to rely on the "efforts of others" as necessary to qualify as a security under the 1933 and 1934 Acts. An even stronger case may be made where the sponsor does not participate in the TIC investment after the initial offering to investors; in that case the co-tenants in the investment must truly an actively participate in all the decisions underlying the management of the investment, and will individually be responsible for the ultimate success/profitability of the investment, and so clearly not be relying on the "efforts of others" for securities law purposes.

National Association of Securities Dealers (NASD)

In March 2005, the National Association of Securities Dealers issued Notice to Members 05-18, which was titled "Private Placements of Tenants-in-Common Interests" and focuses on the consequences of classifying TIC interests as they are sold currently as securities. The Notice takes the position that when view in the light of the 1933 Act, the Securities and Exchange Act of 1934 ("1934 Act") and the NASD rules, investments currently sold as TIC investments do qualify as investment contracts for Securities Law purposes, and therefore must be sold accordingly.

The NASD's rationale is that when TICs are offered and sold together with other arrangements, including the prepackaged financing and contract for third-party management of the investment, the passive nature and third-party reliance components of the investment are sufficient to deem the interests being purchased as investment contracts, despite the fact that the Investors is purchasing into real estate and receiving a fractional interest in the underlying property, and thus securities under the federal securities laws. While this may seem to defy common sense at first glance, it is important to note that for securities laws purposes, the definition of an investment contract is broad: an investment contract may include any contract, transaction or scheme in which persons invest their money in a common enterprise, with the expectation of profits to be derived predominantly from the efforts of others.

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Under this definition of an "investment contract", it is more evident how tenant-in-common investments may be seen to qualify. Typically TIC investments involve the tenants-in-common investing in an undivided fractional interest in the rental real property by pooling their assets and sharing in the risks and benefits of the enterprise, the objective of the investment being enjoyment of the profits derived predominantly from third party leasing, management and operation of the acquired property, as well as the sponsoring company's negotiation of the sale price and the loan. Many opponents of this scheme of classification point to the fact that the investors in a particular TIC program might have authority to terminate a management contract, or even to maintain or repair the property; however, since the operating agreement for these projects typically do not make it the primary responsibility of the tenants-in-common to do so, this is not persuasive evidence that TIC interests are not investment contracts for the purposes of Securities Laws.

The classification of TIC interests as investment contracts for the purpose of Securities Law gives rise to uncertainty as to how these interests should be treated for the purposes of other areas of law, particularly tax-deferral provisions. If TIC investments are truly investment contracts for Securities purposes, then there could potentially be concern that Section 1031 can not appropriately be applied to transactions where the Investor seeks to re-invest in a TIC property as Section 1031 specifically does not apply to any exchange of investment property for "interests in a partnership," "stocks, bonds, notes," or "other securities". Thankfully for investors, brokers and sponsors alike, this is an area where there is a strange interplay between the applicable laws: while federal securities law definitions control the determination of whether or not TIC investments are "securities" for the purposes of Securities Law, that determination is not applicable in the determination of whether or not a TIC qualifies as a securities for the purposes of federal tax law. This means that the fact that TIC interests may be construed to be investment contracts under Securities Laws does not inherently disqualify them as property that may be exchanged under Section 1031. For most Investors purposes, this disparity should be viewed as the best of both worlds: because TIC interests are deemed to be securities for the sake of Securities Laws, all the consumer protection mechanisms

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under those laws apply to the sale of TIC interests, but because those interests are deemed real property for the sake of federal tax law the tax deferral mechanisms such as Section 1031.

Under Securities Regulations, TIC interests are considered a “non-conventional investment” ("NCI"), so that Securities Laws require members engaged in the sale of TICs to ensure they are both offered and sold in a manner consistent with the member's general sales conduct obligations and as with regard to the special circumstances presented by the sale NCI’s. Wth the sale of TIC properties, brokers have an increased responsibility to conduct appropriate due diligence, determine that the specific TIC interest is reasonably suitable for the specific Investor, ensure that promotional materials used by the member are fair, accurate, balanced and non-solicitous and to provide appropriate training to additional ancillary persons involved in the sale of these products.

If TIC interests may validly be deemed to be investment contracts for the purposes of Securities Law, then they must be described as illiquid securities. Given the potential restrictions on sale (no general solicitation, sale to accredited investors only) there is no specific secondary market for TIC interests: typically an Investor can sell his interest in the TIC property if need be, but if the operating agreement does not contain a right of first refusal to the other co-tenants, or they decline to exercise that right, then the Investor must take the interest back to a broker or the sponsor of the property to sell it. This can be further complicated where operating agreement for the investment requires unanimous consent to sell an individual TIC interest. Finally, while the Investor is free to set whatever price for the interest he feels the market will accommodate the limited control over the investment and the lack of a secondary market may require the Investor to significantly discount the net asset value of the undivided interest in the real estate to dispose of the property.

It is important to note that despite the NASD’s position, the issue of whether or not TIC interests constitute securities for the purposes of the Securities Act of 1933 is far

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from settled. Given the varied nature of the types of investments currently being offered, it is fair to say that some offerings are structured in a manner that does fall outside the guidelines promulgated in *Howey* and subsequent case law, thus allowing the sponsoring companies to sell TIC interests as investments in real estate. It is up to the individual investor to carefully evaluate the nature of the offering prior to investing, and consult with legal, tax and financial advisors to determine whether or not the investment as offered appropriately complies with securities laws, of if offered as a real estate investment, as appropriately structured to fall outside the guidelines as established in *Howey* and *Williamson*.

Given the varied nature of tenants-in-common offerings, the type of due diligence required of broker will vary from investment to investment. Typically however, Investors would be wise to make sure their broker has made a reasonable investigation into the offering so as to determine that the private placement memorandum does not contain any false and/or misleading information, has done a preliminary background check on the sponsoring entity and its principals, has reviewed the agreements associated with the investment, including the purchase and sales agreement, the financing agreements, the property management agreement, and the lease agreements, etc. The lease agreements are one area where brokers would do well to concentrate their due diligence and to ensure that any agreement associated with the TIC transaction is has been drafter with due care from a tax perspective. It is not uncommon for offerings to include language which is not problematic from a investment perspective, such as a master lease agreement with a real estate investment trust or its operating partnership or a transaction mandated after the acquisition of the TIC interest, which is extremely deleterious from a tax perspective; any of the aforementioned would be valid grounds to disqualify a tax-deferred like-kind exchange. In evaluating

One of the most intensely debated subjects with regards to the sale of TIC interests is the ability of brokers/sponsors to pay third parties referral fees for any business they refer. If TIC interest do truly qualify as investment contracts under Securities Laws, then such fees are not permissible under NASD Rule 2420, which prohibits payment of

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commissions and fees to entities that operate as unregistered broker-dealers. As Section 3(a)(4)(A) of the 1934 Securities Act defines a "broker" as a person "engaged in the business of effecting transactions in securities for the account of others", it is relatively clear the SEC could easily characterize payment of a referral fee from a broker-dealer to a realtor in connection with the sale of a TIC interest to be the type of activity that would render the real estate agent an unregistered broker-dealer.

As the situation stands now, a broker-dealer that subscribes to the view that TIC interests constitute investment contracts for applicable Securities Laws may not pay a real estate agent who is not registered as a broker-dealer for referral of a client to whom a subsequent TIC is sold, nor may a broker-dealer pay a real estate agent for referring TIC business that involves securities. Further, broker-dealers can not seek to evade the restrictions NASD Rule 2420 by devising a scheme of indirect compensation, whereby the broker-dealer reduces normal commissions on the particular TIC investment with the requirement that the Investor pay the difference to the real estate agent for referring the business to the broker-dealer.

The inability to pay realtors a referral fee has resulted in realtors by and large viewing TIC interests as competition to their business, and being hesitant to refer their clients to TIC investments even where they are most suited to the Investor’s particular objectives. The competition with traditional real estate has to some degree hampered the growth the TIC industry, and is an issue the industry’s professional organization is currently lobbying the SEC extensively to address.

<u>TIC Broker versus TIC Sponsor</u>

“Syndicators” or TIC Sponsors are the parties responsible for locating, evaluating, financing and acquiring a tenant-in-common property. Once arrangements to acquire or the actual acquisition of the property has taken place, the property is ready to take to market. From that point, TIC Brokers market the tenant-in-common interests in the same manner as other regulated securities.

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Overview of CORE or TIC Structures

As described above, the process of putting together a syndicated tenancy-in-common offering begins with a sponsor, usually a larger real estate investment company, scouring commercial properties currently listed across the United States for properties that they deem to have good cash flow potential, and that are under market value. When such a property is found, they Sponsor's acquisition team begins their due diligence process, to verify the representations made regarding the property are true, and their initial assessment as to its value is correct. Once they have completed the due diligence process, the Sponsor then purchases the property: this means both arranging the purchase/sale agreement, and the financing of the property.

The actual syndication of the property into Tenant-in-common investments begins at this point: the Sponsoring company then makes the property's availability known to its network of Brokers to offer to their clients that qualify as accredited investors under Securities Laws. These properties typically are offered in what are referred to as "Reg. D" offerings, an exemption to the Securities Act of 1933. When a prospective investor is interests in buying into the particular property – either as a direct purchase, or as part of a 1031 tax-deferred exchange – the broker will sit down with the prospective investor and go through the Private Placement Memorandum (typically referred to as a PPM) which contains all the information rendered from the due diligence process of the Sponsor, and determine whether or not the investment is suitable for the particular investor. If it is determine that it is a suitable investment, then the Broker will ascertain what percentage of the property the Investors purchase money and/or equity will buy of the total offering, and the Investor will acquire a percentage of the property and a percentage of the debt already arranged by the Sponsor according to that ratio.

Subscription Offering

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Almost all TIC transactions are offered as Regulation D Offerings, one of the exemptions to the Securities and Exchange Act of 1933 that allows the offering to be made without compliance with the securities registration requirements.

Subscription offerings are properties marketed and sold through licensed securities representatives, and as such must be accompanying by a Private Placement Memorandum or PPM. The Private Placement Memorandum provides the potential Investor with a complete and full disclose of all relevant information necessary to make an educated decision as to whether or not to acquire the tenant-in-common interest as an investment.

One of the fundamental requirements of Regulation D offerings pursuant to SEC Rule 505 and SEC Rule 506 is a prohibition on general solicitation. This restriction is no doubt the most frustrating consequence for broker-dealers, as it them and any person acting on their behalf from offering the TIC interests in any manner that may be deemed a “general solicitation” or “general advertisement”, which has been interpreted to include any publication or presentation of information in a seminar where attendees have been invited by any general solicitation or advertisement.

A critical factor for determining whether a communication is appropriately limited, and thus not a "general solicitation," is the existence of a substantial pre-existing relationship between a member and the eventual TIC Investor: when the broker can substantiate an adequate pre-existing relationship, the potential TIC investor's can be evaluated for their level of sophistication and financial circumstances and a determination made as to whether or not TIC investments are appropriate for their particular situation.

Tenant-In-Common Agreement

While Revenue procedure 2002-22 permits up to 35 Investors in any one single tenant-in-common property transaction, many times the number of offerings in a

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particular TIC interest is smaller, as the TIC Sponsor may wish to minimize the number of investors in a particular property. In reality, the final determining factor is typically the lender who will make the final decision on how many TIC Investors they will allow into each specific TIC property.

The individual investors, whatever number has purchased an interest in the particular tenancy-in-common property, will execute and be governed by a Tenant-In-Common Agreement, which enumerates the conditions and management requirements of the tenancy-in-common property.

Special Purpose, Single Member Limited Liability Company ("SPE")

Although the tenancy-in-common interests are acquired by the individual Investors, the interests themselves are actually held by designated special purpose entities. These special purpose entities are typically single member limited liability companies, and are disregarded entities for tax purposes. The purpose of maintaining each interest within these special purpose entities is to protect the Investors from the liability that might arise from the conduct of the other Tenants-in-common, and from the property itself, and to protect the individual TIC Investors from each other due to bankruptcy filings, etc.

Non-Recourse Debt

The financing is put into place by the sponsoring entity and is typically non-recourse to the individual investors. This is a tremendous advantage of the tenant-in-common properties, especially for those Investors that may have a hard time qualifying for debt due to earned income levels. Under the typically financing of a Tenancy-in-Common property, the Investor is only liable for the amount of his investment contributed into the property. In the event of a default on the loan, the lender cannot attach any of the Investors personal assets due to the non-recourse language.

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Loan provisions typically contain carve outs referred to as "Bad-Boy Provisions" as a means by which the Lender may protect themselves from the intentional misbehavior of TIC co-owners. These restrictions are typically drafted by the lender, and contain such provisions as a prohibition on the sale of one co-owners special purpose entity to another Investor without lender approval, etc. "Bad Boy Provisions" also generally provide that misbehavior on the part of a co-tenant triggers any of the "Bad-Boy" provisions also results in the debt generated by the behavior becoming recourse to the offending co-tenant.

Professional property management

One of the primary advantages of a Tenancy-in-common interest to the individual Investor is the significant decrease in management responsibilities. Tenant-in-common sponsors have professional property management operations either in house have nationally recognized professional commercial property management firms on retainer to manage the tenant-in-common property. When buying a Tenancy-in-common interest, the Investor acquires institutional quality property with no property management headaches attached to it.

Professional Acquisition Team

The TIC Sponsors typically have experienced, professional acquisition teams that are fully qualified to evaluate, analyze, finance, and acquire the tenant-in-common properties, and perform due diligence that the average Investor does not have the resources or skills to undertake.

Discounts For Estate Tax Purposes

Tenant-in-common ownership interests are fractional interests, and as such are not liquid; the marketability of a TIC interest depends significantly on the performance of the subject property, current market demand and conditions, the characteristics of the particular interest, and whether or not any of the other co-tenants are interested

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in acquiring it. The only benefit to the lack of liquidity for the Investor is that when a TIC interest comprises part of a decedent's estate, the investment can be heavily discounted to account for the restrained marketability.

New depreciation deductions with increased basis

The Investor can take advantage of some significant changes in their depreciation deductions by leveraging their investment by exchanging out for their fully depreciated property and acquire into a tenant-in-common property with an increased cost basis.

Issues involved in TIC Investments

While Rev. Proc. 2002-22 established some of the main-stay components to typical TIC offerings, Investors should be aware that there can be substantial difference in how offerings are structured. These differences may include terms indicating whether or not the sponsor may be compensated on the later sale of the investment, who will manage the property, whether the sponsor retains the ability to refinance the property, and other terms. Investors need to be aware that these differences, in addition to effecting how much control each individual TIC owner will retain over certain aspects of their investment, may pose an additional risk that the entity may be recharacterized for tax purposes.

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EXETER
1031 Exchange Services LLC

GLOSSARY AND DEFINITION OF TERMS

1031 exchange: The sale or disposition of real estate or personal property (relinquished property) and the acquisition of like-kind real estate or personal property (replacement property) structured as a tax-deferred, like-kind exchange transaction pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Treasury Regulations in order to defer Federal, and in most cases state, capital gain and depreciation recapture taxes.

Accelerated Cost Recovery System (ACRS): A depreciation method used for most property placed into service from 1981 to 1986. This method allowed property to be depreciated at a faster rate than had been allowed previously. The modified accelerated cost recovery system (MACRS) replaced ACRS for assets placed into service after 1986.

Accelerated Depreciation: A depreciation method that allows you to deduct a greater portion of the cost of depreciable property in the first years after the property is placed in service, rather than spreading the cost evenly over the life of the asset, as with the straight-line depreciation method.

Accommodator: An unrelated third party who participates in the tax-deferred, like-kind exchange to facilitate the disposition of the Investor's relinquished property and the acquisition of the Investor's replacement property. The Accommodator has no economic interest in the Investor's tax-deferred like-kind exchange transaction except for any fee compensation (exchange fees) it may charge and receive for acting as the Accommodator in facilitating the exchange as defined in Section 1.1031 of the Department of the Treasury Regulations. The Accommodator is technically referred to as the Qualified Intermediary under the Treasury Regulations, but is often referred to in the real estate industry as an Exchange Accommodator or Exchange Facilitator.

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Actual Receipt: Direct access to and/or taking actual possession of your tax-deferred like-kind exchange funds or other property means the Investor is in actual receipt of the funds. Receiving exchange funds during the tax-deferred like-kind exchange period will disqualify your exchange. (See Section on Constructive Receipt)

Adjusted Cost Basis: The amount you use to determine your capital gain or loss from a sale or disposition of property. To determine the adjusted cost basis for your property, you must start with the original purchase cost or original cost basis. You then add your cost of capital improvements to the property and then subtract depreciation you have taken or were allowed to take.

After-Tax Return: The return from an investment after the tax liabilities have been factored in.

Agent: An entity that acts on behalf of the Investor. A Qualified Intermediary cannot be your agent at the time of or during a tax-deferred, like-kind exchange. For tax-deferred like-kind exchange purposes, an agent includes your employee, attorney, accountant or investment banker or real estate agent or broker within the two-year period prior to the transfer of your first relinquished property. An agency relationship does not exist with entities that offer tax-deferred like-kind exchange services or routine title, escrow, trust or financial services. (See Related Parties)

Alternative Minimum Tax: A method of calculating income tax that does not allow certain deductions, credits, and exclusions. The Alternative Minimum tax was devised to ensure that individuals, trusts, and estates that benefit from tax preferences do not avoid paying any federal income taxes.

Asset: Anything owned by an Investor that has monetary value.

Asset Allocation: Repositioning assets within a portfolio to maximize a return for a specific level of risk.

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Asset Class: A category of investments that contain similar characteristics.

Balancing the Exchange: A balanced exchange ensures that the Investor defers 100% of his taxes on capital gain and depreciation recapture. To achieve a balanced exchange an Investor must: 1) acquire a replacement property that is equal to or greater than the relinquished property in terms of net-sales price or value; and 2) reinvest all of the net equity or cash proceeds from the close of the relinquished property transaction in the replacement property; and 3) assume debt or place new debt on the replacement property that is equal to or greater in amount than the debt paid off on the relinquished property or contribute cash to make up the deficiency. (See Partial Tax Deferment; Boot and Mortgage Boot/Relief)

Basis: The original purchase price or cost of your property plus any out-of-pocket expenses such as brokerage commissions, escrow costs, title insurance premiums, sales tax (if personal property) and other closing costs directly related to the acquisition.

Beneficiary: An individual, company, organization, or other entity named in a trust, life insurance policy, annuity, will or other agreement who receives a financial benefit upon the death of the principal. A beneficiary can be an individual, company, organization, etc.

Bond: Evidence of debt in which the issuer promises to pay the bondholders a specified amount of interest and to repay the principal at maturity. Bonds are usually issued in multiples of $1,000.

Boot: Non-like-kind property (cash or other property) given by one party to another party in a tax-deferred, like-kind exchange. For instance, if you trade in a delivery truck on a new model, the cash you pay in addition to your old truck is boot. Boot

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received may be offset by boot paid. Boot is taxable to the extent there is depreciation recapture and/or capital gain. (See also Mortgage Boot)

Build-to-suit Exchange: A tax-deferred, like-kind exchange whereby the Qualified Intermediary and/or Exchange Accommodation Titleholder acquires title and holds title to the replacement property on behalf of the Investor, during which time structures or improvements are constructed or installed on or within the replacement property. Also known as an Improvement or Construction Exchange.

Business Assets: Real property, tangible depreciable property, intangible property and other types of property contained or used in a business. Exchanging one business for another business is not permitted under Section 1031 of the Internal Revenue Code. However, Investors may exchange business assets on an asset-by-asset basis, usually as part of a Mixed-Property (Multi-Asset) Exchange.

Capital Gain or Loss: The difference between the selling price of a property or asset and its Adjusted Cost Basis.

Capital Gain Tax: Tax levied by Federal and state governments on investments that are held for one year or more. Investments may include real estate, stocks, bonds, collectibles and tangible depreciable personal property. (See Income Tax)

Capital Improvements: For land or buildings, improvements (also known as capital improvements) are the expenses of permanently upgrading your property rather than maintaining or repairing it. Instead of taking a deduction for the cost of improvements in the year paid, you add the cost of the improvements to the basis of the property. If the property you improved is a building that is being depreciated, you must depreciate the improvements over the same useful life as the building.

Capitalization Rate: The rate of return an Investor wants to achieve on real property. The capitalization rate can provide for the return of the investment and the return on

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the investment (profit). To obtain a property's capitalization rate, divide the net operating income of a property by its value. To determine a property's value, divide the property's net operating income by the desired capitalization rate. In the Income-Capitalization Method of real property appraisal, a capitalization rate is used to appraise a property's value. The Income-Capitalization Method of appraisal is used to value investment property, such as apartment buildings, commercial office buildings and retail malls. (See Net Operating Income)

Cash Equivalents: Short-term investments, such as U.S. Treasury securities, certificates of deposit, and money market fund shares, that can easily be liquidated into cash.

Charitable Lead Trust: A trust established for the benefit of a charitable organization under which the charitable organization receives income from an asset for a set number of years or for the trustor's lifetime. Upon the termination of the trust, the asset reverts to the trustor or to his designated heirs. This type of trust can reduce estate taxes and allows the trustor's heirs to retain control of the assets.

Charitable Remainder Trust: A trust established for the benefit of a charitable organization under which the trustor receives income from an asset for a set number of years or for the trustor's lifetime. Upon the termination of the trust, the assets reverts to the charitable organization. The trustor receives a charitable contribution deduction in the year in which the trust is established, and the assets placed in the trust are exempt from capital gain tax.

Collectibles: Personal property, such as baseball cards, coins, stamps, works of art and memorabilia that is held for investment. Collectibles are exchangeable under Section 1031 of the Internal Revenue Code.

Community Property: All property acquired by a husband and wife during their marriage. Each spouse has a right to an equal interest in the property. Gifts and

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inheritances received by an individual spouse during the marriage are treated as separate property. Property acquired by the spouse prior to marriage, property acquired with separate property or rents or profits generated from separate property are treated as separate property. Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin are community property states.

Concurrent Exchange: A tax-deferred, like-kind exchange transaction whereby the disposition of the relinquished property and the acquisition of the replacement property close or transfer at the same time. A Concurrent Exchange is also referred to as a Simultaneous Exchange.

Condominium: A form of real estate ownership, usually residential property, in which the owners own their proportionate share of a fee interest as well as an undivided proportionate share of all common areas.

Constructive Receipt: Exercising control over or having the right to your exchange funds or other property. Control over your exchange funds includes having money or property from the exchange credited to your bank account or property or funds reserved for you. Being in constructive receipt of exchange funds or property may result in the disallowance of the tax-deferred, like-kind exchange transaction thereby creating a taxable sale. (See also Actual Receipt)

Cooperation Clause: Language to be included in the Purchase and Sale Contracts for both the relinquished and replacement properties that indicates and discloses to all parties that the transaction is part of an intended tax-deferred, like-kind exchange transaction and requires that all parties cooperate in completing said tax-deferred like-kind exchange transaction. (See our Forms and Documents section on our web site for sample cooperation clause language.)

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Cooperatives: A form of real estate ownership, usually residential property, in which individual owners hold shares of stock in a corporation. Each owner leases property from the corporation under a proprietary lease.

Corporation: A separate entity created by law. Investors in the corporation hold shares of stock. The corporation benefits from any profits generated and is responsible for any losses received. Shareholders may receive dividends on stock and incur any appreciation or depreciation on the sale of their shares of stock. Shareholders are not liable for any debts incurred by the corporation. Creditors can attach a shareholder's shares in the corporation.

Deduction: An amount that can be subtracted from gross income, from a gross estate, or from a gift, lowering the amount on which tax is assessed.

Deferred Exchange: The sale or disposition of real estate or personal property (relinquished property) and the acquisition of like-kind real estate or personal property (replacement property) structured as a tax-deferred, like-kind exchange transaction pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Treasury Regulations in order to defer Federal, and in most cases state, capital gain and depreciation recapture taxes.

Delayed Exchange: A tax-deferred, like-kind exchange where there is a delay or period of time between the close and transfer of the Investor's relinquished property and replacement property.

Depreciable Property: Property with a useful life of more than one year that is held for investment or used in your trade or business. You spread the cost of the asset over its estimated useful life rather than deducting the entire cost in the year that you placed the asset in service. (See Depreciation Recapture for more information regarding the sale or disposition of assets that have been depreciated.)

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Depreciation: Periodic wearing away of property over the property's economic life. The I.R.S. requires Investors and business owners to take a tax deduction on the amount of a property's depreciation. The practice of amortizing or spreading the cost of depreciable property over a specified period of time, usually its estimated depreciable life. To put it another way, you are allowed a deduction on your income tax return for the wearing away and expensing over time of property or assets, such as aircraft, vehicles, livestock and buildings. A depreciable asset is a capital expenditure in depreciable property; used in a trade or business or held for the production of income and has a definite useful life of more than one year. Non-depreciable property includes vacant land. For assets that have an expected useful life of more than one year, you spread the cost of the asset over its estimated useful life rather than deducting the entire cost in the year you place the asset in service. The tax code (law) specifies the depreciation period for specific types of assets.

Depreciation Recapture: The amount of gain resulting from the disposition of property that represents the recovery of depreciation expense that has been previously deducted on the Investor's (Investor's) income tax returns.

Direct Deeding: A practice authorized by Revenue Ruling 90-34 issued by the Department of the Treasury whereby either the relinquished property or the replacement property can be deeded directly from seller to buyer without deeding the property to the Qualified Intermediary. (See Sequential Deeding for industry practices prior to Treasury Revenue Ruling 90-34.)

Disposition: The sale, exchange or other disposal of property that causes a gain or a loss including like-kind exchanges and involuntary conversions.

Dividend: A pro-rata portion of earnings distributed in cash by a contribution to its stockholders. In preferred stock, dividends are usually fixed; with common shares, dividends may vary with the performance of the company.

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Errors & Omissions Insurance ("E&O"): Losses resulting from an error or omission of an employee or otherwise on behalf of a company are insured against with an errors and omissions insurance policy. Errors and omissions is perhaps the most important insurance coverage necessary because errors and omissions are more likely than theft of funds, however, errors and omissions can be extremely difficult for a Qualified Intermediary ("Accommodator" or "Facilitator") to qualify for and can be extremely expensive.

EAT: Acronym for Exchange Accommodation Titleholder. (See Exchange Accommodation Titleholder)

Equity: The value of a person's ownership in real property or securities; the market value of a property or business, less any claims or liens on it.

Exchange: The sale or disposition of real estate or personal property (relinquished property) and the acquisition of like-kind real estate or personal property (replacement property) structured as a tax-deferred, like-kind exchange transaction pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Treasury Regulations in order to defer Federal, and in most cases state, capital gain and depreciation recapture taxes.

Exchange Accommodation Titleholder ("EAT"): An unrelated party that holds the Qualified Indicia of Ownership (customarily the title) of either the replacement or relinquished property in order to facilitate a reverse and/or build-to-suit tax-deferred, like-kind exchange transaction pursuant to Revenue Procedure 2000-37.

Exchange Agreement: A written agreement between the Qualified Intermediary and Investor setting forth the Investor's intent to exchange relinquished property for replacement property, as well as the terms, conditions and responsibilities of each party pursuant to the tax-deferred, like-kind exchange transaction.

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Exchange Period: The period of time during which the Investor must complete the acquisition of the replacement property(ies) in his tax-deferred, like-kind exchange transaction. The exchange period is 180 *calendar* days from the transfer of the Investor's first relinquished property, or the due date (including extensions) of the Investor's income tax return for the year in which the tax-deferred, like-kind exchange transaction took place, whichever is earlier, and is not extended due to holidays or weekends.

Excluded Property: The rules for like-kind exchanges do not apply to property held for personal use (such as homes, boats or cars); cash; stock in trade or other property held primarily for sale (such as inventories, raw materials and real estate held by dealers); stocks, bonds, notes or other securities or evidences of indebtedness (such as accounts receivable); partnership interests; certificates of trust or beneficial interest; choses in action.

Fair Market Value: The price at which property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts.

Fidelity Bond: A fidelity bond insures an operation from or against losses resulting from the theft, embezzlement or misappropriate of funds by an employee of the company. Fidelity bond coverage is typically "in aggregate," which means the face amount is the total amount of coverage available for a twelve month period, while a fidelity bond written as a "per occurrence" bond means the fact amount is the total coverage available per loss or theft of funds.

Fixed Income: Income from investments, such as CDs, Social Security benefits, pension benefits, some annuities, or most bonds, that is the same every month.

Fractional Interest: An undivided fractional interest or partial interest in property. See also Tenancy-In-Common Interests.

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Going Concern Value: Additional value that attaches to property because the property is an integral part pf an ongoing business activity. It includes value based on the ability of a business to continue to function and generate business even though there is a change in ownership.

Goodwill: The value of a business or trade based on continued customer patronage due to its name, reputation, or any other factor. The goodwill of a business is not exchangeable under Section 1031 of the Internal Revenue Code.

Gross Multiplier: A variation on the Income-Capitalization Method of appraising property. The Gross Multiplier approach is a way to obtain a fast, rough estimate of a property's value. In this approach, a monthly or annual number is multiplied by a property's gross income to obtain the property's value. Dividing the sale price of a similar property by its gross income provides its gross multiplier.

Identification Period: The period of time during which the Investor must identify potential replacement properties in his tax-deferred, like-kind exchange. The period is 45 *calendar* days from the transfer of the Investor's relinquished property and is not extended due to holidays or weekends.

Improvement Exchange: A tax-deferred, like-kind exchange whereby the Qualified Intermediary and/or Exchange Accommodation Titleholder acquires title and holds title to the replacement property on behalf of Investor, during which time new or additional structures or improvements are constructed or installed on or within the replacement property. Also known as a build-to-suit exchange.

Improvements: For land or buildings, improvements (also known as capital improvements) are the expenses of permanently upgrading your property rather than maintaining or repairing it. Instead of taking a deduction for the cost of improvements in the year paid, you add the cost of the improvements to the basis of the property. If

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the property you improved is a building that is being depreciated, you must depreciate the improvements over the same useful life as the building.

Intangible Personal Property: Property that does not have value itself, but represents something else. Trademarks, patents and franchises are examples of intangible property. Aircraft, business furniture and equipment are examples of tangible personal property.

Intermediary: An unrelated party who participates in the tax-deferred, like-kind exchange to facilitate the disposition of the Investor's relinquished property and the acquisition of the Investor's replacement property. The Intermediary has no economic interest except for any compensation (exchange fee) it may receive for acting as an Intermediary in facilitating the exchange as defined in Section 1031 of the Internal Revenue Code. The Intermediary is technically referred to as the Qualified Intermediary, but is also known as the Accommodator, Facilitator or Intermediary.

Internal Revenue Code: Internal Revenue Code (tax code/laws).

Internal Revenue Code Section 1031: Section 1031 of the Internal Revenue Code allows an Investor to defer his capital gain tax and depreciation recapture tax when he or she exchanges relinquished property for like-kind or like-class replacement property.

Investor: The Investor who is completing the tax-deferred, like-kind exchange transaction. An Investor may be an individual, partnership, limited liability company, corporation, institution or business.

Irrevocable Trust: A trust that may not be modified or terminated by the trustor after its creation.

I.R.S.: Internal Revenue Service, a Department of the United States Treasury.

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Joint Tenancy: Two or more individuals who own an undivided equal interest in a piece of property. Four unities are required to create a joint tenancy: 1) Time–all joint tenants must obtain their interest at one time; 2) Title–all must obtain their interest by the same document; 3) Interest–each joint tenant has an equal share in ownership; 4) Possession–each joint tenant has an equal right of possession. If one of the joint tenants dies, his interest passes automatically to the surviving party or parties. No inheritance taxes or probate proceedings are required. No joint tenant can sell his ownership interest without terminating the joint tenancy.

Like-Class and Like-Kind Personal Property: Refers to the nature or character of the property and not to its grade or quality. Personal property listed or contained within the same general asset classification or product classification ("SIC Code") will be considered to be of like-class and therefore like-kind.

Like-Kind Exchange: The sale or disposition of real estate or personal property (relinquished property) and the acquisition of like-kind real estate or personal property (replacement property) structured as a tax-deferred, like-kind exchange transaction pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Treasury Regulations in order to defer Federal, and in most cases state, capital gain and depreciation recapture taxes.

Like-Kind Property: Property that is exchangeable with another property. Refers to the nature or character of the property and not to its grade or quality.

Limited Liability Company (LLC): Members of Limited Liability companies enjoy the limited liability offered by corporations and the minimum requirements of an S corporation. Limited Liability Companies typically contain two or more members and must file articles of organization with the secretary of state, although single member limited liability companies are allowed in certain states.

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Limited Partnership: Investors who pool their money to develop or purchase income-producing properties. Income from these properties is distributed as dividend payments. In a limited partnership, each limited partner's liability is limited to the amount of his investment. A limited partner only contributes money and is not actively involved in the business. A limited partnership must have one general partner, who is personally liable for all debts.

Living Trusts: A trust created by an individual(s), often a husband and wife, during his lifetime. Often these individuals hold property as joint trustees for their benefit. If one spouse dies, the surviving spouse would hold title to the property as a trustee. When the surviving spouse dies, the property would pass to the beneficiaries of the trust. Holding property in a living trust allows the heirs to avoid probate and inheritance taxes.

Mixed Property (Multi-Asset) Exchange: An exchange that contains different types of properties, such as depreciable tangible personal property, real property, and intangible personal property. In a Mixed Property Exchange, relinquished properties are segmented in like-kind groups and matched with corresponding like-kind groups of replacement properties.

Modified Accelerated Cost Recovery System (MACRS): The depreciation method generally used since 1986 for writing off the value of depreciable property other than real estate, over time. MACRS allows you to write off the cost of assets faster than the straight-line depreciation method.

Mortgage Boot/Relief: When you assume debt on your replacement property that is less than the debt on your relinquished property, you receive mortgage boot or mortgage relief. Generally speaking, mortgage boot received triggers the recognition of gain and is taxable, unless offset by cash boot added or given up in the exchange. (See Boot)

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Multiple Property Exchange: Disposition and/or acquisition of more than one property in a tax-deferred like-kind exchange.

Net Operating Income: A property's gross income (scheduled rents and 100% vacancy factor) less its total annual expenses (including management costs, utilities, services, repairs, a vacancy factor and a credit loss factor) plus any additional other income (vending machines, coin laundry operations, etc.). Principal and interest payments on the mortgage and tax liability are not included.

Ordinary Income Tax: Tax levied by Federal and State governments on an Investor's adjusted gross income. Investments that are held for less than one year are taxed at ordinary income tax rates. (See Capital Gain Tax)

Parking Arrangement: A process or procedure whereby either the Investor's relinquished property or replacement property is acquired by an Exchange Accommodation Titleholder ("Exchange Accommodation Titleholder") in order to facilitate a reverse and/or build-to-suit tax-deferred, like-kind exchange transaction pursuant to Treasury Revenue Ruling 2000-37.

Partial Exchange: When an exchange entails receiving cash, excluded property and/or non-like-kind property and/or any net reduction in debt (mortgage relief) on the replacement property as well as an exchange of qualified, like-kind property. In the case of a partial exchange, tax liability would be incurred on the non-qualifying portion and capital gain deferred on the qualifying portion under INTERNAL REVENUE CODE Section 1031.

Partnership (tenancy in partnership): an association of two or more persons who engage in a business for profit. A partnership is created by an agreement, which does not have to be in writing. However, for the partnership to hold title in a partnership name, the partnership agreement must be signed, acknowledged and recorded. Tenancy in partnership allows any number of partners to have equal or unequal

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interest in property in relation to their interests in the partnership. Profits and liabilities are passed through to the members. In a limited partnership, each limited partner's liability is limited to the amount of his investment. A limited partner only contributes money and is not actively involved in the business. A limited partnership must have one general partner, who is personally liable for all debts. Partnership entities can complete exchanges. Partnership interests are not exchangeable. Difficulties sometimes occur in tax-deferred like-kind exchange when some partners want to enter into an exchange while others want to sell.

Personal Property Exchange: A tax-deferred transfer of personal property (relinquished property) for other personal property (replacement property) that are of like-kind or like-class to each other.

Principal Residence Exemption: Exclusion from capital gain tax on the sale of principal residence of $250,000 for individual Investors and $500,000 for couples, filing jointly, under INTERNAL REVENUE CODE Section 121. Property must have been the principal residence of the Investor(s) 24 months out of the last 60 months. In the case of a dual use property, such as ranch, retail store, duplex or triplex, the Investor can defer taxes on the portion of the property used for business or investment under INTERNAL REVENUE CODE Section 1031 and exclude capital gain on the portion used as the primary residence under Section 121.

Qualified Exchange Accommodation Arrangement: The contractual arrangement between the Investor and the Exchange Accommodator Titleholder whereby the Exchange Accommodation Titleholder holds a parked property pursuant to Revenue Procedure 2000-37.

Qualified Exchange Accommodation Agreement: The actual contract or agreement between the Investor and the Exchange Accommodator Titleholder that outlines the terms for parking property pursuant to Revenue Procedure 2000-37.

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Qualified Intermediary: An unrelated party who participates in the tax-deferred, like-kind exchange to facilitate the disposition of the Investor's relinquished property and the acquisition of the Investor's replacement property. The Qualified Intermediary has no economic interest except for any compensation (exchange fee) it may receive for facilitating the exchange as defined in Section 1031 of the Internal Revenue Code. The Qualified Intermediary is the correct technical reference pursuant to the Treasury Regulations, but the Qualified Intermediary is also known as the Accommodator, Facilitator or Intermediary.

Qualified Use: An Investor must intend to use the property in their trade or business, to hold the property for investment or to hold the property for income production in order to satisfy the qualified use test.

Real Property: Land and buildings (improvements), including but not limited to homes, apartment buildings, shopping centers, commercial buildings, factories, condominiums, leases of 30-years or more, quarries and oil fields. All types of real property are exchangeable for all other types of real property. In general, state law determines what constitutes Real Property.

Real Estate Investment Trust (REIT): A trust that invests primarily in real estate and mortgages and passes income, losses, and other tax items to its Investors. REITS are typically classified as a security and are therefore not exchangeable.

Real Property Exchange: The sale or disposition of real estate (relinquished property) and the acquisition of like-kind real estate (replacement property) structured as a tax-deferred, like-kind exchange transaction pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Treasury Regulations in order to defer Federal, and in most cases state, capital gain and depreciation recapture taxes.

Related Person: Any person bearing a relationship to the Investor as described in Section 267(b) of the Internal Revenue Code. Related parties include family members

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(spouses, children, siblings, parents or grandparents but not aunts, uncles, cousins or ex-spouses) and a corporation in which you have more than a 50% ownership; or a partnership or two partnership in which you directly or indirectly own more a 50% share of the capital or profits.

Relinquished Property: The property to be sold or disposed of by the Investor in the tax-deferred, like-kind exchange transaction.

Replacement Property: The like-kind property to be acquired or received by the Investor in the tax-deferred, like-kind exchange transaction.

Reverse Exchange: A tax-deferred, like-kind exchange transaction whereby the replacement property is acquired first and the disposition of the relinquished property occurs at a later date.

Reverse/Improvement Exchange: The Exchange Accommodation Titleholder can make improvements to the replacement property before transferring it to the Investor as part of a Reverse Exchange.

Revocable Trust: A trust in which the creator reserves the right to modify or terminate the trust at any time.

Rollover: A method by which an individual can transfer the assets from one retirement program to another without the recognition of income for tax purposes. The requirements for a rollover depend on the type of program from which the distribution is made and the type of program receiving the distribution.

Roth IRA: A nondeductible IRA that allows tax-free withdrawals when certain conditions are met. Income and contribution limits apply.

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S Corporation: A small, closely held corporation (75 or fewer Investors) who elect to be taxed as a partnership where shareholders pay taxes on all earnings. This avoids double taxation of corporate income and dividend income that occurs in corporations.

Safe Harbors: The Treasury Regulations provide certain Safe Harbors that assist Qualified Intermediaries and Investors in structuring tax-deferred, like-kind exchange transactions so they can be assured that no constructive receipt issues will be encountered during the exchange cycle.

Seller Carry-Back Financing: When the buyer of a property gives the seller of the property a note, secured by a deed of trust or mortgage. In a tax-deferred like-kind exchange, seller carry-back financing is treated as boot, unless it is sold at a discount on the secondary market or assigned to the seller as a down payment on the replacement property.

Sequential Deeding: The former practice of transferring or deeding title to the Investor's relinquished property to the Qualified Intermediary first and then sequentially and immediately transferring or deeding title from the Qualified Intermediary to the buyer in order to properly structure a tax-deferred, like-kind exchange prior to the issuance of Revenue Ruling 90-34 issued by the Department of the Treasury. See Direct Deeding for the current day practice. Sequential deeding is used only in special tax-deferred, like-kind exchange transactions today that require special structuring.

Service: A nickname used by income tax professionals and legal advisors to refer to the Internal Revenue Service.

Simultaneous Exchange: A tax-deferred, like-kind exchange transaction whereby the disposition of the relinquished property and the acquisition of the replacement property close or transfer at the same time. A Simultaneous Exchange is also referred to as a Concurrent Exchange.

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Starker Exchange: Another common name for the tax-deferred, like-kind exchange transaction based on a court decision that was handed down (Starker vs. Commissioner) in 1979. The Ninth Circuit Court of Appeals eventually agreed with Starker that its delayed tax-deferred, like-kind exchange transaction did in fact constitute a valid exchange pursuant to Section 1031 of the Internal Revenue Code. This ruling set the precedent for our current day delayed exchange structures.

Straight-line Depreciation Method: A depreciation method that spreads the cost or other basis of property evenly over its estimated useful life.

Tangible Personal Property: Property other than real estate that physically exists. Aircraft, business equipment and vehicles are examples of tangible personal property. Assets such as trademarks, patents and franchises only represent value and are therefore intangible property.

Tax-Deferral: The postponement of taxes to a later year, usually by recognizing income or a gain at a later time. Tax-deferred, like-kind exchange transactions are a common method of deferring capital gain and depreciation recapture taxes.

Tax-deferred exchange: The sale or disposition of real estate or personal property (relinquished property) and the acquisition of like-kind real estate or personal property (replacement property) structured as a tax-deferred, like-kind exchange transaction pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Treasury Regulations in order to defer Federal, and in most cases state, capital gain and depreciation recapture taxes.

Investor: The person or entity that is completing the tax-deferred, like-kind exchange transaction, commonly referred to as Investor.

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Tenancy-In-Common Interest (Co-Tenancy): a separate, undivided fractional interest in property. A tenancy-in-common interest is made up of two or more individuals, who have equal rights of possession. Co-tenants' interests may be equal or unequal and may be created at different times and through the use of different conveyances. Each co-tenant has the right to dispose of or encumber his interest without the agreement of the other co-tenants. he cannot, however, encumber the entire property without the consent of all of the co-tenants. In a tax-deferred like-kind exchange, an Investor may acquire a Tenancy-In-Common Interest with one or more other Investors, as his like-kind replacement property. For purposes of tax-deferred like-kind exchange, a co-tenancy must only engage in investment activities, including supporting services that would typically accompany the investment. Co-tenants that are engaging in separate business activities are treated as partnerships by the Internal Revenue Service.

Tenancy in Severalty: Separate ownership of property by one person.

Titleholder: The entity that owns/holds title to property. In a tax-deferred like-kind exchange, the titleholder of the relinquished property must generally be the same as the titleholder of the replacement property. If an Investor dies prior to the acquisition of the replacement property, his estate may complete the exchange. When the acquisition and disposition entities bear the same Investor identification numbers, such as disregarded entities (single-member limited liability companies and Revocable Living Trusts), the exchange usually qualifies.

Trust: A legal entity created by an individual in which one person or institution holds right to manage property or assets for the benefit of someone else.

Trustee: An individual or institution appointed to administer a trust for its beneficiaries.

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APPENDIX

APPENDIX A – BIOGRAPHIES OF THE AUTHORS

APPENDIX B – SECTION 1031 OF THE INTERNAL REVENUE CODE

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Appendix A

Biographies of Authors

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![EXETER 1031 Exchange Services LLC]

William L. Exeter

President and Chief Executive Officer
Exeter 1031 Exchange Services, LLC

William L. Exeter is President and Chief Executive Officer of The Exeter Group, LLC and its subsidiary companies, including Exeter 1031 Exchange Services, LLC, Exeter Reverse 1031 Exchange Services, LLC, Exeter Advanced Exchange Strategies, LLC, Exeter Consulting Group, LLC and Exeter Self-Directed IRA Services, LLC.

Mr. Exeter has been in the financial services industry since 1980 and entered the 1031 exchange services industry in 1986. He has written and lectured extensively on tax-deferred, like-kind exchange transactions pursuant to Section 1031 of the Internal Revenue Code and on Tenant-In-Common (TIC) Properties as like-kind replacement property options pursuant to Revenue Procedure 2002-22. In addition, he is a frequent expert on "The Financial Advisors - Money Talk Radio Show" on AM News Radio 600 KOGO San Diego and on the "Inside Business Radio Show" on AM Radio 1000 KCEO San Diego.

Immediately prior to his position with The Exeter Group of Companies he served as President and Chief Executive Officer of Diversified Exchange Corporation for four years and prior to that as Executive Vice President and Chief Operating Officer of The Chicago Trust Company of California and its 1031 exchange subsidiary for 13 years. In addition, he served as a senior executive with two 1031 exchange companies in the 1980s during the 1031 exchange industry's infancy, and is one of the founding members of the Federation of Exchange Accommodators. He has administered in excess of 60,000 1031 exchange transactions during his career.

Mr. Exeter's professional experience includes 1031 exchange, title insurance and escrow services (including specialized escrow services), trust and retirement account administration, trust operations, investment management services, commercial banking, and insurance administration.

Mr. Exeter is involved with numerous professional organizations including, COREnet Global, AIR Commercial Real Estate, ICSC, the San Diego Chapters of CCIM and CREW, NAIOP, SIOR, California Escrow Association, San Diego County Escrow Association, NorCal Escrow Association, and the Federation of Exchange Accommodators.

Mr. Exeter graduated from California State University, Los Angeles with a Bachelors of Science degree in Accounting, and from the Canon Financial Institute, attaining the Certified Securities Operations Professional (CSOP) designation. He is currently working toward his Certified Commercial Investment Member (CCIM) designation.

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Alexis Aiken, J.D., is an Assistant Vice President and the Legal Department Manager for The Exeter Group, LLC and its subsidiary companies, including Exeter 1031 Exchange Services, LLC, Exeter Reverse 1031 Exchange Services, LLC, Exeter Advanced Exchange Strategies, LLC, Exeter Consulting Group, LLC and Exeter Self-Directed IRA Services, LLC.

Ms. Aiken assists in the management of the national 1031 exchange operation, manages corporate legal related issues, and writes and lectures extensively on tax-deferred, like-kind exchange transactions pursuant to Section 1031 of the Internal Revenue Code, combination Section 121 and 1031 transactions under Revenue Procedure 2005-14, and Tenant-In-Common Properties as like-kind replacement property options pursuant to Revenue Procedure 2002-22. In addition, she is a frequent guest expert on "The Financial Advisors - Money Talk Radio Show" hosted by Aubrey Morrow on AM News Radio 600 KOGO San Diego and on the "Inside Business Radio Show" hosted by Bob Ryan on AM Radio 1000 KCEO San Diego.

Ms. Aiken received her Juris Doctorate from the University of Pennsylvania Law School in May of 2005, and completed a cross-disciplinary course of study from the University of Pennsylvania Wharton School of Business in Business and Public Policy with an emphasis on real estate transactions. While in law school, Alexis clerked for the United States Attorney's Office for the District of Delaware, as well as the California Department of Justice Torts and Condemnation Section in Los Angeles, California. Ms. Aiken also served as a law clerk for the private national law firm of Morgan, Lewis & Bockius LLP, and as an intern for the Office of Public Counsel with both the Veterans Homelessness Prevention Project and the Children's Rights Project.

Shortly after graduating law school, Ms. Aiken founded and managed a private international trading company, specializing in the import and export of consumer luxury goods in the Pacific Rim.

Ms. Aiken is involved with numerous professional organizations including the California Escrow Association (CEA), San Diego County Escrow Association, NorCal Escrow Association, the San Diego County Chapters of CCIM, CREW, NAIOP, SIOR, and COREnet Global, American Association of Women Accountants (ASWA) and the Federation of Exchange Accommodators (FEA).

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Appendix B

Section 1031 of the Internal Revenue Code

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TITLE 26 – INTERNAL REVENUE CODE

Subtitle A – Income Taxes

Chapter 1 – Normal Taxes And Surtaxes

Subchapter O – Gain Or Loss On Disposition Of Property

Part III – Common Nontaxable Exchanges

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Section 1031

of

The Internal Revenue Code

Exchange Of Property Held For

Productive Use Or For Investment

- **(a) Non-recognition Of Gain Or Loss From Exchanges Solely In Kind**
  - (1) In general

    No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

  - (2) Exception

    This subsection shall not apply to any exchange of -

    - (A) stock in trade or other property held primarily for sale,
    - (B) stocks, bonds, or notes,
    - (C) other securities or evidences of indebtedness or interest,
    - (D) interests in a partnership,
    - (E) certificates of trust or beneficial interests, or
    - (F) choses in action.

For purposes of this section, an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.

  - (3) Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property

For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if -

    - (A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

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- (B) such property is received after the earlier of -
  - (i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or
  - (ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

- **(b) Gain From Exchanges Not Solely In Kind**

  If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

- **(c) Loss From Exchanges Not Solely In Kind**

  If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

- **(d) Basis**

  If property was acquired on an exchange described in this section, section 1035(a), section 1036(a), or section 1037(a), then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by this section, section 1035(a), section 1036(a), or section 1037(a), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. For purposes of this section, section 1035(a), and section 1036(a), where as part of the consideration to the taxpayer another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the

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amount of the liability) shall be considered as money received by the taxpayer on the exchange.

- **(e) Exchanges Of Livestock Of Different Sexes**

  For purposes of this section, livestock of different sexes are not property of a like kind.

- **(f) Special Rules For Exchanges Between Related Persons**

  - (1) In general – If –

    - (A) a taxpayer exchanges property with a related person,

    - (B) there is non-recognition of gain or loss to the taxpayer under this section with respect to the exchange of such property (determined without regard to this subsection), and

    - (C) before the date 2 years after the date of the last transfer which was part of such exchange -

      - (i) the related person disposes of such property, or

      - (ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer, there shall be no non-recognition of gain or loss under this section to the taxpayer with respect to such exchange; except that any gain or loss recognized by the taxpayer by reason of this subsection shall be taken into account as of the date on which the disposition referred to in subparagraph (C) occurs.

  - (2) Certain dispositions not taken into account

    For purposes of paragraph (1)(C), there shall not be taken into account any disposition -

    - (A) after the earlier of the death of the taxpayer or the death of the related person,

    - (B) in a compulsory or involuntary conversion (within the meaning of section 1033) if the exchange occurred before the threat or imminence of such conversion, or

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    - (C) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.

  - (3) Related person

    For purposes of this subsection, the term "related person" means any person bearing a relationship to the taxpayer described in section 267(b) or 707(b)(1).

  - (4) Treatment of certain transactions

    This section shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection.

- **(g) Special Rule Where Substantial Diminution Of Risk**

  - (1) In general

    If paragraph (2) applies to any property for any period, the running of the period set forth in subsection (f)(1)(C) with respect to such property shall be suspended during such period.

  - (2) Property to which subsection applies

    This paragraph shall apply to any property for any period during which the holder's risk of loss with respect to the property is substantially diminished by -

    - (A) the holding of a put with respect to such property,

    - (B) the holding by another person of a right to acquire such property, or

    - (C) a short sale or any other transaction.

- **(h) Special Rule For Foreign Real And Personal Property**

  For purposes of this section –

  - (1) Real property

    Real property located in the United States and real property located outside the United States are not property of a like kind.

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- (2) Personal property
  - (A) In general,

    Personal property used predominantly within the United States and personal property used predominantly outside the United States are not property of a like kind.

  - (B) Predominant Use

    Except as provided in subparagraph (C) and (D), the predominant use of any property shall be determined based on –

    - (i) in the case of the property relinquished in the exchange, the 2-year period ending on the date of such relinquishment, and
    - in the case of the property acquired in the exchange, the 2-year period beginning on the date of such acquisition.

  - (C) Property held for less than 2 years

    Except in the case of an exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection –

    - (i) only the period the property was held by the person relinquishing the property (or any related person) shall be taken into account under subparagraph (b) (i), and
    - (ii) only the periods the property was held by the person acquiring the property (or any related person) shall be taken into account under subparagraph (B) (ii).

  - (D) Special rule for certain property

    Property described in any subparagraph of section 168 (g) (4) shall be treated as used predominantly in the United States.

-- END --

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Appendix C

Section 1.1031 of the Department of the Treasury Regulations

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TITLE 26 -- INTERNAL REVENUE SERVICE REGULATIONS

CHAPTER I -- INTERNAL REVENUE SERVICE
DEPARTMENT OF THE TREASURY

SUBCHAPTER A -- INCOME TAX

PART 1 -- INCOME TAXES

NORMAL TAXES AND SURTAXES

GAIN OR LOSS ON DISPOSITION OF PROPERTY

COMMON NONTAXABLE EXCHANGES

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§ 1.1031 (a)-2(b)(3) Product Classes

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END OF INDEX

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§ 1.1031(a)-1 Property held for productive use in a trade or business or for investment.

(a) In general—

(1) Exchanges of property solely for property of a like kind.

Section 1031(a)(1) provides an exception from the general rule requiring the recognition of gain or loss upon the sale or exchange of property. Under section 1031(a)(1), no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment. Under section 1031(a)(1), property held for productive use in a trade or business may be exchanged for property held for investment. Similarly, under section 1031(a)(1), property held for investment may be exchanged for property held for productive use in a trade or business. However, section 1031(a)(2) provides that section 1031(a)(1) does not apply to any exchange of--

(i) Stock in trade or other property held primarily for sale;

(ii) Stocks, bonds, or notes;

(iii) Other securities or evidences of indebtedness or interest;

(iv) Interests in a partnership;

(v) Certificates of trust or beneficial interests; or

(vi) Choses in action.

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. An exchange of an interest in such a partnership does not qualify for nonrecognition of gain or loss under section 1031 with respect to any asset of the partnership that is described in section 1031(a)(2) or to the extent the exchange of assets of the partnership does not otherwise satisfy the requirements of section 1031(a).

(2) Exchanges of property not solely for property of a like kind.

A transfer is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or property which does not meet the requirements of section 1031(a), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). Similarly, a transfer is not within the

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provisions of section 1031(a) if, as part of the consideration, the other party to the exchange assumes a liability of the taxpayer (or acquires property from the taxpayer that is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). A transfer of property meeting the requirements of section 1031(a) may be within the provisions of section 1031(a) even though the taxpayer transfers in addition property not meeting the requirements of section 1031(a) or money. However, the nonrecognition treatment provided by section 1031(a) does not apply to the property transferred which does not meet the requirements of section 1031(a).

(b) Definition of "like kind."

As used in section 1031(a), the words like kind have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. 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. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale. For additional rules for exchanges of personal property, see § 1.1031 (a)-2.

(c) Examples of exchanges of property of a "like kind."

No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

(d) Examples of exchanges not solely in kind.

Gain or loss is recognized if, for instance, a taxpayer exchanges (1) Treasury bonds maturing March 15, 1958, for Treasury bonds maturing December 15, 1968, unless section 1037(a) (or so much of section 1031 as relates to section 1037(a)) applies to such exchange, or (2) a real estate mortgage for consolidated farm loan bonds.

(e) Effective date relating to exchanges of partnership interests.

The provisions of paragraph (a)(1) of this section relating to exchanges of partnership interests apply to transfers of property made by taxpayers on or after April 25, 1991.

§ 1.1031(a)-2 Additional rules for exchanges of personal property.

(a) Introduction.

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Section 1.1031(a)-1(b) provides that the nonrecognition rules of section 1031 do not apply to an exchange of one kind or class of property for property of a different kind or class. This section contains additional rules for determining whether personal property has been exchanged for property of a like kind or like class. Personal properties of a like class are considered to be of a "like kind" for purposes of section 1031. In addition, an exchange of properties of a like kind may qualify under section 1031 regardless of whether the properties are also of a like class. In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class. Under paragraph (b) of this section, depreciable tangible personal properties are of a like class if they are either within the same General Asset Class (as defined in paragraph (b)(2) of this section) or within the same Product Class (as defined in paragraph (b)(3) of this section). Paragraph (c) of this section provides rules for exchanges of intangible personal property and nondepreciable personal property.

(b) Depreciable tangible personal property –

(1) General rule.

Depreciable tangible personal property is exchanged for property of a "like kind" under section 1031 if the property is exchanged for property of a like kind or like class. Depreciable tangible personal property is of a like class to other depreciable tangible personal property if the exchanged properties are either within the same General Asset Class or within the same Product Class. A single property may not be classified within more than one General Asset Class or within more than one Product Class. In addition, property classified within any General Asset Class may not be classified within a Product Class. A property's General Asset Class or Product Class is determined as of the date of the exchange.

(2) General Asset Classes.

Except as provided in paragraphs (b)(4) and (b)(5) of this section, property within a General Asset Class consists of depreciable tangible personal property described in one of asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87-56, 1987-2 C.B. 674. These General Asset Classes describe types of depreciable tangible personal property that frequently are used in many businesses.

The General Asset Classes are as follows:

(i) Office furniture, fixtures, and equipment (asset class 00.11),

(ii) Information systems (computers and peripheral equipment) (asset class 00.12),

(iii) Data handling equipment, except computers (asset class 00.13),

(iv) Airplanes (airframes and engines), except those used in commercial or contract

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carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21),

(v) Automobiles, taxis (asset class 00.22),

(vi) Buses (asset class 00.23),

(vii) Light general purpose trucks (asset class 00.241),

(viii) Heavy general purpose trucks (asset class 00.242),

(ix) Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25),

(x) Tractor units for use over-the-road (asset class 00.26),

(xi) Trailers and trailer-mounted containers (asset class 00.27),

(xii) Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28), and

(xiii) Industrial steam and electric generation and/or distribution systems (asset class 00.4).

(3) Product classes.

Except as provided in paragraphs (b)(4) and (5) of this section, or as provided by the Commissioner in published guidance of general applicability, property within a product class consists of depreciable tangible personal property that is described in a 6-digit product class within Sectors 31, 32, and 33 (pertaining to manufacturing industries) of the North American Industry Classification System (NAICS), set forth in Executive Office of the President, Office of Management and Budget, North American Industry Classification System, United States, 2002 (NAICS Manual), as periodically updated. Copies of the NAICS Manual may be obtained from the National Technical Information Service, an agency of the U.S. Department of Commerce, and may be accessed on the internet. Sectors 31 through 33 of the NAICS Manual contain listings of specialized industries for the manufacture of described products and equipment. For this purpose, any 6-digit NAICS product class with a last digit of 9 (a miscellaneous category) is not a product class for purposes of this section. If a property is listed in more than one product class, the property is treated as listed in any one of those product classes. A property's 6-digit product class is referred to as the property's NAICS code.

(4) Modifications of NAICS product classes.

The product classes of the NAICS Manual may be updated or otherwise modified from time to time as the manual is updated, effective on or after the date of the

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modification. The NAICS Manual generally is modified every five years, in years ending in a 2 or 7 (such as 2002, 2007, and 2012). The applicability date of the modified NAICS Manual is announced in the Federal Register and generally is January 1 of the year the NAICS Manual is modified. Taxpayers may rely on these modifications as they become effective in structuring exchanges under this section. Taxpayers may rely on the previous NAICS Manual for transfers of property made by a taxpayer during the one-year period following the effective date of the modification. For transfers of property made by a taxpayer on or after January 1, 1997, and on or before January 1, 2003, the NAICS Manual of 1997 may be used for determining product classes of the exchanged property.

(5) Administrative procedures for revising general asset classes and product classes.

The Commissioner may, through published guidance of general applicability, supplement, modify, clarify, or update the guidance relating to the classification of properties provided in this paragraph (b). (See § 601.601(d)(2) of this chapter.) For example, the Commissioner may determine not to follow (in whole or in part) a general asset class for purposes of identifying property of like class, may determine not to follow (in whole or in part) any modification of product classes published in the NAICS Manual, or may determine that other properties not listed within the same or in any product class or general asset class nevertheless are of a like class. The Commissioner also may determine that two items of property that are listed in separate product classes or in product classes with a last digit of 9 are of a like class, or that an item of property that has a NAICS code is of a like class to an item of property that does not have a NAICS code.

(6) No inference outside of section 1031.

The rules provided in this section concerning the use of general asset classes or product classes are limited to exchanges under section 1031. No inference is intended with respect to the classification of property for other purposes, such as depreciation.

(7) Examples.

The application of this paragraph (b) may be illustrated by the following examples:

Example 1. Taxpayer A transfers a personal computer (asset class 00.12) to B in exchange for a printer (asset class 00.12). With respect to A, the properties exchanged are within the same General Asset Class and therefore are of a like class.

Example 2. Taxpayer C transfers an airplane (asset class 00.21) to D in exchange for a heavy general purpose truck (asset class 00.242). The properties exchanged are not of a like class because they are within different General Asset Classes. Because each of the properties is within a General Asset Class, the properties may not be classified within a Product Class. The airplane and heavy general purpose truck are also not of a like kind. Therefore, the exchange does not qualify for nonrecognition of gain or loss under section 1031.

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Example 3. Taxpayer E transfers a grader to F in exchange for a scraper. Neither property is within any of the general asset classes. However, both properties are within the same product class (NAICS code 333120). The grader and scraper are of a like class and deemed to be of a like kind for purposes of section 1031.

Example 4. Taxpayer G transfers a personal computer (asset class 00.12), an airplane (asset class 00.21) and a sanding machine (NAICS code 333210), to H in exchange for a printer (asset class 00.12), a heavy general purpose truck (asset class 00.242) and a lathe (NAICS code 333210). The personal computer and the printer are of a like class because they are within the same general asset class. The sanding machine and the lathe are of a like class because they are within the same product class (although neither property is within any of the general asset classes). The airplane and the heavy general purpose truck are neither within the same general asset class nor within the same product class, and are not of a like kind.

(8) Transition rule.

Properties within the same product classes based on the 4-digit codes contained in Division D of the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (1987), will be treated as property of a like class for transfers of property made by taxpayers on or before May 19, 2005.

(c) Intangible personal property and nondepreciable personal property –

(1) General rule.

An exchange of intangible personal property of nondepreciable personal property qualifies for nonrecognition of gain or loss under section 1031 only if the exchanged properties are of a like kind. No like classes are provided for these properties. Whether intangible personal property is of a like kind to other intangible personal property generally depends on the nature or character of the rights involved (e.g., a patent or a copyright) and also on the nature or character of the underlying property to which the intangible personal property relates.

(2) Goodwill and going concern value.

The goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business.

(3) Examples.

The application of this paragraph (c) may be illustrated by the following examples:

Example (1). Taxpayer K exchanges a copyright on a novel for a copyright on a different novel. The properties exchanged are of a like kind.

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Example (2). Taxpayer J exchanges a copyright on a novel for a copyright on a song. The properties exchanged are not of a like kind.

(d) Effective date.

Except as otherwise provided in this paragraph (d), this section applies to exchanges occurring on or after April 11, 1991. Paragraphs (b)(3) through (b)(6), Example 3 and Example 4 of paragraph (b)(7), and paragraph (b)(8) of this section apply to transfers of property made by taxpayers on or after August 12, 2004. However, taxpayers may apply paragraphs (b)(3) through (b)(6), and Example 3 and Example 4 of paragraph (b)(7) of this section to transfers of property made by taxpayers on or after January 1, 1997, in taxable years for which the period of limitation for filing a claim for refund or credit under section 6511 has not expired.

§ 1.1031(b)-1 Receipt of other property or money in tax-free exchange

(a) If the taxpayer receives other property (in addition to property permitted to be received without recognition of gain) or money--

(1) 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,

(2) In an exchange described in section 1035(a) of insurance policies or annuity contracts,

(3) In an exchange described in section 1036(a) of common stock for common stock, or preferred stock for preferred stock, in the same corporation and not in connection with a corporate reorganization, or

(4) In an exchange described in section 1037(a) of obligations of the United States, issued under the Second Liberty Bond Act (31 U.S.C. 774 (2)), solely for other obligations issued under such Act, 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, but the loss, if any, to the taxpayer from such an exchange will not be recognized under section 1031(c) to any extent.

(b) The application of this section may be illustrated by the following examples:

Example 1. A, who is not a dealer in real estate, in 1954 exchanges real estate held for investment, which he purchased in 1940 for $ 5,000, for other real estate (to be held for productive use in trade or business) which has a fair market value of $ 6,000, and $ 2,000 in cash. The gain from the transaction is $ 3,000, but is recognized only to the extent of the cash received of $ 2,000.

Example 2. (a) B, who uses the cash receipts and disbursements method of accounting and the calendar year as his taxable year, has never elected under section 454(a) to

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include in gross income currently the annual increase in the redemption price of non-interest-bearing obligations issued at a discount. In 1943, for $ 750 each, B purchased four $ 1,000 series E U.S. savings bonds bearing an issue date of March 1, 1943.

(b) On October 1, 1963, the redemption value of each such bond was $ 1,396, and the total redemption value of the four bonds was $ 5,584. On that date B submitted the four $ 1,000 series E bonds to the United States in a transaction in which one of such $ 1,000 bonds was reissued by issuing four $ 100 series E U.S. savings bonds bearing an issue date of March 1, 1943, and by considering six $ 100 series E bonds bearing an issue date of March 1, 1943, to have been issued. The redemption value of each such $ 100 series E bond was $ 139.60 on October 1, 1963. Then, as part of the transaction, the six $ 100 series E bonds so considered to have been issued and the three $ 1,000 series E bonds were exchanged, in an exchange qualifying under section 1037(a), for five $ 1,000 series H U.S. savings bonds plus $ 25.60 in cash.

(c) The gain realized on the exchange qualifying under section 1037(a) is $ 2,325.60, determined as follows:

Amount realized:		
Par value of five series H bonds	$ 5,000.00	
Cash received	25.60	---------
Total realized	5,025.60	
Less: Adjusted basis of series E bonds surrendered in the exchange:		
Three $1,000 series E bonds	$ 2,250.00	
Six $100 series E bonds at $75 each	450.00	
		2,700.00
Gain realized	-------	2,325.60

(d) Pursuant to section 1031(b), only $ 25.60 (the money received) of the total gain of $ 2,325.60 realized on the exchange is recognized at the time of exchange and must be included in B's gross income for 1963. The $ 2,300 balance of the gain ($ 2,325.60 less $ 25.60) must be included in B's gross income for the taxable year in which the series H bonds are redeemed or disposed of, or reach final maturity, whichever is earlier, as provided in paragraph (c) of § 1.454-1.

(e) The gain on the four $ 100 series E bonds, determined by using $ 75 as a basis for each such bond, must be included in B's gross income for the taxable year in which such bonds are redeemed or disposed of, or reach final maturity, whichever is earlier.

Example 3. (a) The facts are the same as in example (2), except that, as part of the

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transaction, the $ 1,000 series E bond is reissued by considering ten $ 100 series E bonds bearing an issue date of March 1, 1943, to have been issued. Six of the $ 100 series E bonds so considered to have been issued are surrendered to the United States as part of the exchange qualifying under section 1037(a) and the other four are immediately redeemed.

(b) Pursuant to section 1031(b), only $ 25.60 (the money received) of the total gain of $ 2,325.60 realized on the exchange qualifying under section 1037(a) is recognized at the time of the exchange and must be included in B's gross income for 1963. The $ 2,300 balance of the gain ($ 2,325.60 less $ 25.60) realized on such exchange must be included in B's gross income for the taxable year in which the series H bonds are redeemed or disposed of, or reach final maturity, whichever is earlier, as provided in paragraph (c) of § 1.454-1.

(c) The redemption on October 1, 1963, of the four $ 100 series E bonds considered to have been issued at such time results in gain of $ 258.40, which is then recognized and must be included in B's gross income for 1963. This gain of $ 258.40 is the difference between the $ 558.40 redemption value of such bonds on the date of the exchange and the $ 300 (4 x $ 75) paid for such series E bonds in 1943.

Example 4. On November 1, 1963, C purchased for $ 91 a marketable U.S. bond which was originally issued at its par value of $ 100 under the Second Liberty Bond Act. On February 1, 1964, in an exchange qualifying under section 1037(a), C surrendered the bond to the United States for another marketable U.S. bond, which then had a fair market value of $ 92, and $ 1.85 in cash, $ 0.85 of which was interest. The $ 0.85 interest received is includible in gross income for the taxable year of the exchange, but the $ 2 gain ($ 93 less $ 91) realized on the exchange is recognized for such year under section 1031(b) to the extent of $ 1 (the money received). Under section 1031(d), C's basis in the bond received in exchange is $ 91 (his basis of $ 91 in the bond surrendered, reduced by the $ 1 money received and increased by the $ 1 gain recognized).

(c) Consideration received in the form of an assumption of liabilities (or a transfer subject to a liability) is to be treated as other property or money for the purposes of section 1031(b). Where, on an exchange described in section 1031(b), each party to the exchange eit her assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of other property or money for purposes of section 1031(b), consideration given in the form of an assumption of liabilities (or a receipt of property subject to a liability) shall be offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability). See § 1.1031(d)-2, examples (1) and (2).

§ 1.1031(b)-2 Safe harbor for Qualified Intermediaries (“Accommodator”)

(a) In the case of simultaneous transfers of like-kind properties involving a qualified intermediary (as defined in § 1.1031(k)-1(g)(4)(iii)), the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case,

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the transfer and receipt of property by the taxpayer is treated as an exchange.

(b) In the case of simultaneous exchanges of like-kind properties involving a qualified intermediary (as defined in § 1.1031(k)-1(g)(4)(iii)), the receipt by the taxpayer of an evidence of indebtedness of the transferee of the qualified intermediary is treated as the receipt of an evidence of indebtedness of the person acquiring property from the taxpayer for purposes of section 453 and § 15a.453-1(b)(3)(i) of this chapter.

(c) Paragraph (a) of this section applies to transfers of property made by taxpayers on or after June 10, 1991.

(d) Paragraph (b) of this section applies to transfers of property made by taxpayers on or after April 20, 1994. A taxpayer may choose to apply paragraph (b) of this section to transfers of property made on or after June 10, 1991.

§ 1.1031(c)-1 Nonrecognition of loss.

Section 1031(c) provides that a loss shall not be recognized from an exchange of property described in section 1031(a), 1035(a), 1036(a), or 1037(a) where there is received in the exchange other property or money in addition to property permitted to be received without recognition of gain or loss. See example (4) of paragraph (a)(3) of § 1.1037-1 for an illustration of the application of this section in the case of an exchange of U.S. obligations described in section 1037(a).

§ 1.1031(d)-1 Property acquired upon a tax-free exchange.

(a) If, in an exchange of property solely of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), 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 proper 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 regulations thereunder).

(b) If, in an exchange of properties of the type indicated in section 1031, section 1035(a), section 1036(a), or section 1037(a), 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 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. The application of this paragraph may be illustrated by the following example:

Example. A, an individual in the moving and storage business, in 1954 transfers one of his moving trucks with an adjusted basis in his hands of $ 2,500 to B in exchange for a truck (to be used in A's business) with a fair market value of $ 2,400 and $ 200

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in cash. A realizes a gain of $ 100 upon the exchange, all of which is recognized under section 1031(b). The basis of the truck acquired by A is determined as follows:

Adjusted basis of A's former truck	$ 2,500
Less: Amount of money received	200

Difference	2,300
Plus: Amount of gain recognized	100

Basis of truck acquired by A	2,400

(c) If, upon an exchange of properties of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), the taxpayer received other property (not permitted to be received without the recognition of gain) and gain from the transaction was recognized as required under section 1031(b), or a similar provision of a prior revenue law, the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of any money received and increased by the amount of gain recognized, must be allocated to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of the basis of the properties received, there must be assigned to such other property an amount equivalent to its fair market value at the date of the exchange.

The application of this paragraph may be illustrated by the following example:

Example. A, who is not a dealer in real estate, in 1954 transfers real estate held for investment which he purchased in 1940 for $ 10,000 in exchange for other real estate (to be held for investment) which has a fair market value of $ 9,000, an automobile which has a fair market value of $ 2,000, and $ 1,500 in cash. A realizes a gain of $ 2,500, all of which is recognized under section 1031(b). The basis of the property received in exchange is the basis of the real estate A transfers ($ 10,000) decreased by the amount of money received ($ 1,500) and increased in the amount of gain that was recognized ($ 2,500), which results in a basis for the property received of $ 11,000. This basis of $11,000 is allocated between the automobile and the real estate received by A, the basis of the automobile being its fair market value at the date of the exchange, $2,000, and the basis of the real estate received being the remainder, $9,000.

(d) Section 1031(c) and, with respect to section 1031 and section 1036(a), similar provisions of prior revenue laws provide that no loss may be recognized on an exchange of properties of a type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), although the taxpayer receives other property or money from the transaction. However, the basis of the property or properties (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be allocated to the properties received, and for this purpose there must be allocated to

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such other property an amount of such basis equivalent to its fair market value at the date of the exchange.

(e) If, upon an exchange of properties of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), the taxpayer also exchanged other property (not permitted to be transferred without the recognition of gain or loss) and gain or loss from the transaction is recognized under section 1002 or a similar provision of a prior revenue law, the basis of the property acquired is the total basis of the properties transferred (adjusted to the date of the exchange) increased by the amount of gain and decreased by the amount of loss recognized on the other property. For purposes of this rule, the taxpayer is deemed to have received in exchange for such other property an amount equal to its fair market value on the date of the exchange. The application of this paragraph may be illustrated by the following example:

Example. A exchanges real estate held for investment plus stock for real estate to be held for investment. The real estate transferred has an adjusted basis of $ 10,000 and a fair market value of $ 11,000. The stock transferred has an adjusted basis of $ 4,000 and a fair market value of $ 2,000. The real estate acquired has a fair market value of $ 13,000. A is deemed to have received a $ 2,000 portion of the acquired real estate in exchange for the stock, since $ 2,000 is the fair market value of the stock at the time of the exchange. A $ 2,000 loss is recognized under section 1002 on the exchange of the stock for real estate. No gain or loss is recognized on the exchange of the real estate since the property received is of the type permitted to be received without recognition of gain or loss. The basis of the real estate acquired by A is determined as follows:

Adjusted basis of real estate transferred	$10,000
Adjusted basis of stock transferred	4,000

	14,000
Less: Loss recognized on transfer of stock	2,000
Basis of real estate acquired upon the exchange	12,000

§ 1.1031(d)-1T Coordination of section 1060 with section 1031 (temporary)

If the properties exchanged under section 1031 are part of a group of assets which constitute a trade or business under section 1060, the like-kind property and other property or money which are treated as transferred in exchange for the like-kind property shall be excluded from the allocation rules of section 1060. However, section 1060 shall apply to property which is not like-kind property or other property or money which is treated as transferred in exchange for the like-kind property. For application of the section 1060 allocation rules to property which is not part of the like-kind exchange, see § 1.1060-1(b), (c), and (d)

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§ 1.1031(d)-2 Treatment of assumption of liabilities

For the purposes of section 1031(d), the amount of any liabilities of the taxpayer assumed by the other party to the exchange (or of any liabilities to which the property exchanged by the taxpayer is subject) is to be treated as money received by the taxpayer upon the exchange, whether or not the assumption resulted in a recognition of gain or loss to the taxpayer under the law applicable to the year in which the exchange was made. The application of this section may be illustrated by the following examples:

Example 1. B, an individual, owns an apartment house which has an adjusted basis in his hands of $ 500,000, but which is subject to a mortgage of $ 150,000. On September 1, 1954, he transfers the apartment house to C, receiving in exchange therefor $ 50,000 in cash and another apartment house with a fair market value on that date of $ 600,000. The transfer to C is made subject to the $ 150,000 mortgage. B realizes a gain of $ 300,000 on the exchange, computed as follows:

Value of property received		$ 600,000
Cash		50,000
Liabilities subject to which old property was transferred		150,000
Total consideration received		800,000
Less: Adjusted basis of property transferred		500,000
Gain realized		300,000
Under section 1031(b), $200,000 of the $300,000 gain is recognized. The basis of the apartment house acquired by B upon the exchange is $500,000, computed as follows: Adjusted basis of property transferred		500,000
Less: Amount of money received:		
Cash	$ 50,000	
Amount of liabilities subject to which property was transferred	150,000	
		200,000
Difference	------	300,000
Plus: Amount of gain recognized upon the exchange		200,000
Basis of property acquired upon the exchange		500,000

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Example 2. (a) D, an individual, owns an apartment house. On December 1, 1955, the apartment house owned by D has an adjusted basis in his hands of $ 100,000, a fair market value of $ 220,000, but is subject to a mortgage of $ 80,000. E, an individual, also owns an apartment house. On December 1, 1955, the apartment house owned by E has an adjusted basis of $ 175,000, a fair market value of $ 250,000, but is subject to a mortgage of $ 150,000. On December 1, 1955, D transfers his apartment house to E, receiving in exchange therefore $ 40,000 in cash and the apartment house owned by E. Each apartment house is transferred subject to the mortgage on it.

(b) D realizes a gain of $ 120,000 on the exchange, computed as follows:

Value of property received	-------	$ 250,000
Cash	40,000	
Liabilities subject to which old property was transferred	80,000	-------
Total consideration received	370,000	
Less:		
Adjusted basis of property transferred	$ 100,000	
Liabilities to which new property is subject	150,000	
	250,000	
Gain realized	-------	120,000

For purposes of section 1031(b), the amount of other property or money received by D is $40,000. (Consideration received by D in the form of a transfer subject to a liability of $ 80,000 is offset by consideration given in the form of a receipt of property subject to a $ 150,000 liability. Thus, only the consideration received in the form of cash, $40,000 is treated as other property or money for purposes of section 1031(b).) Accordingly, under section 1031(b), $40,000 of the $120,000 gain is recognized. The basis of the apartment house acquired by D is $ 170,000, computed as follows:

Adjusted basis of property transferred	$ 100,000	
Liabilities to which new property is subject	150,000	--------
Total	250,000	
Less: Amount of money received: Cash	$ 40,000	
Amount of liabilities subject to which property was transferred	80,000	

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	120,000	
Difference	130,000	
Plus: Amount of gain recognized upon the exchange	40,000	-------
Basis of property acquired upon the exchange	170,000	

(c) E realizes a gain of $ 75,000 on the exchange, computed as follows:

Value of property received	$ 220,000	
Liabilities subject to which old property was transferred	150,000	-------
Total consideration received	370,000	
Less:		
Adjusted basis of property transferred	$ 175,000	
Cash	40,000	
Liabilities to which new property is subject	80,000	
	295,000	
Gain realized	75,000	

For purposes of section 1031(b), the amount of other property or money received by E is $ 30,000. (Consideration received by E in the form of a transfer subject to a liability of $ 150,000 is offset by consideration given in the form of a receipt of property subject to an $ 80,000 liability and by the $ 40,000 cash paid by E. Although consideration received in the form of cash or other property is not offset by consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability, consideration given in the form of cash or other property is offset against consideration received in the form of an assumption of liabilities or a transfer of property subject to a liability.) Accordingly, under section 1031(b), $ 30,000 of the $ 75,000 gain is recognized. The basis of the apartment house acquired by E is $ 175,000, computed as follows:

Adjusted basis of property transferred	$ 175,000	
Cash	40,000	
Liabilities to which new property is subject	80,000	-------
Total	295,000	

Less: Amount of money received: Amount of liabilities subject to which property was

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Transferred	$ 150,000	
	150,000	
Difference	145,000	
Plus: Amount of gain recognized upon the exchange	30,000	--------
Basis of property acquired upon the exchange	175,000	

§ 1.1031(e)-1 Exchanges of livestock of the different sexes.

Section 1031(e) provides that livestock of different sexes are not property of like kind. Section 1031(e) and this section are applicable to taxable years to which the Internal Revenue Code of 1954 applies.

§ 1.1031(j)-1 Exchanges of multiple properties.

(a) Introduction –

(1) Overview.

As a general rule, the application of section 1031 requires a property-by-property comparison for computing the gain recognized and basis of property received in a like-kind exchange. This section provides an exception to this general rule in the case of an exchange of multiple properties. An exchange is an exchange of multiple properties if, under paragraph (b)(2) of this section, more than one exchange group is created. In addition, an exchange is an exchange of multiple properties if only one exchange group is created but there is more than one property being transferred or received within that exchange group. Paragraph (b) of this section provides rules for computing the amount of gain recognized in an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031. Paragraph (c) of this section provides rules for computing the basis of properties received in an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031.

(2) General approach.

(i) In general, the amount of gain recognized in an exchange of multiple properties is computed by first separating the properties transferred and the properties received by the taxpayer in the exchange into exchange groups in the manner described in paragraph (b)(2) of this section. The separation of the properties transferred and the properties received in the exchange into exchange groups involves matching up properties of a like kind of like class to the extent possible. Next, all liabilities assumed by the taxpayer as part of the transaction are offset by all liabilities of which the taxpayer is relieved as part of the transaction, with the excess liabilities assumed or relieved allocated in accordance with paragraph (b)(2)(ii) of this section. Then, the rules of section 1031 and the regulations thereunder are applied separately to each exchange group to determine the amount of gain recognized in the exchange. See §§

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1.1031(b)-1 and 1.1031(c)-1. Finally, the rules of section 1031 and the regulations thereunder are applied separately to each exchange group to determine the basis of the properties received in the exchange. See §§ 1.1031(d)-1 and 1.1031(d)-2.

(ii) For purposes of this section, the exchanges are assumed to be made at arms' length, so that the aggregate fair market value of the property received in the exchange equals the aggregate fair market value of the property transferred. Thus, the amount realized with respect to the properties transferred in each exchange group is assumed to equal their aggregate fair market value.

(b) Computation of gain recognized --

(1) In general.

In computing the amount of gain recognized in an exchange of multiple properties, the fair market value must be determined for each property transferred and for each property received by the taxpayer in the exchange. In addition, the adjusted basis must be determined for each property transferred by the taxpayer in the exchange.

(2) Exchange groups and residual group.

The properties transferred and the properties received by the taxpayer in the exchange are separated into exchange groups and a residual group to the extent provided in this paragraph (b)(2).

(i) Exchange groups. Each exchange group consists of the properties transferred and received in the exchange, all of which are of a like kind or like class. If a property could be included in more than one exchange group, the taxpayer may include the property in any of those exchange groups. Property eligible for inclusion within an exchange group does not include money or property described in section 1031(a)(2) (i.e., stock in trade or other property held primarily for sale, stocks, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action). For example, an exchange group may consist of all exchanged properties that are within the same General Asset Class or within the same Product Class (as defined in § 1.1031(a)-2(b)). Each exchange group must consist of at least one property transferred and at least one property received in the exchange.

(ii) Treatment of liabilities. (A) All liabilities assumed by the taxpayer as part of the exchange are offset against all liabilities of which the taxpayer is relieved as part of the exchange, regardless of whether the liabilities are recourse or nonrecourse and regardless of whether the liabilities are secured by or otherwise relate to specific property transferred or received as part of the exchange. See §§ 1.1031 (b)-1(c) and 1.1031(d)-2. For purposes of this section, liabilities assumed by the taxpayer as part of the exchange consist of liabilities of the other party to the exchange assumed by the taxpayer and liabilities subject to which the other party's property is transferred in the exchange. Similarly, liabilities of which the taxpayer is relieved as part of the exchange

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consist of liabilities of the taxpayer assumed by the other party to the exchange and liabilities subject to which the taxpayer's property is transferred.

(B) If there are excess liabilities assumed by the taxpayer as part of the exchange (i.e., the amount of liabilities assumed by the taxpayer exceeds the amount of liabilities of which the taxpayer is relieved), the excess is allocated among the exchange groups (but not to the residual group) in proportion to the aggregate fair market value of the properties received by the taxpayer in the exchange groups. The amount of excess liabilities assumed by the taxpayer that are allocated to each exchange group may not exceed the aggregate fair market value of the properties received in the exchange group.

(C) If there are excess liabilities of which the taxpayer is relieved as part of the exchange (i.e., the amount of liabilities of which the taxpayer is relieved exceeds the amount of liabilities assumed by the taxpayer), the excess is treated as a Class I asset for purposes of making allocations to the residual group under paragraph (b)(2)(iii) of this section.

(D) Paragraphs (b)(2)(ii) (A), (B), and (C) of this section are applied in the same manner even if section 1031 and this section apply to only a portion of a larger transaction (such as a transaction described in section 1060(c) and § 1.1060-1T(b)). In that event, the amount of excess liabilities assumed by the taxpayer or the amount of excess liabilities of which the taxpayer is relieved is determined based on all liabilities assumed by the taxpayer and all liabilities of which the taxpayer is relieve as part of the larger transaction.

(iii) Residual group. If the aggregate fair market value of the properties transferred in all of the exchange groups differs from the aggregate fair market value of the properties received in all of the exchange groups (taking liabilities into account in the manner described in paragraph (b)(2)(ii) of this section), a residual group is created. The residual group consists of an amount of money or other property having an aggregate fair market value equal to that difference. The residual group consists of either money or other property transferred in the exchange or money or other property received in the exchange, but not both. For this purpose, other property includes property described in section 1031(a)(2) (i.e., stock in trade or other property held primarily for sale, stocks, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action), property transferred that is not of a like kind or like class with any property received, and property received that is not of a like kind or like class with any property transferred. The money and properties that are allocated to the residual group are considered to come from the following assets in the following order: first from Class I assets, then from Class II assets, then from Class III assets, and then from Class IV assets. The terms Class I assets, Class II assets, Class III assets, and Class IV assets have the same meanings as in § 1.338-6(b), to which reference is made by § 1.1060-1(c)(2). Within each Class, taxpayers may choose which properties are allocated to the residual group.

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(iv) Exchange group surplus and deficiency. For each of the exchange groups described in this section, an "exchange group surplus" or "exchange group deficiency," if any, must be determined. An exchange group surplus is the excess of the aggregate fair market value of the properties received (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group), in an exchange group over the aggregate fair market value of the properties transferred in that exchange group. An exchange group deficiency is the excess of the aggregate fair market value of the properties transferred in an exchange group over the aggregate fair market value of the properties received (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group) in that exchange group.

(3) Amount of gain recognized. –

(i) For purposes of this section, the amount of gain or loss realized with respect to each exchange group and the residual group is the difference between the aggregate fair market value of the properties transferred in that exchange group or residual group and the properties' aggregate adjusted basis. The gain realized with respect to each exchange group is recognized to the extent of the lesser of the gain realized and the amount of the exchange group deficiency, if any. Losses realized with respect to an exchange group are not recognized. See section 1031 (a) and (c). The total amount of gain recognized under section 1031 in the exchange is the sum of the amount of gain recognized with respect to each exchange group. With respect to the residual group, the gain or loss realized (as determined under this section) is recognized as provided in section 1001 or other applicable provision of the Code.

(ii) The amount of gain or loss realized and recognized with respect to properties transferred by the taxpayer that are not within any exchange group or the residual group is determined under section 1001 and other applicable provisions of the Code, with proper adjustments made for all liabilities not allocated to the exchange groups or the residual group.

(c) Computation of basis of properties received.

In an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031 and this section, the aggregate basis of properties received in each of the exchange groups is the aggregate adjusted basis of the properties transferred by the taxpayer within that exchange group, increased by the amount of gain recognized by the taxpayer with respect to that exchange group, increased by the amount of the exchange group surplus or decreased by the amount of the exchange group deficiency, and increased by the amount, if any, of excess liabilities assumed by the taxpayer that are allocated to that exchange group. The resulting aggregate basis of each exchange group is allocated proportionately to each property received in the exchange group in accordance with its fair market value. The basis of each property received within the residual group (other than money) is equal to its fair market value.

(d) Examples.

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The application of this section may be illustrated by the following examples:

Example 1. (i) K exchanges computer A (asset class 00.12) and automobile A (asset class 00.22), both of which were held by K for productive use in its business, with W for printer B (asset class 00.12) and automobile B (asset class 00.22), both of which will be held by K for productive use in its business. K's adjusted basis and the fair market value of the exchanged properties are as follows:

	Adjusted basis	**Fair market value**
Computer A	$375	$1,000
Automobile A	1,500	4,000
Printer B		2,050
Automobile B		2,950

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A and printer B (both are within the same General Asset Class) and, as to K, has an exchange group surplus of $ 1050 because the fair market value of printer B ($ 2050) exceeds the fair market value of computer A ($ 1000) by that amount.

(B) The second exchange group consists of automobile A and automobile B (both are within the same General Asset Class) and, as to K, has an exchange group deficiency of $ 1050 because the fair market value of automobile A ($ 4000) exceeds the fair market value of automobile B ($ 2950) by that amount.

(iii) K recognizes gain on the exchange as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A ($ 1000) over its adjusted basis ($ 375), or $ 625. The amount of gain recognized is the lesser of the gain realized ($ 625) and the exchange group deficiency ($ 0), or $ 0.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A ($ 4000) over its adjusted basis ($ 1500), or $ 2500. The amount of gain recognized is the lesser of the gain realized ($ 2500) and the exchange group deficiency ($ 1050), or $ 1050.

(iv) The total amount of gain recognized by K in the exchange is the sum of the gains recognized with respect to both exchange groups ($ 0 + $ 1050), or $ 1050.

(v) The bases of the property received by K in the exchange, printer B and automobile

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B, are determined in the following manner:

(A) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within the exchange group ($ 375), increased by the amount of gain recognized with respect to that exchange group ($ 0), increased by the amount of the exchange group surplus ($ 1050), and increased by the amount of excess liabilities assumed allocated to that exchange group ($ 0), or $ 1425. Because printer B was the only property received within the first exchange group, the entire basis of $ 1425 is allocated to printer B.

(B) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($ 1500), increased by the amount of gain recognized with respect to that exchange group ($ 1050), decreased by the amount of the exchange group deficiency ($ 1050), and increased by the amount of excess liabilities assumed allocated to that exchange group ($ 0), or $ 1500. Because automobile B was the only property received within the second exchange group, the entire basis of $ 1500 is allocated to automobile B.

Example 2. (i) F exchanges computer A (asset class 00.12) and automobile A (asset class 00.22), both of which were held by F for productive use in its business, with G for printer B (asset class 00.12) and automobile B (asset class 00.22), both of which will be held by F for productive use in its business, and corporate stock and $ 500 cash. The adjusted basis and fair market value of the properties are as follows:

	Adjusted basis	**Fair market value**
Computer A	$375	$1,000
Automobile A	3,500	4,000
Printer B		800
Automobile B		2,950
Corporate stock		750
Cash		500

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A and printer B (both are within the same General Asset Class) and, as to F, has an exchange group deficiency of $ 200 because the fair market value of computer A ($ 1000) exceeds the fair market value of printer B ($ 800) by that amount.

(B) The second exchange group consists of automobile A and automobile B (both are within the same General Asset Class) and, as to F, has an exchange group deficiency of $ 1050 because the fair market value of automobile A ($ 4000) exceeds the fair market value of automobile B ($ 2950) by that amount.

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(C) Because the aggregate fair market value of the properties transferred by F in the exchange groups ($ 5,000) exceeds the aggregate fair market value of the properties received by F in the exchange groups ($ 3750) by $ 1250, there is a residual group in that amount consisting of the $ 500 cash and the $ 750 worth of corporate stock.

(iii) F recognizes gain on the exchange as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A ($ 1000) over its adjusted basis ($ 375), or $ 625. The amount of gain recognized is the lesser of the gain realized ($ 625) and the exchange group deficiency ($ 200), or $ 200.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A ($ 4000) over its adjusted basis ($ 3500), or $ 500. The amount of gain recognized is the lesser of the gain realized ($ 500) and the exchange group deficiency ($ 1050), or $ 500.

(C) No property transferred by F was allocated to the residual group. Therefore, F does not recognize gain or loss with respect to the residual group.

(iv) The total amount of gain recognized by F in the exchange is the sum of the gains recognized with respect to both exchange groups ($ 200 + $ 500), or $ 700.

(v) The bases of the properties received by F in the exchange (printer B, automobile B, and the corporate stock) are determined in the following manner:

(A) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($ 375), increased by the amount of gain recognized with respect to that exchange group ($ 200), decreased by the amount of the exchange group deficiency ($ 200), and increased by the amount of excess liabilities assumed allocated to that exchange group ($ 0), or $ 375. Because printer B was the only property received within the first exchange group, the entire basis of $ 375 is allocated to printer B.

(B) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($ 3500), increased by the amount of gain recognized with respect to that exchange group ($ 500), decreased by the amount of the exchange group deficiency ($ 1050), and increased by the amount of excess liabilites assumed allocated to that exchange group ($ 0), or $ 2950. Because automobile B was the only property received within the second exchange group, the entire basis of $ 2950 is allocated to automobile B.

(C) The basis of the property received within the residual group (the corporate stock) is equal to its fair market value or $ 750. Cash of $ 500 is also received within the residual group.

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Example 3. (i) J and H enter into an exchange of the following properties. All of the property (except for the inventory) transferred by J was held for productive use in J's business. All of the property received by J will be held by J for productive use in its business.

J Transfers:			**H transfers:**	
Property	**Adjusted basis**	**Fair market value**	**Property**	**Fair market value**
Computer A	$1,500	$5,000	Computer Z	$4,500
Computer B	500	3,000	Printer Y	2,500
Printer C	2,000	1,500	Real Estate X	1,000
Real Estate D	1,200	2,000	Real Estate W	4,000
Real Estate E	0	1,800	Grader V	2,000
Scraper F	3,300	2,500	Truck T	1,700
Inventory	1,000	1,700	Cash	1,800
	----------	----------		----------
Total	9,500	17,500		17,500

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A, computer B, printer C, computer Z, and printer Y (all are within the same General Asset Class) and, as to J, has an exchange group deficiency of $ 2500 (($ 5000 + $ 3000 + $ 1500) - ($ 4500 + $ 2500)).

(B) The second exchange group consists of real estate D, E, X and W (all are of a like kind) and, as to J, has an exchange group surplus of $ 1200 (($ 1000 + $ 4000) - ($ 2000 + $ 1800)).

(C) The third exchange group consists of scraper F and grader V (both are within the same Product Class (NAICS code 333120)) and, as to J, has an exchange group deficiency of $ 500 ($ 2500 - $ 2000).

(D) Because the aggregate fair market value of the properties transferred by J in the exchange groups ($ 15,800) exceeds the aggregate fair market value of the properties received by J in the exchange groups ($ 14,000) by $ 1800, there is a residual group in that amount consisting of the $ 1800 cash (a Class I asset).

(E) The transaction also includes a taxable exchange of inventory (which is property described in section 1031 (a)(2)) for truck T (which is not of a like kind or like class to any property transferred in the exchange).

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(iii) J recognizes gain on the transaction as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the aggregate fair market value of the properties transferred in the exchange group ($ 9500) over the aggregate adjusted basis ($ 4000), or $ 5500. The amount of gain recognized is the lesser of the gain realized ($ 5500) and the exchange group deficiency ($ 2500), or $ 2500.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the aggregate fair market value of the properties transferred in the exchange group ($ 3800) over the aggregate adjusted basis ($ 1200), or $ 2600. The amount of gain recognized is the lesser of the gain realized ($ 2600) and the exchange group deficiency ($ 0), or $ 0.

(C) With respect to the third exchange group, a loss is realized in the amount of $ 800 because the fair market value of the property transferred in the exchange group ($ 2500) is less than its adjusted basis ($ 3300). Although a loss of $ 800 was realized, under section 1031 (a) and (c) losses are not recognized.

(D) No property transferred by J was allocated to the residual group. Therefore, J does not recognize gain or loss with respect to the residual group.

(E) With respect to the taxable exchange of inventory for truck T, gain of $ 700 is realized and recognized by J (amount realized of $ 1700 (the fair market value of truck T) less the adjusted basis of the inventory ($ 1000)).

(iv) The total amount of gain recognized by J in the transaction is the sum of the gains recognized under section 1031 with respect to each exchange group ($ 2500 + $ 0 + $ 0) and any gain recognized outside of section 1031 ($ 700), or $ 3200.

(v) The bases of the property received by J in the exchange are determined in the following manner:

(A) The aggregate basis of the properties received in the first exchange group is the adjusted basis of the properties transferred within that exchange group ($ 4000), increased by the amount of gain recognized with respect to that exchange group ($ 2500), decreased by the amount of the exchange group deficiency ($ 2500), and increased by the amount of excess liabilities assumed allocated to that exchange group ($ 0), or $ 4000. This $ 4000 of basis is allocated proportionately among the assets received within the first exchange group in accordance with their fair market values: Computer Z's basis is $ 2571 ($ 4000 x $ 4500/$ 7000); printer Y's basis is $ 1429 ($ 4000 x $ 2500/$ 7000).

(B) The aggregate basis of the properties received in the second exchange group is the adjusted basis of the properties transferred within that exchange group ($ 1200), increased by the amount of gain recognized with respect to that exchange group ($ 0), increased by the amount of the exchange group surplus ($ 1200), and increased by

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the amount of excess liabilities assumed allocated to that exchange group ($ 0), or $ 2400. This $ 2400 of basis is allocated proportionately among the assets received within the second exchange group in accordance with their fair market values: Real estate X's basis is $ 480 ($ 2400 x $ 1000/$ 5000); real estate W's basis is $ 1920 ($ 2400 x $ 4000/$ 5000).

(c) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group ($ 3300), increased by the amount of gain recognized with respect to that exchange group ($ 0), decreased by the amount of the exchange group deficiency ($ 500), and increased by the amount of excess liabilities assumed allocated to that exchange group ($ 0), or $ 2800. Because grader V was the only property received within the third exchange group, the entire basis of $ 2800 is allocated to grader V.

(D) Cash of $ 1800 is received within the residual group.

(E) The basis of the property received in the taxable exchange (truck T) is equal to its cost of $ 1700.

Example 4. (i) B exchanges computer A (asset class 00.12), automobile A (asset class 00.22) and truck A (asset class 00.241), with C for computer R (asset class 00.12), automobile R (asset class 00.22), truck R (asset class 00.241) and $ 400 cash. All properties transferred by either B or C were held for productive use in the respective transferor's business. Similarly, all properties to be received by either B or C will be held for productive use in the respective recipient's business. Automobile A, automobile R and truck R are each secured by a nonrecourse liability and are transferred subject to such liability. The adjusted basis, fair market value, and liability secured by each property, if any, are as follows:

	Adjusted basis	**Fair market value**	**Liability**
B transfers:			
Computer A	$800	$1,500	$0
Automobile A	900	2,500	500
Truck A	700	2,000	0
C transfers:			
Computer R	1,100	1,600	0
Automobile R	2,100	3,100	750
Truck R	600	1,400	250
Cash		400	

(ii) The tax treatment to B is as follows:

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(A)(1) The first exchange group consists of computers A and R (both are within the same General Asset Class).

(2) The second exchange group consists of automobiles A and R (both are within the same General Asset Class).

(3) The third exchange group consists of trucks A and R (both are in the same General Asset Class).

(B) Under paragraph (b)(2)(ii) of this section, all liabilities assumed by B ($ 1000) are offset by all liabilities of which B is relieved ($ 500), resulting in excess liabilities assumed of $ 500. The excess liabilities assumed of $ 500 is allocated among the exchange groups in proportion to the fair market value of the properties received by B in the exchange groups as follows:

(1) $ 131 of excess liabilities assumed ($ 500 x $ 1600/$ 6100) is allocated to the first exchange group. The first exchange group has an exchange group deficiency of $ 31 because the fair market value of computer A ($ 1500) exceeds the fair market value of computer R less the excess liabilities assumed allocated to the exchange group ($ 1600-$ 131) by that amount.

(2) $ 254 of excess liabilities assumed ($ 500 x $ 3100/$ 6100) is allocated to the second exchange group. The second exchange group has an exchange group surplus of $ 346 because the fair market value of automobile R less the excess liabilities assumed allocated to the exchange group ($ 3100-$ 254) exceeds the fair market value of automobile A ($ 2500) by that amount.

(3) $ 115 of excess liabilities assumed ($ 500 x $ 1400/$ 6100) is allocated to the third exchange group. The third exchange group has an exchange group deficiency of $ 715 because the fair market value of truck A ($ 2000) exceeds the fair market value of truck R less the excess liabilities assumed allocated to the exchange group ($ 1400-$ 115) by that amount.

(4) The difference between the aggregate fair market value of the properties transferred in all of the exchange groups, $ 6000, and the aggregate fair market value of the properties received in all of the exchange groups (taking excess liabilities assumed into account), $ 5600, is $ 400. Therefore there is a residual group in that amount consisting of $ 400 cash received.

(C) B recognizes gain on the exchange as follows:

(1) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A ($ 1500) over its adjusted basis ($ 800), or $ 700. The amount of gain recognized is the lesser of the gain realized ($ 700) and the exchange group deficiency ($ 31), or $ 31.

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(2) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A ($ 2500) over its adjusted basis ($ 900), or $ 1600.

The amount of gain recognized is the lesser of the gain realized ($ 1600) and the exchange group deficiency ($ 0), or $ 0.

(3) With respect to the third exchange group, the amount of gain realized is the excess of the fair market value of truck A ($ 2000) over its adjusted basis ($ 700), or $ 1300. The amount of gain recognized is the lesser of gain realized ($ 1300) and the exchange group deficiency ($ 715), or $ 715.

(4) No property transferred by B was allocated to the residual group. Therefore, B does not recognize gain or loss with respect to the residual group.

(D) The total amount of gain recognized by B in the exchange is the sum of the gains recognized under section 1031 with respect to each exchange group ($ 31 + $ 0 +$ 715), or $ 746.

(E) the bases of the property received by B in the exchange (computer R, automobile R, and truck R) are determined in the following manner:

(1) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($ 800), increased by the amount of gain recognized with respect to that exchange group ($ 31), decreased by the amount of the exchange group deficiency ($ 31), and increased by the amount of excess liabilities assumed allocated to that exchange group ($ 131), or $ 931. Because computer R was the only property received within the first exchange group, the entire basis of $ 931 is allocated to computer R.

(2) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($ 900), increased by the amount of gain recognized with respect to that exchange group ($ 0), increased by the amount of the exchange group surplus ($ 346), and increased by the amount of excess liabilities assumed allocated to that exchange group ($ 254), or $ 1500. Because automobile R was the only property received within the second exchange group, the entire basis of $ 1500 is allocated to automobile R.

(3) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group ($ 700), increased by the amount of gain recognized with respect to that exchange group ($ 715), decreased by the amount of the exchange group deficiency ($ 715), and increased by the amount of excess liabilities assumed allocated to that exchange group ($ 115), or $ 815. Because truck R was the only property received within the third exchange group, the entire basis of $ 815 is allocated to truck R.

(F) Cash of $ 400 is also received by B.

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(iii) The tax treatment to C is as follows:

(A) (1) The first exchange group consists of computers R and A (both are within the same General Asset Class).

(2) The second exchange group consists of automobiles R and A (both are within the same General Asset Class).

(3) The third exchange group consists of trucks R and A (both are in the same General Asset Class).

(B) Under paragraph (b)(2)(ii) of this section, all liabilities of which C is relieved ($ 1000) are offset by all liabilities assumed by C ($ 500), resulting in excess liabilities relieved of $ 500. This excess liabilities relieved is treated as cash received by C.

(1) The first exchange group has an exchange group deficiency of $ 100 because the fair market value of computer R ($ 1600) exceeds the fair market value of computer A ($ 1500) by that amount.

(2) The second exchange group has an exchange group deficiency of $ 600 because the fair market value of automobile R ($ 3100) exceeds the fair market value of automobile A ($ 2500) by that amount.

(3) The third exchange group has an exchange group surplus of $ 600 because the fair market value of truck A ($ 2000) exceeds the fair market value of truck R ($ 1400) by that amount.

(4) The difference between the aggregate fair market value of the properties transferred by C in all of the exchange groups, $ 6100, and the aggregate fair market value of the properties received by C in all of the exchange groups, $ 6000, is $ 100. Therefore, there is a residual group in that amount, consisting of excess liabilities relieved of $ 100, which is treated as cash received by C.

(5) The $ 400 cash paid by C and $ 400 of the excess liabilities relieved which is treated as cash received by C are not within the exchange groups of the residual group.

(C) C recognizes gain on the exchange as follows:

(1) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer R ($ 1600) over its adjusted basis ($ 1100), or $ 500. The amount of gain recognized is the lesser of the gain realized ($ 500) and the exchange group deficiency ($ 100), or $ 100.

(2) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile R ($ 3100) over its adjusted basis ($

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2100), or $ 1000. The amount of gain recognized is the lesser of the gain realized ($ 1000) and the exchange group deficiency ($ 600), or $ 600.

(3) With respect to the third exchange group, the amount of gain realized is the excess of the fair market value of truck R ($ 1400) over its adjusted basis ($ 600), or $ 800. The amount of gain recognized is the lesser of gain realized ($ 800) and the exchange group deficiency ($ 0), or $ 0.

(4) No property transferred by C was allocated to the residual group. Therefore, C does not recognize any gain with respect to the residual group.

(D) The total amount of gain recognized by C in the exchange is the sum of the gains recognized under section 1031 with respect to each exchange group ($ 100+$ 600+$ 0), or $ 700.

(E) The bases of the properties received by C in the exchange (computer A, automobile A, and truck A) are determined in the following manner:

(1) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($ 1100), increased by the amount of gain recognized with respect to that exchange group ($ 100), decreased by the amount of the exchange group deficiency ($ 100), and increased by the amount of excess liabilities assumed allocated to that exchange group ($ 0), or $ 1100. Because computer A was the only property received within the first exchange group, the entire basis of $ 1100 is allocated to computer A.

(2) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($ 2100), increased by the amount of gain recognized with respect to that exchange group ($ 600), decreased by the amount of the exchange group deficiency ($ 600), and increased by the amount of excess liabilities assumed allocated to that exchange group ($ 0), or $ 2100. Because automobile A was the only property received within the second exchange group, the entire basis of $ 2100 is allocated to automobile A.

(3) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group ($ 600), increased by the amount of gain recognized with respect to that exchange group ($ 0), increased by the amount of the exchange group surplus ($ 600), and increased by the amount of excess liabilities assumed allocated to that exchange group ($ 0), or $ 1200. Because truck A was the only property received within the third exchange group, the entire basis of $ 1200 is allocated to truck A.

Example 5. (i) U exchanges real estate A, real estate B, and grader A (NAICS code 333120) with V for real estate R and railroad car R (General Asset Class 00.25). All properties transferred by either U or V were held for productive use in the respective transferor's business. Similarly, all properties to be received by either U or V will be held for productive use in the respective recipient's business. Real estate R is secured

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by a recourse liability and is transferred subject to that liability. The adjusted basis, fair market value, and liability secured by each property, if any, are as follows:

	Adjusted basis	Fair market value	Liability
U Transfers:			
Real Estate A	$2000	$5000	
Real Estate B	8000	13,500	
Grader A	500	2000	
V Transfers:			
Real Estate R	$20,000	$26,500	$7000
Railroad car R	1200	1000	

(ii) The tax treatment to U is as follows:

(A) The exchange group consists of real estate A, real estate B, and real estate R.

(B) Under paragraph (b)(2)(ii) of this section, all liabilities assumed by U ($ 7000) are excess liabilities assumed. The excess liabilities assumed of $ 7000 is allocated to the exchange group.

(1) The exchange group has an exchange group surplus of $ 1000 because the fair market value of real estate R less the excess liabilities assumed allocated to the exchange group ($ 26,500-$ 7000) exceeds the aggregate fair market value of real estate A and B ($ 18,500) by that amount.

(2) The difference between the aggregate fair market value of the properties received in the exchange group (taking excess liabilities assumed into account), $ 19,500, and the aggregate fair market value of the properties transferred in the exchange group, $ 18,500, is $ 1000. Therefore, there is a residual group in that amount consisting of $ 1000 (or 50 percent of the fair market value) of grader A.

(3) The transaction also includes a taxable exchange of the 50 percent portion of grader A not allocated to the residual group (which is not of a like kind or like class to any property received by U in the exchange) for railroad car R (which is not of a like kind or like class to any property transferred by U in the exchange).

(C) U recognizes gain on the exchange as follows:

(1) With respect to the exchange group, the amount of the gain realized is the excess of the aggregate fair market value of real estate A and B ($ 18,500) over the aggregate adjusted basis ($ 10,000), or $ 8500. The amount of the gain recognized is the lesser of the gain realized ($ 8500) and the exchange group deficiency ($ 0), or $ 0.

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(2) With respect to the residual group, the amount of gain realized and recognized is the excess of the fair market value of the 50 percent portion of grader A that is allocated to the residual group ($ 1000) over its adjusted basis ($ 250), or $ 750.

(3) With respect to the taxable exchange of the 50 percent portion of grader A not allocated to the residual group for railroad car R, gain of $ 750 is realized and recognized by U (amount realized of $ 1000 (the fair market value of railroad car R) less the adjusted basis of the 50 percent portion of grader A not allocated to the residual group ($ 250)).

(D) The total amount of gain recognized by U in the transaction is the sum of the gain recognized under section 1031 with respect to the exchange group ($ 0), any gain recognized with respect to the residual group ($ 750), and any gain recognized with respect to property transferred that is not in the exchange group or the residual group ($ 750), or $ 1500.

(E) The bases of the property received by U in the exchange (real estate R and railroad car R) are determined in the following manner:

(1) The basis of the property received in the exchange group is the aggregate adjusted basis of the property transferred within that exchange group ($ 10,000), increased by the amount of gain recognized with respect to that exchange group ($ 0), increased by the amount of the exchange group surplus ($ 1000), and increased by the amount of excess liabilities assumed allocated to that exchange group ($ 7000), or $ 18,000. Because real estate R is the only property received within the exchange group, the entire basis of $ 18,000 is allocated to real estate R.

(2) The basis of railroad car R is equal to its cost of $ 1000.

(iii) The tax treatment to V is as follows:

(A) The exchange group consists of real estate R, real estate A, and real estate B.

(B) Under paragraph (b)(2)(ii) of this section, the liabilities of which V is relieved ($ 7000) results in excess liabilities relieved of $ 7000 and is treated as cash received by V.

(1) The exchange group has an exchange group deficiency of $ 8000 because the fair market value of real estate R ($ 26,500) exceeds the aggregate fair market value of real estate A and B ($ 18,500) by that amount.

(2) The difference between the aggregate fair market value of the properties transferred by V in the exchange group, $ 26,500, and the aggregate fair market value of the properties received by V in the exchange group, $ 18,500, is $ 8000. Therefore, there is a residual group in that amount, consisting of the excess liabilities relieved of $ 7000, which is treated as cash received by V, and $ 1000 (or 50 percent of the fair market value) of grader A.

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(3) The transaction also includes a taxable exchange of railroad car R (which is not of a like kind or like class to any property received by V in the exchange) for the 50 percent portion of grader A (which is not of a like kind or like class to any property transferred by V in the exchange) not allocated to the residual group.

(C) V recognizes gain on the exchange as follows:

(1) With respect to the exchange group, the amount of the gain realized is the excess of the fair market value of real estate R ($ 26,500) over its adjusted basis ($ 20,000), or $ 6500. The amount of the gain recognized is the lesser of the gain realized ($ 6500) and the exchange group deficiency ($ 8000), or $ 6500.

(2) No property transferred by V was allocated to the residual group. Therefore, V does not recognize gain or loss with respect to the residual group.

(3) With respect to the taxable exchange of railroad car R for the 50 percent portion of grader A not allocated to the exchange group or the residual group, a loss is realized and recognized in the amount of $ 200 (the excess of the $ 1200 adjusted basis of railroad car R over the amount realized of $ 1000 (fair market value of the 50 percent portion of grader A)).

(D) The basis of the property received by V in the exchange (real estate A, real estate B, and grader A) are determined in the following manner:

(1) The basis of the property received in the exchange group is the adjusted basis of the property transferred within that exchange group ($ 20,000), increased by the amount of gain recognized with respect to that exchange group ($ 6500), and decreased by the amount of the exchange group deficiency ($ 8000), or $ 18,500. This $ 18,500 of basis is allocated proportionately among the assets received within the exchange group in accordance with their fair market values: real estate A's basis is $ 5000 ($ 18,500 $ 5000/$ 18,500); real estate B's basis is $ 13,500 ($ 18,500 $ 13,500/$ 18,500).

(2) The basis of grader A is $ 2000.

(e) Effective date.

Section 1.1031 (j)-1 is effective for exchanges occurring on or after April 11, 1991.

§ 1.1031(K)-1 Treatment of deferred exchanges.

(a) Overview.

This section provides rules for the application of section 1031 and the regulations thereunder in the case of a "deferred exchange." For purposes of section 1031 and this section, a deferred exchange is defined as an exchange in which, pursuant to an

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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 the case of a deferred exchange, if the requirements set forth in paragraphs (b), (c), and (d) of this section (relating to identification and receipt of replacement property) are not satisfied, the replacement property received by the taxpayer will be treated as property which is not of a like kind to the relinquished property. In order to constitute a deferred exchange, the transaction must be an exchange (i.e., a transfer of property for property, as distinguished from a transfer of property for money). For example, a sale of property followed by a purchase of property of a like kind does not qualify for nonrecognition of gain or loss under section 1031 regardless of whether the identification and receipt requirements of section 1031(a)(3) and paragraphs (b), (c), and (d) of this section are satisfied. The transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or property which does not meet the requirements of section 1031(a), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). See § 1.1031(a)-1(a)(2). 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. For purposes of this section, property which does not meet the requirements of section 1031(a) (whether by being described in section 1031(a)(2) or otherwise) is referred to as "other property." For rules regarding actual and constructive receipt, and safe harbors therefrom, see paragraphs (f) and (g), respectively, of this section. For rules regarding the determination of gain or loss recognized and the basis of property received in a deferred exchange, see paragraph (j) of this section.

(b) Identification and receipt requirements –

(1) In general.

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 --

(i) The replacement property is not "identified" before the end of the "identification period," or

(ii) The identified replacement property is not received before the end of the "exchange period."

(2) Identification period and exchange period.

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(i) The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th day thereafter.

(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.

(iv) For purposes of this paragraph (b)(2), property is transferred when the property is disposed of within the meaning of section 1001(a).

(3) Example.

This paragraph (b) may be illustrated by the following example.

Example. (i) M is a corporation that files its Federal income tax return on a calendar year basis. M and C enter into an agreement for an exchange of property that requires M to transfer property X to C. Under the agreement, M is to identify like-kind replacement property which C is required to purchase and to transfer to M. M transfers property X to C on November 16, 1992.

(ii) The identification period ends at midnight on December 31, 1992, the day which is 45 days after the date of transfer of property X. The exchange period ends at midnight on March 15, 1993, the due date for M's Federal income tax return for the taxable year in which M transferred property X. However, if M is allowed the automatic six-month extension for filing its tax return, the exchange period ends at midnight on May 15, 1993, the day which is 180 days after the date of transfer of property X.

(c) Identification of replacement property before the end of the identification period –

(1) In general.

For purposes of paragraph (b)(1)(i) of this section (relating to the identification requirement), replacement property is identified before the end of the identification period only if the requirements of this paragraph (c) are satisfied with respect to the replacement property. However, any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

(2) Manner of identifying replacement property.

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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 (regardless of whether that person is a disqualified person as defined in paragraph (k) of this section); or

(ii) Any other person involved in the exchange other than the taxpayer or a disqualified person (as defined in paragraph (k) of this section).

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).

(3) Description of replacement property.

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 (e.g., the Mayfair Apartment Building). Personal property generally is unambiguously described if it is described by a specific description of the particular type of property. For example, a truck generally is unambigously described if it is described by a specific make, model, and year.

(4) Alternative and multiple properties.

(i) The taxpayer may identify more than one replacement property. Regardless of the number of relinguished 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 relinguished properties as of the date the relinguished properties were transferred by the taxpayer (the "200-percent rule").

(ii) 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. The preceding sentence will not apply, however, and an identification satisfying the requirements of paragraph (c)(4)(i) of this section will be considered made, with respect

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to --

(A) Any replacement property received by the taxpayer before the end of the identification period, and

(B) Any replacement property identified before the end of the identification period and received before the end of the exchange period, but only if the taxpayer receives before the end of the exchange period identified replacement property the fair market vlaue of which is at least 95 percent of the aggregate fair market value of all identified replacement properties (the "95-percent rule").

For this purpose, the fair market value of each identified replacement property is determined as of the earlier of the date the property is received by the taxpayer or the last day of the exchange period.

(iii) For purposes of applying the 3-property rule, the 200-percent rule, and the 95-percent rule, all identifications of replacement property, other than identifications of replacement property that have been revoked in the manner provided in paragraph (c)(6) of this section, are taken into account. For example, if, in a deferred exchange, B transfers property X with a fair market value of $ 100,000 to C and B receives like-kind property Y with a fair market value of $ 50,000 before the end of the identification period, under paragraph (c)(1) of this section, property Y is treated as identified by reason of being received before the end of the identification period. Thus, under paragraph (c)(4)(i) of this section, B may identify either two additional replacement properties of any fair market value or any number of additional replacement properties as long as the aggregate fair market value of the additional replacement properties does not exceed $ 150,000.

(5) Incidental property disregarded. (i) Solely for purposes of applying this paragraph (c), property that is incidental to a larger item of property is not treated as property that is separate from the larger item of property. Property is incidental to a larger item of property if --

(A) In standard commercial transactions, the property is typically transferred together with the larger item of property, and

(B) The aggregate fair market value of all of the incidental property does not exceed 15 percent of the aggregate fair market value of the larger item of property.

(ii) This paragraph (c)(5) may be illustrated by the following examples.

Example 1. For purposes of paragraph (c) of this section, a spare tire and tool kit will not be treated as separate property from a truck with a fair market value of $ 10,000, if the aggregate fair market value of the spare tire and tool kit does not exceed $ 1,500. For purposes of the 3-property rule, the truck, spare tire, and tool kit are treated as 1 property. Moreover, for purposes of paragraph (c)(3) of this section (relating to the description of replacement property), the truck, spare tire, and tool kit are all

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considered to be unambiguously described if the make, model, and year of the truck are specified, even if no reference is made to the spare tire and tool kit.

Example 2. For purposes of paragraph (c) of this section, furniture, laundry machines, and other miscellaneous items of personal property will not be treated as separate property from an apartment building with a fair market value of $ 1,000,000, if the aggregate fair market value of the furniture, laundry machines, and other personal property does not exceed $ 150,000. For purposes of the 3-property rule, the apartment building, furniture, laundry machines, and other personal property are treated as 1 property. Moreover, for purposes of paragraph (c)(3) of this section (relating to the description of replacement property), the apartment building, furniture, laundry machines, and other personal property are all considered to be unambiguously described if the legal description, street address, or distinguishable name of the apartment building is specified, even if no reference is made to the furniture, laundry machines, and other personal property.

(6) Revocation of identification.

An identification of replacement property may be revoked at any time before the end of the identification period. An identification of replacement property is revoked only if the revocation is made in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or othewise sent before the end of the identification period to the person to whom the identification of the replacement property was sent. An identification of replacement property that is made in a written agreement for the exchange of properties is treated as revoked only if the revocation is made in a written amendment to the agreement or in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or othewise sent before the end of the identification period to all of the parties to the agreement.

(7) Examples.

This paragraph (c) may be illustrated by the following examples.

Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $ 100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. No replacement property is identified in the agreement. When subsequently identified, the replacement property is described by legal description and is of a like kind to real property X (determined without regard to

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section 1031(a)(3) and this section). B intends to hold the replacement property received for investment.

Example 1. (i) On July 2, 1991, B identifies real property E as replacement property by designating real property E as replacement property in a written document signed by B and personally delivered to C.

(ii) Because the identification was made after the end of the identification period, pursuant to paragraph (b)(1)(i) of this section (relating to the identification requirement), real property E is treated as property which is not of a like kind to real property X.

Example 2. (i) C is a corporation of which 20 percent of the outstanding stock is owned by B. On July 1, 1991, B identifies real property F as replacement property by designating real property F as replacement property in a written document signed by B and mailed to C.

(ii) Because C is the person obligated to transfer the replacement property to B, real property F is identified before the end of the identification period. The fact that C is a "disqualified person" as defined in paragraph (k) of this section does not change this result.

(iii) Real property F would also have been treated as identified before the end of the identification period if, instead of sending the identification to C, B had designated real property F as replacement property in a written agreement for the exchange of properties signed by all parties thereto on or before July 1, 1991.

Example 3. (i) On June 3, 1991, B identifies the replacement property as "unimproved land located in Hood County with a fair market value not to exceed $ 100,000." The designation is made in a written document signed by B and personally delivered to C. On July 8, 1991, B and C agree that real property G is the property described in the June 3, 1991 document.

(ii) Because real property G was not unambiguously described before the end of the identification period, no replacement property is identified before the end of the identification period.

Example 4. (i) On June 28, 1991, B identifies real properties H, J, and K as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. The written document provides that by August 1, 1991, B will orally inform C which of the identified properties C is to transfer to B. As of July 1, 1991, the fair market values of real properties H, J, and K are $ 75,000, $ 100,000, and $ 125,000, respectively.

(ii) Because B did not identify more than three properties as replacement properties, the requirements of the 3-property rule are satisfied, and real properties H, J, and K are all identified before the end of the identification period.

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Example 5. (i) On May 17, 1991, B identifies real properties L, M, N, and P as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. The written document provides that by July 2, 1991, B will orally inform C which of the identified properties C is to transfer to B. As of July 1, 1991, the fair market values of real properties L, M, N, and P are $ 30,000, $ 40,000, $ 50,000, and $ 60,000, respectively.

(ii) Although B identified more than three properties as replacement properties, the aggregate fair market value of the identified properties as of the end of the identification period ($ 180,000) did not exceed 200 percent of the aggregate fair market value of real property X (200% X $ 100,000=$ 200,000). Therefore, the requirements of the 200-percent rule are satisfied, and real properties L, M, N, and P are all identified before the end of the identification period.

Example 6. (i) On June 21, 1991, B identifies real properties Q, R, and S as replacement properties by designating these properties as replacement properties in a written document signed by B and mailed to C. On June 24, 1991, B identifies real properties T and U as replacement properties in a written document signed by B and mailed to C. On June 28, 1991, B revokes the identification of real properties Q and R in a written document signed by B and personally delivered to C.

(ii) B has revoked the identification of real properties Q and R in the manner provided by paragraph (c)(6) of this section. Identifications of replacement property that have been revoked in the manner provided by paragraph (c)(6) of this section are not taken into account for purposes of applying the 3-property rule. Thus, as of June 28, 1991, B has identified only replacement properties S, T, and U for purposes of the 3-property rule. Because B did not identify more than three properties as replacement properties for purposes of the 3-property rule, the requirements of that rule are satisfied, and real properties S, T, and U are all identified before the end of the identification period.

Example 7. (i) On May 20, 1991, B identifies real properties V and W as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. On June 4, 1991, B identifies real properties Y and Z as replacement properties in the same manner. On June 5, 1991, B telephones C and orally revokes the identification of real properties V and W. As of July 1, 1991, the fair market values of real properties V, W, Y, and Z are $ 50,000, $ 70,000, $ 90,000, and $ 100,000, respectively. On July 31, 1991, C purchases real property Y and Z and transfers them to B.

(ii) Pursuant to paragraph (c)(6) of this section (relating to revocation of identification), the oral revocation of the identification of real properties V and W is invalid. Thus, the identification of real properties V and W is taken into account for purposes of determining whether the requirements of paragraph (c)(4) of this section (relating to the identification of alternative and multiple properties) are satisfied. Because B identified more than three properties and the aggregate fair market value of the identified properties as of the end of the identification period ($ 310,000) exceeds 200

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percent of the fair market value of real property X (200% X $ 100,000 = $ 200,000), the requirements of paragraph (c)(4) of this section are not satisfied, and B is treated as if B did not identify any replacement property.

(d) Receipt of identified replacement property -- (1) In general. For purposes of paragraph (b)(1)(ii) of this section (relating to the receipt requirement), the identified replacement property is received before the end of the exchange period only if the requriements of this paragraph (d) are satisfied with respect to the replacement property. 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.

If the taxpayer has identified more than one replacement property, section 1031(a)(3)(B) and this paragraph (d) are applied separately to each replacement property.

(2) Examples. This paragraph (d) may be illustrated by the following examples. The following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $ 100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. The replacement property is identified in a manner that satisfies paragraph (c) of this section (relating to identification of replacement property) and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

Example 1. (i) In the agreement, B identifies real properties J, K, and L as replacement properties. The agreement provides that by July 26, 1991, B will orally inform C which of the properties C is to transfer to B.

(ii) As of July 1, 1991, the fair market values of real properties J, K, and L are $ 75,000, $ 100,000, and $ 125,000, respectively. On July 26, 1991, B instructs C to acquire real property K. On October 31, 1991, C purchases real property K for $ 100,000 and transfers the property to B.

(iii) Because real property K was identified before the end of the identification period

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and was received before the end of the exchange period, the identification and receipt requirements of section 1031(a)(3) and this section are satisfied with respect to real property K.

Example 2. (i) In the agreement, B identifies real property P as replacement property. Real property P consists of two acres of unimproved land. On October 15, 1991, the owner of real property P erects a fence on the property. On November 1, 1991, C purchases real property P and transfers it to B.

(ii) The erection of the fence on real property P subsequent to its identification did not alter the basic nature or character of real property P as unimproved land. B is considered to have received substantially the same property as identified.

Example 3. (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.

Example 4. (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 11/2 acres of real property R for $ 187,500 and transfers it to B, and B pays $ 87,500 to C.

(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.

(e) Special rules for identification and receipt of replacement property to be produced –

(1) In general.

A transfer of relinquished property in a deferred exchange will not fail to qualify for nonrecognition of gain or loss under section 1031 merely because the replacement property is not in existence or is being produced at the time the property is identified as replacement property. For purposes of this paragraph (e), the terms "produced" and "production" have the same meanings as provided in section 263A(g)(1) and the regulations thereunder.

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(2) Identification of replacement property to be produced.

(i) In the case of replacement property that is to be produced, the replacement property must be identified as provided in paragraph (c) of this section (relating to identification of replacement property). 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.

(ii) For purposes of paragraphs (c)(4)(i)(B) and (c)(5) of this section (relating to the 200-percent rule and incidental property), the fair market value of replacement property that is to be produced is its estimated fair market value as of the date it is expected to be received by the taxpayer.

(3) Receipt of replacement property to be produced.

(i) For purposes of paragraph (d)(1)(ii) of this section (relating to receipt of the identified replacement property), in determining whether the replacement property received by the taxpayer is substantially the same property as identified where the identified replacement property is property to be produced, variations due to usual or typical production changes are not taken into account. However, if substantial changes are made in the property to be produced, the replacement property received will not be considered to be substantially the same property as identified.

(ii) If the identified replacement property is personal property to be produced, the replacement property received will not be considered to be substantially the same property as identified unless production of the replacement property received is completed on or before the date the property is received by the taxpayer.

(iii) 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.

(4) Additional rules.

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

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property after the property is received by the taxpayer will not be treated as the receipt of property of a like kind.

(5) Example.

This paragraph (e) may be illustrated by the following example.

Example. (i) B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers improved real property X and personal property Y to C on May 17, 1991. On or before November 13, 1991 (the end of the exchange period), C is required to transfer to B real property M, on which C is constructing improvements, and personal property N, which C is producing. C is obligated to complete the improvements and production regardless of when properties M and N are transferred to B. Properties M and N are identified in a manner that satisfies paragraphs (c) (relating to identification of replacement property) and (e)(2) of this section. In addition, properties M and N are of a like kind, respectively, to real property X and personal property Y (determined without regard to section 1031(a)(3) and this section). On November 13, 1991, when construction of the improvements to property M is 20 percent completed and the production of property N is 90 percent completed, C transfers to B property M and property N. If construction of the improvements had been completed, property M would have been considered to be substantially the same property as identified. Under local law, property M constitutes real property to the extent of the underlying land and the 20 percent of the construction that is completed.

(ii) Because property N is personal property to be produced and production of property N is not completed before the date the property is received by B, property N is not considered to be substantially the same property as identified and is treated as property which is not of a like kind to property Y.

(iii) Property M is considered to be substantially the same property as identified to the extent of the underlying land and the 20 percent of the construction that is completed when property M is received by B. However, any additional construction performed by C with respect to property M after November 13, 1991, is not treated as the receipt of property of a like kind.

(f) Receipt of money or other property –

(1) In general.

A transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or other property. However, such a transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). See § 1031(a)-1(a)(2). 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 other property before the taxpayer actually receives like-kind replacement property. If the taxpayer

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actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

(2) Actual and constructive receipt.

Except as provided in paragraph (g) of this section (relating to safe harbors), for purposes of section 1031 and this section, the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. The taxpayer is in actual receipt of money or property at the time the taxpayer actually receives the money or property or receives the economic benefit of the money or property. The taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given. Although the taxpayer is not in constructive receipt of money or property if the taxpayer's control of its receipt is subject to substantial limitations or restrictions, the taxpayer is in constructive receipt of the money or property at the time the limitations or restrictions lapse, expire, or are waived. In addition, actual or constructive receipt of money or property by an agent of the taxpayer (determined without regard to paragraph (k) of this section) is actual or constructive receipt by the taxpayer.

(3) Example.

This paragraph (f) may be illustrated by the following example.

Example. (i) B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to the agreement, on May 17, 1991, B transfers real property X to C. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $ 100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. At any time after May 17, 1991, and before C has purchased the replacement property, B has the right, upon notice, to demand that C pay $ 100,000 in lieu of acquiring and transferring the replacement property. Pursuant to the agreement, B identifies replacement property, and C purchases the replacement property and transfers it to B.

(ii) Under the agreement, B has the unrestricted right to demand the payment of $ 100,000 as of May 17, 1991. B is therefore in constructive receipt of $ 100,000 on that date. Because B is in constructive receipt of money in the full amount of the

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consideration for the relinquished property before B actually receives the like-kind replacement property, the transaction constitutes a sale, and the transfer of real property X does not qualify for nonrecognition of gain or loss under section 1031. B is treated as if B received the $ 100,000 in consideration for the sale of real property X and then purchased the like-kind replacement property.

(iii) If B's right to demand payment of the $ 100,000 were subject to a substantial limitation or restriction (e.g., the agreement provided that B had no right to demand payment before November 14, 1991 (the end of the exchange period)), then, for purposes of this section, B would not be in actual or constructive receipt of the money unless (or until) the limitation or restriction lapsed, expired, or was waived.

(g) Safe harbors –

(1) In general.

Paragraphs (g)(2) through (g)(5) of this section set forth four safe harbors the use of which will result in a determination that the taxpayer is not in actual or constructive receipt of money or other property for purposes of section 1031 and this section. More than one safe harbor can be used in the same deferred exchange, but the terms and conditions of each must be separately satisfied. For purposes of the safe harbor rules, the term "taxpayer" does not include a person or entity utilized in a safe harbor (e.g., a qualified intermediary). See paragraph (g)(8), Example 3(v), of this section.

(2) Security or guarantee arrangements.

(i) In the case of a deferred exchange, 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 will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured or guaranteed by one or more of the following --

(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 § 15A.453-1 (b)(3)(iii) and which may not be drawn upon in the absence of a default of the transferee's obligation to transfer like-kind replacement property to the taxpayer, or

(C) A guarantee of a third party.

(ii) Paragraph (g)(2)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive money or other property pursuant to the security or guarantee arrangement.

(3) Qualified escrow accounts and qualified trusts.

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(i) In the case of a deferred exchange, 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 will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured by cash or a cash equivalent if the cash or cash equivalent is held in a qualified escrow account or in a qualified trust.

(ii) A qualified escrow account is an escrow account wherein --

(A) The escrow holder is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and

(B) The escrow agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account as provided in paragraph (g)(6) of this section.

(iii) A qualified trust is a trust wherein --

(A) The trustee is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section, except that for this purpose the relationship between the taxpayer and the trustee created by the qualified trust will not be considered a relationship under section 267(b)), and

(B) The trust agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held by the trustee as provided in paragraph (g)(6) of this section.

(iv) Paragraph (g)(3)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the qualified escrow account or qualified trust. Rights conferred upon the taxpayer under state law to terminate or dismiss the escrow holder of a qualified escrow account or the trustee of a qualified trust are disregarded for this purpose.

(v) A taxpayer may receive money or other property directly from a party to the exchange, but not from a qualified escrow account or a qualified trust, without affecting the application of paragraph (g)(3)(i) of this section.

(4) Qualified intermediaries.

(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

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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 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.

(iii) A qualified intermediary is a person who --

(A) Is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and

(B) Enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

(iv) Regardless of whether an intermediary acquires and transfers property under general tax principals, solely for purposes of paragraph (g)(4)(iii)(B) of this section --

(A) An intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property,

(b) An intermediary is treated as acquiring and transferring the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person, and

(C) An intermediary is treated as acquiring and transferring replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer.

(v) Solely for purposes of paragraphs (g)(4)(iii) and (g)(4)(iv) of this section, an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevent transfer of property. For example, if a taxpayer enters into an agreement for the transfer of relinquished property and thereafter assigns its rights in that agreement to an intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as entering into that agreement. If the relinquished property is transferred pursuant to that agreement, the intermediary is treated as having acquired and transferred the relinquished property.

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(vi) Paragraph (g)(4)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. Rights conferred upon the taxpayer under state law to terminate or dismiss the qualified intermediary are disregarded for this purpose.

(vii) A taxpayer may receive money or other property directly from a party to the transaction other than the qualified intermediary without affecting the application of paragraph (g)(4)(i) of this section.

(5) Interest and growth factors.

In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives the like-kind replacement property will be made without regard to the fact that the taxpayer is or may be entitled to receive any interest or growth factor with respect to the deferred exchange. The preceding sentence applies only if the agreement pursuant to which the taxpayer is or may be entitled to the interest or growth factor expressly limits the taxpayer's rights to receive the interest or growth factor as provided in paragragh (g)(6) of this section. For additional rules concerning interest or growth factors, see paragraph (h) of this section.

(6) Additional restrictions on safe harbors under paragraphs (g)(3) through (g)(5).

(i) An agreement limits a taxpayer's rights as provided in this paragraph (g)(6) only if the agreement provides that the taxpayer has no rights, except as provided in paragraph (g)(6)(ii) and (g)(6)(iii) of this section, to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period.

(ii) The agreement may provide that if the taxpayer has not identified replacement property by the end of the identification period, the taxpayer may have rights to receive, pledge, borrow, or othewise obtain the benefits of money or other property at any time after the end of the identification period.

(iii) The agreement may provide that if the taxpayer has identified replacement property, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property upon or after --

(A) The receipt by the taxpayer of all of the replacement property to which the taxpayer is entitled under the exchange agreement, or

(B) The occurrence after the end of the identification period of a material and substantial contingency that --

(1) Relates to the deferred exchange,

(2) Is provided for in writing, and

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(3) Is beyond the control of the taxpayer and of any disqualified person (as defined in paragraph (k) of this section), other than the person obligated to transfer the replacement property to the taxpayer.

(7) Items disregarded in applying safe harbors under paragraphs (g)(3) through (g)(5). In determining whether a safe harbor under paragraphs (g)(3) through (g)(5) of this section ceases to apply and whether the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property are expressly limited as provided in paragraph (g)(6) of this section, the taxpayer's receipt of or right to receive any of the following items will be disregarded --

(i) Items that a seller may receive as a consequence of the disposition of property and that are not included in the amount realized from the disposition of property (e.g., prorated rents), and

(ii) Transactional items that relate to the disposition of the relinquished property or to the acquisition of the replacement property and appear under local standards in the typical closing statements as the responsibility of a buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees).

(8) Examples.

This paragraph (g) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B is to transfer real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $ 100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. The replacement property is identified as provided in paragraph (c) of this section (relating to identification of replacement property) and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

Example 1. (i) On May 17, 1991, B transfers real property X to C. On the same day, C pays $ 10,000 to B and deposits $ 90,000 in escrow as security for C's obligation to perform under the agreement. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow before November 14, 1991, except that:

(A) if B fails to identify replacement property on or before July 1, 1991, B may demand

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the funds in escrow at any time after July 1, 1991; and

(B) if B identifies and receives replacement property, then B may demand the balance of the remaining funds in escrow at any time after B has received the replacement property.

The funds in escrow may be used to purchase the replacement property. The escrow holder is not a disqualified person as defined in paragraph (k) of this section. Pursuant to the terms of the agreement, B identifies replacement property, and C purchases the replacement property using the funds in escrow and tranfers the replacement property to B.

(ii) C's obligation to transfer the replacement property to B was secured by cash held in a qualified escrow account because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow as provided in paragraph (g)(6) of this section. In addition, B did not have the immediate ability or unrestricted right to receive money or other property in escrow before B actually received the like-kind replacement property. Therefore, for purposes of section 1031 and this section, B is determined not to be in actual or constructive receipt of the $ 90,000 held in escrow before B received the like-kind replacement property. The transfer of real property X by B and B's acquisition of the replacement property qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

Example 2. (i) On May 17, 1991, B transfers real property X to C, and C deposits $ 100,000 in escrow as security for C's obligation to perform under the agreement. Also on May 17, B identifies real property J as replacement property. The escrow agreement provides that no funds may be paid out without prior written approval of both B and C. The escrow agreement also provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow before November 14, 1991, except that:

(A) B may demand the funds in escrow at any time after the later of July 1, 1991, and the occurrence of any of the following events --

(1) real property J is destroyed, seized, requisitioned, or condemned, or

(2) a determination is made that the regulatory approval necessary for the transfer of real property J cannot be obtained in time for real property J to be transferred to B before the end of the exchange period;

(B) B may demand the funds in escrow at any time after August 14, 1991, if real property J has not been rezoned from residential to commercial use by that date; and

(C) B may demand the funds in escrow at the time B receives real property J or any time thereafter.

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Otherwise, B is entitled to all funds in escrow after November 13, 1991. The funds in escrow may be used to purchase the replacement property. The escrow holder is not a disqualified person as described in paragraph (k) of this section. Real property J is not rezoned from residential to commercial use on or before August 14, 1991.

(ii) C's obligation to transfer the replacement property to B was secured by cash held in a qualified escrow account because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow as provided in paragraph (g)(6) of this section. From May 17, 1991, until August 15, 1991, B did not have the immediate ability or unrestricted right to receive money or other property before B actually received the like-kind replacement property. Therefore, for purposes of section 1031 and this section, B is determined not to be in actual or constructive receipt of the $ 100,000 in escrow from May 17, 1991, until August 15, 1991. However, on August 15, 1991, B had the unrestricted right, upon notice, to draw upon the $ 100,000 held in escrow. Thus, the safe harbor ceased to apply and B was in constructive receipt of the funds held in escrow. Because B constructively received the full amount of the consideration ($ 100,000) before B actually received the like-kind replacement property, the transaction is treated as a sale and not as a deferred exchange. The result does not change even if B chose not to demand the funds in escrow and continued to attempt to have real property J rezoned and to receive the property on or before November 13, 1991.

(iii) If real property J had been rezoned on or before August 14, 1991, and C had purchased real property J and transferred it to B on or before November 13, 1991, the transaction would have qualified for nonrecognition of gain or loss under section 1031(a).

Example 3. (i) On May 1, 1991, D offers to purchase real property X for $ 100,000. However, D 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 not a disqualified person as described in paragraph (k) of this section. The exchange agreement between B and C provides that B is to execute and deliver a deed conveying real property X to C who, in turn, is to execute and deliver a deed conveying real property X to D. The exchange agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g)(6) of this section. On May 3, 1991, C enters into an agreement with D to transfer real property X to D for $ 100,000. On May 17, 1991, B executes and delivers to C a deed conveying real property X to C. On the same date, C executes and delivers to D a deed conveying real property X to D, and D deposits $ 100,000 in escrow. The escrow holder is not a disqualified person as defined in paragraph (k) of this section and the escrow agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section. However, the escrow agreement provides that the money in escrow may be used to purchase replacement property. On June 3, 1991, B identifies real property K as replacement property. On

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August 9, 1991, E executes and delivers to C a deed conveying real property K to C and $ 80,000 is released from the escrow and paid to E. On the same date, C executes and delivers to B a deed conveying real property K to B, and the escrow holder pays B $ 20,000, the balance of the $ 100,000 sale price of real property X remaining after the purchase of real property K for $ 80,000.

(ii) B and C entered into an exchange agreement that satisfied the requirements of paragraph (g)(4)(iii)(B) of this section. Regardless of whether C may have acquired and transferred real property X under general tax principles, C is treated as having acquired and transferred real property X because C acquired and transferred legal title to real property X. Similarly, C is treated as having acquired and transferred real property K because C acquired and transferred legal title to real property K. Thus, C was a qualified intermediary. This result is reached for purposes of this section regardless of whether C was B's agent under state law.

(iii) Because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section, the escrow account was a qualified escrow account. For purposes of section 1031 and this section, therefore, B is determined not to be in actual or constructive receipt of the funds in escrow before B received real property K.

(iv) The exchange agreement between B and C expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of any money held by C as provided in paragraph (g)(6) of this section. Because C was a qualified intermediary, for purposes of section 1031 and this section B is determined not to be in actual or constructive receipt of any funds held by C before B received real property K. In addition, B's transfer of real property X and acquisition of real property K qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

(v) If the escrow agreement had expressly limited C's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section, but had not expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of that money or other property, the escrow account would not have been a qualified escrow account. Consequently, paragraph (g)(3)(i) of this section would not have been applicable in determining whether B was in actual or constructive receipt of that money or other property before B received real property K.

Example 4. (i) On May 1, 1991, B enters into an agreement to sell real property X to D for $ 100,000 on May 17, 1991. However, D 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 not a disqualified person as described in paragraph (k) of this section. In the exchange agreement between B and C, B assigns to C all of B's rights in the agreement with D. The exchange agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits

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of money or other property held by C as provided in paragraph (g)(6) of this section. On May 17, 1991, B notifies D in writing of the assignment. On the same date, B executes and delivers to D a deed conveying real property X to D. D pays $ 10,000 to B and $ 90,000 to C. On June 1, 1991, B identifies real property L as replacement property. On July 5, 1991, B enters into an agreement to purchase real property L from E for $ 90,000, assigns its rights in that agreement to C, and notifies E in writing of the assignment. On August 9, 1991, C pays $ 90,000 to E, and E executes and delivers to B a deed conveying real property L to B.

(ii) The exchange agreement entered into by B and C satisfied the requirements of paragraph (g)(4)(iii)(B) of this section. Because B's rights in its agreements with D and E were assigned to C, and D and E were notified in writing of the assignment on or before the transfer of real properties X and L, respectively, C is treated as entering into those agreements. Because C is treated as entering into an agreement with D for the transfer of real property X and, pursuant to that agreement, real property X was transferred to D, C is treated as acquiring and transferring real property X. Similarly, because C is treated as entering into an agreement with E for the transfer of real property K and, pursuant to that agreement, real property K was transferred to B, C is treated as acquiring and transferring real property K. This result is reached for purposes of this section regardless of whether C was B's agent under state law and regardless of whether C is considered, under general tax principles, to have acquired title or beneficial ownership of the properties. Thus, C was a qualified intermediary.

(iii) The exchange agreement between B and C expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by C as provided in paragraph (g)(6) of this section. Thus, B did not have the immediate ability or unrestricted right to receive money or other property held by C before B received real property L. For purposes of section 1031 and this section, therefore, B is determined not to be in actual or constructive receipt of the $ 90,000 held by C before B received real property L. In addition, the transfer of real property X by B and B's acquisition of real property L qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

Example 5. (i) On May 1, 1991, B enters into an agreement to sell real property X to D for $ 100,000. However, D is unwilling to participate in a like-kind exchange. B thus enters into an agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is not a disqualified person as described in paragraph (k) of this section. The agreement between B and C expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g)(6) of this section. C neither enters into an agreement with D to transfer real property X to D nor is assigned B's rights in B's agreement to sell real property X to D. On May 17, 1991, B transfers real property X to D and instructs D to transfer the $ 100,000 to C. On June 1, 1991, B identifies real property M as replacement property. On August 9, 1991, C purchases real property L from E for $ 100,000, and E executes and delivers to C a deed conveying real property M to C. On the same date, C executes and delivers to B a deed conveying real property M to B.

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(ii) Because B transferred real property X directly to D under B's agreement with D, C did not acquire real property X from B and transfer real property X to D. Moreover, because C did not acquire legal title to real property X, did not enter into an agreement with D to transfer real property X to D, and was not assigned B's rights in B's agreement to sell real property X to D, C is not treated as acquiring and transferring real property X. Thus, C was not a qualified intermediary and paragraph (g)(4))(i) of this section does not apply.

(iii) B did not exchange real property X for real property M. Rather, B sold real property X to D and purchased, through C, real property M. Therefore, the transfer of real property X does not qualify for nonrecognition of gain or loss under section 1031.

(h) Interest and growth factors –

(1) In general.

For purposes of this section, the taxpayer is treated as being entitled to receive interest or a growth factor with respect to a deferred exchange if the amount of money or property the taxpayer is entitled to receive depends upon the length of time elapsed between transfer of the relinquished property and receipt of the replacement property.

(2) Treatment as interest.

If, as part of a deferred exchange, the taxpayer receives interest or a growth factor, the interest or growth factor will be treated as interest, regardless of whether it is paid to the taxpayer in cash or in property (including property of a like kind). The taxpayer must include the interest or growth factor in income according to the taxpayer's method of accounting.

(i) [Reserved]

(j) Determination of gain or loss recognized and the basis of property received in a deferred exchange –

(1) In general.

Except as otherwise provided, the amount of gain or loss recognized and the basis of property received in a deferred exchange is determined by applying the rules of section 1031 and the regulations thereunder. See §§ 1.1031(b)-1, 1.1031(c)-1, 1.1031(d)-1, 1.1031(d)-1T, 1.1031(d)-2, and 1.1031(j)-1.

(2) Coordination with section 453 –

(i) Qualified escrow accounts and qualified trusts.

Subject to the limitations of paragraphs (j)(2) (iv) and (v) of this section, in the case of a taxpayer's transfer of relinquished property in which the obligation of the taxpayer's

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transferee to transfer replacement property to the taxpayer is or may be secured by cash or a cash equivalent, 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 will be made without regard to the fact that the obligation is or may be so secured if the cash or cash equivalent is held in a qualified escrow account or a qualified trust. This paragraph (j)(2)(i) ceases to apply at the earlier of --

(A) The time described in paragraph (g)(3)(iv) of this section; or

(B) The end of the exchange period.

(ii) Qualified intermediaries. Subject to the limitations of paragraphs (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.

(iii) Transferee indebtedness. In the case of a transaction described in paragraph (j)(2)(ii) of this section, the receipt by the taxpayer of an evidence of indebtedness of the transferee of the qualified intermediary is treated as the receipt of an evidence of indebtedness of the person acquiring property from the taxpayer for purposes of section 453 and § 15a.453-1(b)(3)(i) of this chapter.

(iv) Bona fide intent requirement. 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.

(v) Disqualified property. The provisions of paragraphs (j)(2) (i) and (ii) of this section do not apply if the relinquished property is disqualified property. For purposes of this paragraph (j)(2), disqualified property means property that is not held for productive use in a trade or business or for investment or is property described in section 1031(a)(2).

(vi) Examples. This paragraph (j)(2) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B is a calendar year taxpayer who agrees to enter into a deferred exchange. Pursuant to the

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agreement, B is to transfer real property X. Real property X, which has been held by B for investment, is unencumbered and has a fair market value of $ 100,000 at the time of transfer. B's adjusted basis in real property X at that time is $ 60,000. B identifies a single like-kind replacement property before the end of the identification period, and B receives the replacement property before the end of the exchange period. The transaction qualifies as a like-kind exchange under section 1031.

Example 1. (i) On September 22, 1994, B transfers real property X to C and C agrees to acquire like-kind property and deliver it to B. On that date B has a bona fide intent to enter into a deferred exchange. C's obligation, which is not payable on demand or readily tradable, is secured by $ 100,000 in cash. The $ 100,000 is deposited by C in an escrow account that is a qualified escrow account under paragraph (g)(3) of this section. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash deposited in the escrow account until the earlier of the date the replacement property is delivered to B or the end of the exchange period. On March 11, 1995, C acquires replacement property having a fair market value of $ 80,000 and delivers the replacement property to B. The $ 20,000 in cash remaining in the qualified escrow account is distributed to B at that time.

(ii) Under section 1031(b), B recognizes gain to the extent of the $ 20,000 in cash that B receives in the exchange. Under paragraph (j)(2)(i) of this section, the qualified escrow account is disregarded 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 C's obligation on September 22, 1994, does not constitute a payment. Instead, B is treated as receiving payment on March 11, 1995, on receipt of the $ 20,000 in cash from the qualified escrow account. Subject to the other requirements of sections 453 and 453A, B may report the $ 20,000 gain in 1995 under the installment method. See section 453(f)(6) for special rules for determining total contract price and gross profit in the case of an exchange described in section 1031(b).

Example 2. (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. On September 22, 1994, pursuant to the agreement, B transfers real property X to C who transfers it to D for $ 100,000 in cash. On that date B has a bona fide intent to enter into a deferred exchange. C is a qualified intermediary under paragraph (g)(4) of this section. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by C until the earlier of the date the replacement property is delivered to B or the end of the exchange period. On March 11, 1995, C acquires replacement property having a fair market value of $ 80,000 and delivers it, along with the remaining $ 20,000 from the transfer of real property X to B.

(ii) Under section 1031(b), B recognizes gain to the extent of the $ 20,000 cash B receives in the exchange. Under paragraph (j)(2)(ii) of this section, any agency relationship between B and C is disregarded 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 is not treated as having received payment on September 22, 1994, on

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C's receipt of payment from D for the relinquished property. Instead, B is treated as receiving payment on March 11, 1995, on receipt of the $ 20,000 in cash from C. Subject to the other requirements of sections 453 and 453A, B may report the $ 20,000 gain in 1995 under the installment method.

Example 3. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B enters into an exchange agreement with C whereby B retains C as a qualified intermediary to facilitate an exchange with respect to real property X. On December 1, 1994, pursuant to the agreement, B transfers real property X to C who transfers it to D for $ 100,000 in cash. 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 cash held by C until the earliest of the end of the identification period if B has not identified replacement property, the date the replacement property is delivered to B, or the end of the exchange period. Although B has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period, B does not identify or acquire any replacement property. In 1995, at the end of the identification period, C delivers the entire $ 100,000 from the sale of real property X to B.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($ 100,000) over the adjusted basis in real property X ($ 60,000), or $ 40,000. Because B has a bona fide intent at the beginning of the exchange period to enter into a deferred exchange, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(ii) of this section inapplicable even though B fails to acquire replacement property. Further, under paragraph (j)(2)(ii) of this section, C is a qualified intermediary even though C does not acquire and transfer replacement property to B. Thus, any agency relationship between B and C is disregarded 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 is not treated as having received payment on December 1, 1994, on C's receipt of payment from D for the relinquished property. Instead, B is treated as receiving payment at the end of the identification period in 1995 on receipt of the $ 100,000 in cash from C. Subject to the other requirements of sections 453 and 453A, B may report the $ 40,000 gain in 1995 under the installment method.

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.

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(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.

Example 5. (i) B is a corporation that has held real property X to expand its manufacturing operations. However, at a meeting in November 1994, B's directors decide that real property X is not suitable for the planned expansion, and authorize a like-kind exchange of this property for property that would be suitable for the planned expansion. B enters into an exchange agreement with C whereby B retains C as a qualified intermediary to facilitate an exchange with respect to real property X. On November 28, 1994, pursuant to the agreement, B transfers real property X to C, who then transfers it to D for $ 100,000 in cash. The exchange agreement does not include any limitations or conditions that make it unreasonable to believe that like-kind replacement property will be acquired before the end of the exchange period. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash held by C until the earliest of the end of the identification period, if B has not identified replacement property, the date the replacement property is delivered to B, or the end of the exchange period. In early January 1995, B's directors meet and decide that it is not feasible to proceed with the planned expansion due to a business downturn reflected in B's preliminary financial reports for the last quarter of 1994. Thus, B's directors instruct C to stop seeking replacement property. C delivers the $ 100,000 cash to B on January 12, 1995, at the end of the identification period. Both the decision to exchange real property X for other property and the decision to cease seeking replacement property because of B's business downturn are recorded in the minutes of the directors' meetings. There are no other facts or circumstances that would indicate whether, on November 28, 1994, B had a bona fide intent to enter into a deferred like-kind exchange.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($ 100,000) over the adjusted basis of real property X ($ 60,000), or $ 40,000. The directors' authorization of a like-kind exchange, the terms of the exchange agreement with C, and the absence of other relevant facts, indicate that B had a bona fide intent at the beginning of the exchange period to enter into a deferred like-kind exchange. Thus, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(ii) of this section inapplicable, even though B fails to acquire replacement property. Further, under paragraph (j)(2)(ii) of this section, C is a qualified intermediary, even though C does not transfer replacement property to B. Thus, any agency relationship between B and C is disregarded 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 is not treated as having received payment until January 12, 1995, on receipt of the $ 100,000 cash from C.

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Subject to the other requirements of sections 453 and 453A, B may report the $ 40,000 gain in 1995 under the installment method.

Example 6. (i) B has held real property X for use in its trade or business, but decides to transfer that property because it is no longer suitable for B's planned expansion of its commercial enterprise. B and D agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to D on September 22, 1994, and D deposits $ 100,000 cash in a qualified escrow account as security for D's obligation under the agreement to transfer replacement property to B before the end of the exchange period. D's obligation is not payable on demand or readily tradable. The agreement provides that B is not required to accept any property that is not zoned for commercial use. Before the end of the identification period, B identifies real properties J, K, and L, all zoned for residential use, as replacement properties. Any one of these properties, rezoned for commercial use, would be suitable for B's planned expansion. In recent years, the zoning board with jurisdiction over properties J, K, and L has rezoned similar properties for commercial use. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in the escrow account until the earlier of the time that the zoning board determines, after the end of the identification period, that it will not rezone the properties for commercial use or the end of the exchange period. On January 5, 1995, the zoning board decides that none of the properties will be rezoned for commercial use. Pursuant to the exchange agreement, B receives the $ 100,000 cash from the escrow on January 5, 1995. There are no other facts or circumstances that would indicate whether, on September 22, 1994, B had a bona fide intent to enter into a deferred like-kind exchange.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($ 100,000) over the adjusted basis of real property X ($ 60,000), or $ 40,000. The terms of the exchange agreement with D, the identification of properties J, K, and L, the efforts to have those properties rezoned for commercial purposes, and the absence of other relevant facts, indicate that B had a bona fide intent at the beginning of the exchange period to enter into a deferred exchange. Moreover, the limitations imposed in the exchange agreement on acceptable replacement property do not make it unreasonable to believe that like-kind replacement property would be acquired before the end of the exchange period. Therefore, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(i) of this section inapplicable even though B fails to acquire replacement property. Thus, for purposes of section 453 and § 15a.453-1(b)(3)(i) of this chapter, the qualified escrow account is disregarded in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on September 22, 1994, on D's deposit of the $ 100,000 cash into the qualified escrow account. Instead, B is treated as receiving payment on January 5, 1995. Subject to the other requirements of sections 453 and 453A, B may report the $ 40,000 gain in 1995 under the installment method.

(vii) Effective date. This paragraph (j)(2) is effective for transfers of property occurring on or after April 20, 1994. Taxpayers may apply this paragraph (j)(2) to transfers of property occurring before April 20, 1994, but on or after June 10, 1991, if those

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transfers otherwise meet the requirements of § 1.1031(k)-1. In addition, taxpayers may apply this paragraph (j)(2) to transfers of property occurring before June 10, 1991, but on or after May 16, 1990, if those transfers otherwise meet the requirements of § 1.1031(k)-1 or follow the guidance of IA-237-84 published in 1990-1, C.B. See § 601.601(d)(2)(ii)(b) of this chapter.

(3) Examples.

This paragraph (j) may be illustrated by the following examples.

Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B is to transfer real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $ 100,000. B's adjusted basis in real property X is $ 40,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received. The replacement property is identified as provided in paragraph (c) of this section and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

Example 1. (i) On May 17, 1991, B transfers real property X to C and identifies real property R as replacement property. On June 3, 1991, C transfers $ 10,000 to B. On September 4, 1991, C purchases real property R for $ 90,000 and transfers real property R to B.

(ii) The $ 10,000 received by B is "money or other property" for purposes of section 1031 and the regulations thereunder. Under section 1031(b), B recognizes gain in the amount of $ 10,000. Under section 1031(d), B's basis in real property R is $ 40,000 (i.e., B's basis in real property X ($ 40,000), decreased in the amount of money received ($ 10,000), and increased in the amount of gain recognized ($ 10,000) in the deferred exchange).

Example 2. (i) On May 17, 1991, B transfers real property X to C and identifies real property S as replacement property, and C transfers $ 10,000 to B. On September 4, 1991, C purchases real property S for $ 100,000 and transfers real property S to B. On the same day, B transfers $ 10,000 to C.

(ii) The $ 10,000 received by B is "money or other property" for purposes of section 1031 and the regulations thereunder. Under section 1031(b), B recognizes gain in the amount of $ 10,000. Under section 1031(d), B's basis in real property S is $ 50,000 (i.e., B's basis in real property X ($ 40,000), decreased in the amount of money

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received ($ 10,000), increased in the amount of gain recognized ($ 10,000), and increased in the amount of the additional consideration paid by B ($ 10,000) in the deferred exchange).

Example 3. (i) Under the exchange agreement, B has the right at all times to demand $ 100,000 in cash in lieu of replacement property. On May 17, 1991, B transfers real property X to C and identifies real property T as replacement property. On September 4, 1991, C purchases real property T for $ 100,000 and transfers real property T to B.

(ii) Because B has the right on May 17, 1991, to demand $ 100,000 in cash in lieu of replacement property, B is in constructive receipt of the $ 100,000 on that date. Thus, the transaction is a sale and not an exchange, and the $ 60,000 gain realized by B in the transaction (i.e., $ 100,000 amount realized less $ 40,000 adjusted basis) is recognized. Under section 1031(d), B's basis in real property T is $ 100,000.

Example 4. (i) Under the exchange agreement, B has the right at all times to demand up to $ 30,000 in cash and the balance in replacement propertry instead of receiving replacement property in the amount of $ 100,000. On May 17, 1991, B transfers real property X to C and identifies real property U as replacement property. On September 4, 1991, C purchases real property U for $ 100,000 and transfers real property U to B.

(ii) The transaction qualifies as a deferred exchange under section 1031 and this section. However, because B had the right on May 17, 1991, to demand up to $ 30,000 in cash, B is in constructive receipt of $ 30,000 on that date. Under section 1031(b), B recognizes gain in the amount of $ 30,000. Under section 1031(d), B's basis in real property U is $ 70,000 (i.e., B's basis in real property X ($ 40,000), decreased in the amount of money that B received ($ 30,000), increased in the amount of gain recognized ($ 30,000), and increased in the amount of additional consideration paid by B ($ 30,000) in the deferred exchange).

Example 5. (i) Assume real property X is encumbered by a mortgage of $ 30,000. On May 17, 1991, B transfers real property X to C and identifies real property V as replacement property, and C assumes the $ 30,000 mortgage on real property X. Real property V is encumbered by a $ 20,000 mortgage. On July 5, 1991, C purchases real property V for $ 90,000 by paying $ 70,000 and assuming the mortgage and transfers real property V to B with B assuming the mortgage.

(ii) The consideration received by B in the form of the liability assumed by C ($ 30,000) is offset by the consideration given by B in the form of the liability assumed by B ($ 20,000). The excess of the liability assumed by C over the liability assumed by B, $ 10,000, is treated as "money or other property." See § 1.1031(b)-1(c). Thus, B recognizes gain under section 1031(b) in the amount of $ 10,000. Under section 1031(d), B's basis in real property V is $ 40,000 (i.e., B's basis in real property X ($ 40,000), decreased in the amount of money that B is treated as receiving in the form of the liability assumed by C ($ 30,000), increased in the amount of money that B is treated as paying in the form of the liability assumed by B ($ 20,000), and increased in the amount of the gain recognized ($ 10,000) in the deferred exchange).

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(k) Definition of disqualified person.

(1) For purposes of this section, a disqualified person is a person described in paragraph (k)(2), (k)(3), or (k)(4) of this section.

(2) The person is the agent of the taxpayer at the time of the transaction. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction. Solely for purposes of this paragraph (k)(2), performance of the following services will not be taken into account --

(i) Services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under section 1031; and

(ii) Routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.

(3) The person and the taxpayer bear a relationship described in either section 267(b) or section 707(b) (determined by substituting in each section "10 percent" for "50 percent" each place it appears).

(4)(i) Except as provided in paragraph (k)(4)(ii) of this section, the person and a person described in paragraph (k)(2) of this section bear a relationship described in either section 267(b) or 707(b) (determined by substituting in each section "10 percent" for "50 percent" each place it appears).

(ii) In the case of a transfer of relinquished property made by a taxpayer on or after January 17, 2001, paragraph (k)(4)(i) of this section does not apply to a bank (as defined in section 581) or a bank affiliate if, but for this paragraph (k)(4)(ii), the bank or bank affiliate would be a disqualified person under paragraph (k)(4)(i) of this section solely because it is a member of the same controlled group (as determined under section 267(f)(1), substituting "10 percent" for "50 percent' where it appears) as a person that has provided investment banking or brokerage services to the taxpayer within the 2-year period described in paragraph (k)(2) of this section. For purposes of this paragraph (k)(4)(ii), a bank affiliate is a corporation whose principal activity is rendering services to facilitate exchanges of property intended to qualify for nonrecognition of gain under section 1031 and all of whose stock is owned by either a bank or a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a)).

(5) This paragraph (k) may be illustrated by the following examples. Unless otherwise provided, the following facts are assumed: On May 1, 1991, B enters into an exchange agreement (as defined in paragraph (g)(4)(iii)(B) of this section) with C whereby B retains C to facilitate an exchange with respect to real property X. On May 17, 1991, pursuant to the agreement, B executes and delivers to C a deed conveying real

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property X to C. C has no relationship to B described in paragraphs (k)(2), (k)(3), or (k)(4) of this section.

Example 1. (i) C is B's accountant and has rendered accounting services to B within the 2-year period ending on May 17, 1991, other than with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under section 1031.

(ii) C is a disqualified person because C has acted as B's accountant within the 2-year period ending on May 17, 1991.

(iii) If C had not acted as B's accountant within the 2-year period ending on May 17, 1991, or if C had acted as B's accountant within that period only with respect to exchanges intended to qualify for nonrecognition of gain or loss under section 1031, C would not have been a disqualified person.

Example 2. (i) C, which is engaged in the trade or business of acting as an intermediary to facilitate deferred exchanges, is a wholly owned subsidiary of an escrow company that has performed routine escrow services for B in the past. C has previously been retained by B to act as an intermediary in prior section 1031 exchanges.

(ii) C is not a disqualified person notwithstanding the intermediary services previously provided by C to B (see paragraph (k)(2)(i) of this section) and notwithstanding the combination of C's relationship to the escrow company and the escrow services previously provided by the escrow company to B (see paragraph (k)(2)(ii) of this section).

Example 3. (i) C is a corporation that is only engaged in the trade or business of acting as an intermediary to facilitate deferred exchanges. Each of 10 law firms owns 10 percent of the outstanding stock of C. One of the 10 law firms that owns 10 percent of C is M. J is the managing partner of M and is the president of C. J, in his capacity as a partner in M, has also rendered legal advice to B within the 2-year period ending on May 17, 1991, on matters other than exchanges intended to qualify for nonrecognition of gain or loss under section 1031.

(ii) J and M are disqualified persons. C, however, is not a disqualified person because neither J nor M own, directly or indirectly, more than 10 percent of the stock of C. Similarly, J's participation in the management of C does not make C a disqualified person.

(1) [Reserved]

(m) Definition of fair market value.

For purposes of this section, the fair market value of property means the fair market value of the property without regard to any liabilities secured by the property.

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(n) No inference with respect to actual or constructive receipt rules outside of section 1031.

The rules provided in this section relating to actual or constructive receipt are intended to be rules for determining whether there is actual or constructive receipt in the case of a deferred exchange. No inference is intended regarding the application of these rules for purposes of determining whether actual or constructive receipt exists for any other purpose.

(o) Effective date.

This section applies to transfers of property made by a taxpayer on or after June 10, 1991. However, a transfer of property made by a taxpayer on or after May 16, 1990, but before June 10, 1991, will be treated as complying with section 1031 (a)(3) and this section if the deferred exchange satisfies either the provision of this section or the provisions of the notice of proposed rulemaking published in the FEDERAL REGISTER on May 16, 1990 (55 FR 20278).

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Appendix D

Internal Revenue Service: Revenue Procedures

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Internal Revenue Servic3
Revenue Procedure 2000-37

Revenue Procedure 2000-37: Safe Harbor Reverse Exchange Structure
Internal Revenue Services (I.R.S.)

26 CFR 1.1031(a)-1: Property held for productive use in trade or business or for investment; 1.1031(k)-1: Treatment of deferred exchanges.

2000-2 C.B. 308; 2000-40 I.R.B. 308; REV. PROC. 2000-37

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor under which the Internal Revenue Service will not challenge (a) the qualification of property as either "replacement property" or "relinquished property" (as defined in § 1.1031(k)-1(a) of the Income Tax Regulations) for purposes of § 1031 of the Internal Revenue Code and the regulations thereunder or (b) the treatment of the "exchange accommodation titleholder" as the beneficial owner of such property for federal income tax purposes, if the property is held in a "qualified exchange accommodation arrangement" (QEAA), as defined in section 4.02 of this revenue procedure.

SECTION 2. BACKGROUND

.01 Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.

.02 Section 1031(a)(3) provides that property received by the taxpayer is not treated as like-kind property if it: (a) is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the relinquished property; or (b) is received after the earlier of the date that is 180 days after the date on which the taxpayer transfers the relinquished property, or the due date (determined with regard to extension) for the transferor's federal income tax return for the year in which the transfer of the relinquished property occurs.

.03 Determining the owner of property for federal income tax purposes requires an analysis of all of the facts and circumstances. As a general rule, the party that bears the economic burdens and benefits of ownership will be considered the owner of property for federal income tax purposes. See Rev. Rul. 82-144, 1982-2 C.B. 34.

.04 On April 25, 1991, the Treasury Department and the Service promulgated final regulations under § 1.1031(k)-1 providing rules for deferred like-kind exchanges under § 1031(a)(3). The preamble to the final regulations states that the deferred exchange rules under § 1031(a)(3) do not apply to reverse-Starker exchanges (i.e., exchanges

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where the replacement property is acquired before the relinquished property is transferred) and consequently that the final regulations do not apply to such exchanges. T.D. 8346, 1991-1 C.B. 150, 151; see Starker v. United States, 602 F.2d 1341 (9th Cir. 1979). However, the preamble indicates that Treasury and the Service will continue to study the applicability of the general rule of § 1031(a)(1) to these transactions. T.D. 8346, 1991-1 C.B. 150, 151.

.05 Since the promulgation of the final regulations under § 1.1031(k)-1, taxpayers have engaged in a wide variety of transactions, including so-called "parking" transactions, to facilitate reverse like-kind exchanges. Parking transactions typically are designed to "park" the desired replacement property with an accommodation party until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange. Once such a transfer is arranged, the taxpayer transfers the relinquished property to the accommodation party in exchange for the replacement property, and the accommodation party then transfers the relinquished property to the ultimate transferee. In other situations, an accommodation party may acquire the desired replacement property on behalf of the taxpayer and immediately exchange such property with the taxpayer for the relinquished property, thereafter holding the relinquished property until the taxpayer arranges for a transfer of such property to the ultimate transferee. In the parking arrangements, taxpayers attempt to arrange the transaction so that the accommodation party has enough of the benefits and burdens relating to the property so that the accommodation party will be treated as the owner for federal income tax purposes.

.06 Treasury and the Service have determined that it is in the best interest of sound tax administration to provide taxpayers with a workable means of qualifying their transactions under § 1031 in situations where the taxpayer has a genuine intent to accomplish a like-kind exchange at the time that it arranges for the acquisition of the replacement property and actually accomplishes the exchange within a short time thereafter. Accordingly, this revenue procedure provides a safe harbor that allows a taxpayer to treat the accommodation party as the owner of the property for federal income tax purposes, thereby enabling the taxpayer to accomplish a qualifying like-kind exchange.

SECTION 3. SCOPE

.01 Exclusivity. This revenue procedure provides a safe harbor for the qualification under § 1031 of certain arrangements between taxpayers and exchange accommodation titleholders and provides for the treatment of the exchange accommodation titleholder as the beneficial owner of the property for federal income tax purposes. These provisions apply only in the limited context described in this revenue procedure. The principles set forth in this revenue procedure have no application to any federal income tax determinations other than determinations that involve arrangements qualifying for the safe harbor.

.02 No inference. No inference is intended with respect to the federal income tax

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treatment of arrangements similar to those described in this revenue procedure that were entered into prior to the effective date of this revenue procedure. Further, the Service recognizes that "parking" transactions can be accomplished outside of the safe harbor provided in this revenue procedure. Accordingly, no inference is intended with respect to the federal income tax treatment of "parking" transactions that do not satisfy the terms of the safe harbor provided in this revenue procedure, whether entered into prior to or after the effective date of this revenue procedure.

.03 Other issues. Services for the taxpayer in connection with a person's role as the exchange accommodation titleholder in a QEAA shall not be taken into account in determining whether that person or a related person is a disqualified person (as defined in § 1.1031(k)-1(k)). Even though property will not fail to be treated as being held in a QEAA as a result of one or more arrangements described in section 4.03 of this revenue procedure, the Service still may recast an amount paid pursuant to such an arrangement as a fee paid to the exchange accommodation titleholder for acting as an exchange accommodation titleholder to the extent necessary to reflect the true economic substance of the arrangement. Other federal income tax issues implicated, but not addressed, in this revenue procedure include the treatment, for federal income tax purposes, of payments described in section 4.03(7) and whether an exchange accommodation titleholder may be precluded from claiming depreciation deductions (e.g., as a dealer) with respect to the relinquished property or the replacement property.

.04 Effect of Noncompliance. If the requirements of this revenue procedure are not satisfied (for example, the property subject to a QEAA is not transferred within the time period provided), then this revenue procedure does not apply. Accordingly, the determination of whether the taxpayer or the exchange accommodation titleholder is the owner of the property for federal income tax purposes, and the proper treatment of any transactions entered into by or between the parties, will be made without regard to the provisions of this revenue procedure.

SECTION 4. QUALIFIED EXCHANGE ACCOMMODATION ARRANGEMENTS

.01 Generally. The Service will not challenge the qualification of property as either "replacement property" or "relinquished property" (as defined in § 1.1031(k)-1(a)) for purposes of § 1031 and the regulations thereunder, or the treatment of the exchange accommodation titleholder as the beneficial owner of such property for federal income tax purposes, if the property is held in a QEAA.

.02 Qualified Exchange Accommodation Arrangements. For purposes of this revenue procedure, property is held in a QEAA if all of the following requirements are met:

(1) Qualified indicia of ownership of the property is held by a person (the "exchange accommodation titleholder") who is not the taxpayer or a disqualified person and either such person is subject to federal income tax or, if such person is treated as a partnership or S corporation for federal income tax purposes, more than 90 percent of its interests or stock are owned by partners or shareholders who are subject to federal

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income tax. Such qualified indicia of ownership must be held by the exchange accommodation titleholder at all times from the date of acquisition by the exchange accommodation titleholder until the property is transferred as described in section 4.02(5) of this revenue procedure. For this purpose, "qualified indicia of ownership" means legal title to the property, other indicia of ownership of the property that are treated as beneficial ownership of the property under applicable principles of commercial law (e.g., a contract for deed), or interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (e.g., a single member limited liability company) and that holds either legal title to the property or such other indicia of ownership;

(2) At the time the qualified indicia of ownership of the property is transferred to the exchange accommodation titleholder, it is the taxpayer's bona fide intent that the property held by the exchange accommodation titleholder represent either replacement property or relinquished property in an exchange that is intended to qualify for nonrecognition of gain (in whole or in part) or loss under § 1031;

(3) No later than five business days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, the taxpayer and the exchange accommodation titleholder enter into a written agreement (the "qualified exchange accommodation agreement") that provides that the exchange accommodation titleholder is holding the property for the benefit of the taxpayer in order to facilitate an exchange under § 1031 and this revenue procedure and that the taxpayer and the exchange accommodation titleholder agree to report the acquisition, holding, and disposition of the property as provided in this revenue procedure. The agreement must specify that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with this agreement;

(4) No later than 45 days after the transfer of qualified indicia of ownership of the replacement property to the exchange accommodation titleholder, the relinquished property is properly identified. Identification must be made in a manner consistent with the principles described in § 1.1031(k)-1(c). For purposes of this section, the taxpayer may properly identify alternative and multiple properties, as described in § 1.1031(k)-1(c)(4);

(5) No later than 180 days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, (a) the property is transferred (either directly or indirectly through a qualified intermediary (as defined in § 1.1031(k)-1(g)(4))) to the taxpayer as replacement property; or (b) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property; and

(6) The combined time period that the relinquished property and the replacement property are held in a QEAA does not exceed 180 days.

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.03 Permissible Agreements. Property will not fail to be treated as being held in a QEAA as a result of any one or more of the following legal or contractual arrangements, regardless of whether such arrangements contain terms that typically would result from arm's length bargaining between unrelated parties with respect to such arrangements:

(1) An exchange accommodation titleholder that satisfies the requirements of the qualified intermediary safe harbor set forth in §1.1031(k)-1(g)(4) may enter into an exchange agreement with the taxpayer to serve as the qualified intermediary in a simultaneous or deferred exchange of the property under § 1031;

(2) The taxpayer or a disqualified person guarantees some or all of the obligations of the exchange accommodation titleholder, including secured or unsecured debt incurred to acquire the property, or indemnifies the exchange accommodation titleholder against costs and expenses;

(3) The taxpayer or a disqualified person loans or advances funds to the exchange accommodation titleholder or guarantees a loan or advance to the exchange accommodation titleholder;

(4) The property is leased by the exchange accommodation titleholder to the taxpayer or a disqualified person;

(5) The taxpayer or a disqualified person manages the property, supervises improvement of the property, acts as a contractor, or otherwise provides services to the exchange accommodation titleholder with respect to the property;

(6) The taxpayer and the exchange accommodation titleholder enter into agreements or arrangements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, effective for a period not in excess of 185 days from the date the property is acquired by the exchange accommodation titleholder; and

(7) The taxpayer and the exchange accommodation titleholder enter into agreements or arrangements providing that any variation in the value of a relinquished property from the estimated value on the date of the exchange accommodation titleholder's receipt of the property be taken into account upon the exchange accommodation titleholder's disposition of the relinquished property through the taxpayer's advance of funds to, or receipt of funds from, the exchange accommodation titleholder.

.04 Permissible Treatment. Property will not fail to be treated as being held in a QEAA merely because the accounting, regulatory, or state, local, or foreign tax treatment of the arrangement between the taxpayer and the exchange accommodation titleholder is different from the treatment required by section 4.02(3) of this revenue procedure.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for QEAAs entered into with respect to an exchange

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accommodation titleholder that acquires qualified indicia of ownership of property on or after September 15, 2000.

SECTION 6. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1701. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collections of information are contained in section 4.02 of this revenue procedure, which requires taxpayers and exchange accommodation titleholders to enter into a written agreement that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. This information is required to ensure that both parties to a QEAA treat the transaction consistently for federal tax purposes. The likely respondents are businesses and other for-profit institutions, and individuals.

The estimated average annual burden to prepare the agreement and certification is two hours. The estimated number of respondents is 1,600, and the estimated total annual reporting burden is 3,200 hours.

The estimated annual frequency of responses is on occasion.

Books and records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

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Internal Revenue Service
Revenue Procedure 2002-22

Revenue Procedure 2002-22: Tenancy-In-Common Interests; Undivided Fractional Interests
Internal Revenue Service (I.R.S.)

TENANCY IN COMMON INTERESTS; UNDIVIDED FRACTIONAL INTERESTS

SECTION 1. PURPOSE

This revenue procedure specifies the conditions under which the Internal Revenue Service will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property as defined in section 614) is not an interest in a business entity, within the meaning of 301.7701-2(a) of the Procedure and Administration Regulations.

This revenue procedure supersedes Rev. Proc. 2000-46, 2002-2 C.B. 438, which provides that the Service will not issue advance rulings or determination letters on the questions of whether an undivided fractional interest in real property is an interest in an entity that is not eligible for tax-free exchange under 1031(a)(1) of the Internal Revenue Code and whether arrangements where taxpayers acquire undivided fractional interests in real property constitute separate entities for federal tax purposes under 7701. This revenue procedure also modifies Rev. Proc. 2002-3, 2002-1 I.R.B. 117, by removing these issues from the list of subjects on which the Service will not rule. Requests for advance rulings described in Rev. Proc. 2000-46 that are not covered by this revenue procedure, such as rulings concerning mineral property, will be considered under procedures set forth in Rev. Proc. 2002-1, 2002-1 I.R.B. 1 (or its successor).

SECTION 2. BACKGROUND

Section 301.7701-1(a)(1) provides that whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal law and does not depend on whether the entity is recognized as an entity under local law. Section 301.7701-1(a)(2) provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom, but the mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.

Section 301.7701-2(a) provides that a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under 301.7701-3) that is not properly classified as a trust under 301.7701-4 or otherwise subject to special

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treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.

Section 761(a) provides that the term partnership includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and that is not a corporation or a trust or estate.

Section 1.761-1(a) of the Income Tax Regulations provides that the term partnership means a partnership as determined under 301.7701-1, 301.7701-2, and 301.7701-3.

The central characteristic of a tenancy in common, one of the traditional concurrent estates in land, is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants the possession of the whole parcel and has the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property. These rights generally provide a tenant in common the benefits of ownership of the property within the constraint that no rights may be exercised to the detriment of the other tenants in common. 7 Richard R. Powell, Powell on Real Property 50.01-50.07 (Michael Allan Wolf ed., 2000).

Rev. Rul. 75-374, 1975-2 C.B. 261, concludes that a two-person co-ownership of an apartment building that was rented to tenants did not constitute a partnership for federal tax purposes. In the revenue ruling, the co-owners employed an agent to manage the apartments on their behalf; the agent collected rents, paid property taxes, insurance premiums, repair and maintenance expenses, and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The ruling concludes that the agent's activities in providing customary services to the tenants, although imputed to the co-owners, were not sufficiently extensive to cause the co-ownership to be characterized as a partnership. See also Rev. Rul. 79-77, 1979-1 C.B. 448, which did not find a business entity where three individuals transferred ownership of a commercial building subject to a net lease to a trust with the three individuals as beneficiaries.

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Where a sponsor packages co-ownership interests for sale by acquiring property, negotiating a master lease on the property, and arranging for financing, the courts have looked at the relationships not only among the co-owners, but also between the sponsor (or persons related to the sponsor) and the co-owners in determining whether the co-ownership gives rise to a partnership. For example, in Bergford v. Commissioner, 12 F.3d 166 (9th Cir. 1993), seventy-eight investors purchased co-ownership interests in computer equipment that was subject to a 7-year net lease. As part of the purchase, the co-owners authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the co-owners to decide by majority vote whether to sell or lease the equipment at the end of the lease. Absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10 percent of the equipment's selling price or lease rental whether or not a co-owner terminated the agreement or the manager performed any remarketing. A co-owner could assign an interest in the co-ownership only after fulfilling numerous conditions and obtaining the manager's consent.

The court held that the co-ownership arrangement constituted a partnership for federal tax purposes. Among the factors that influenced the court's decision were the limitations on the co-owners' ability to sell, lease, or encumber either the co-ownership interest or the underlying property, and the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances). Bergford, 12 F.3d at 169-170. Accord Bussing v. Commissioner, 88 T.C. 449 (1987), aff'd on reh'g, 89 T.C. 1050 (1987); Alhouse v. Commissioner, T.C. Memo. 1991-652.

Under 1.761-1(a) and 301.7701-1 through 301.7701-3, a federal tax partnership does not include mere co-ownership of property where the owners activities are limited to keeping the property maintained, in repair, rented or leased. However, as the above authorities demonstrate, a partnership for federal tax purposes is broader in scope than the common law meaning of partnership and may include groups not classified by state law as partnerships. Bergford, 12 F.3d at 169. Where the parties to a venture join together capital or services with the intent of conducting a business or enterprise and of sharing the profits and losses from the venture, a partnership (or other business entity) is created. Bussing, 88 T.C. at 460. Furthermore, where the economic benefits to the individual participants are not derivative of their co-ownership, but rather come from their joint relationship toward a common goal, the co-ownership arrangement will be characterized as a partnership (or other business entity) for federal tax purposes. Bergford, 12 F.3d at 169.

SECTION 3. SCOPE

This revenue procedure applies to co-ownership of rental real property (other than mineral interests) (the Property) in an arrangement classified under local law as a tenancy-in-common.

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This revenue procedure provides guidelines for requesting advance rulings solely to assist taxpayers in preparing ruling requests and the Service in issuing advance ruling letters as promptly as practicable. The guidelines set forth in this revenue procedure are not intended to be substantive rules and are not to be used for audit purposes.

SECTION 4. GUIDELINES FOR SUBMITTING RULING REQUESTS

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the information described in section 5 of this revenue procedure is included in the ruling request and the conditions described in section 6 of this revenue procedure are satisfied. Even if sections 5 and 6 of this revenue procedure are satisfied, however, the Service may decline to issue a ruling under this revenue procedure whenever warranted by the facts and circumstances of a particular case and whenever appropriate in the interest of sound tax administration.

Where multiple parcels of property owned by the co-owners are leased to a single tenant pursuant to a single lease agreement and any debt of one or more co-owners is secured by all of the parcels, the Service will generally treat all of the parcels as a single Property. In such a case, the Service will generally not consider a ruling request under this revenue procedure unless: (1) each co-owner's percentage interest in each parcel is identical to that co-owner's percentage interest in every other parcel, (2) each co-owner's percentage interests in the parcels cannot be separated and traded independently, and (3) the parcels of property are properly viewed as a single business unit. The Service will generally treat contiguous parcels as comprising a single business unit. Even if the parcels are not contiguous, however, the Service may treat multiple parcels as comprising a single business unit where there is a close connection between the business use of one parcel and the business use of another parcel. For example, an office building and a garage that services the tenants of the office building may be treated as a single business unit even if the office building and the garage are not contiguous.

For purposes of this revenue procedure, the following definitions apply. The term co-owner means any person that owns an interest in the Property as a tenant in common. The term sponsor means any person who divides a single interest in the Property into multiple co-ownership interests for the purpose of offering those interests for sale. The term related person means a person bearing a relationship described in 267(b) or 707(b)(1), except that in applying 267(b) or 707(b)(1), the co-ownership will be treated as a partnership and each co-owner will be treated as a partner. The term disregarded entity means an entity that is disregarded as an entity separate from its owner for federal tax purposes. Examples of disregarded entities include qualified REIT subsidiaries (within the meaning of 856(i)(2)), qualified subchapter S subsidiaries (within the meaning of 1361(b)(3)(B)), and business entities that have only one owner and do not elect to be classified as corporations. The term blanket lien means any mortgage or trust deed that is recorded against the Property as a whole.

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SECTION 5. INFORMATION TO BE SUBMITTED

.01 Section 8 of Rev. Proc. 2002-1 outlines general requirements concerning the information to be submitted as part of a ruling request, including advance rulings under this revenue procedure. For example, any ruling request must contain a complete statement of all facts relating to the co-ownership, including those relating to promoting, financing, and managing the Property. Among the information to be included are the items of information specified in this revenue procedure; therefore, the ruling request must provide all items of information and conditions specified below and in section 6 of this revenue procedure, or at least account for all of the items. For example, if a co-ownership arrangement has no brokerage agreement permitted in section 6.12 of this revenue procedure, the ruling request should so state. Furthermore, merely submitting documents and supplementary materials required by section 5.02 of this revenue procedure does not satisfy all of the information requirements contained in section 5.02 of this revenue procedure or in section 8 of Rev. Proc. 2002-1; all material facts in the documents submitted must be explained in the ruling request and may not be merely incorporated by reference. All submitted documents and supplementary materials must contain applicable exhibits, attachments, and amendments. The ruling request must identify and explain any information or documents required in section 5 of this revenue procedure that are not included and any conditions in section 6 of this revenue procedure that are or are not satisfied.

.02 Required General Information and Copies of Documents and Supplementary Materials. Generally the following information and copies of documents and materials must be submitted with the ruling request:

(1) The name, taxpayer identification number, and percentage fractional interest in Property of each co-owner;

(2) The name, taxpayer identification number, ownership of, and any relationship among, all persons involved in the acquisition, sale, lease and other use of Property, including the sponsor, lessee, manager, and lender;

(3) A full description of the Property;

(4) A representation that each of the co-owners holds title to the Property (including each of multiple parcels of property treated as a single Property under this revenue procedure) as a tenant in common under local law;

(5) All promotional documents relating to the sale of fractional interests in the Property;

(6) All lending agreements relating to the Property;

(7) All agreements among the co-owners relating to the Property;

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(8) Any lease agreement relating to the Property;

(9) Any purchase and sale agreement relating to the Property;

(10) Any property management or brokerage agreement relating to the Property; and

(11) Any other agreement relating to the Property not specified in this section, including agreements relating to any debt secured by the Property (such as guarantees or indemnity agreements) and any call and put options relating to the Property.

SECTION 6. CONDITIONS FOR OBTAINING RULINGS

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the conditions described below are satisfied. Nevertheless, where the conditions described below are not satisfied, the Service may consider a request for a ruling under this revenue procedure where the facts and circumstances clearly establish that such a ruling is appropriate.

.01 Tenancy in Common Ownership. Each of the co-owners must hold title to the Property (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the Property as a whole may not be held by an entity recognized under local law.

.02 Number of Co-Owners. The number of co-owners must be limited to no more than 35 persons. For this purpose, person is defined as in 7701(a)(1), except that a husband and wife are treated as a single person and all persons who acquire interests from a co-owner by inheritance are treated as a single person.

.03 No Treatment of Co-Ownership as an Entity. The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity). The Service generally will not issue a ruling under this revenue procedure if the co-owners held interests in the Property through a partnership or corporation immediately prior to the formation of the co-ownership.

.04 Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition (see section 6.06 of this revenue procedure for conditions relating to restrictions on alienation); or that certain actions on behalf of the co-ownership require the vote of co-

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owners holding more than 50 percent of the undivided interests in the Property (see section 6.05 of this revenue procedure for conditions relating to voting).

.05 Voting. The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion or all of the Property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the Property. A co-owner who has consented to an action in conformance with this section 6.05 may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.

.06 Restrictions on Alienation. In general, each co-owner must have the rights to transfer, partition, and encumber the co-owner's undivided interest in the Property without the agreement or approval of any person. However, restrictions on the right to transfer, partition, or encumber interests in the Property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. See section 6.14 of this revenue procedure for restrictions on who may be a lender. Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any co-owner's exercise of the right to transfer the co-ownership interest in the Property. In addition, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition.

.07 Sharing Proceeds and Liabilities upon Sale of Property. If the Property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

08 Proportionate Sharing of Profits and Losses. Each co-owner must share in all revenues generated by the Property and all costs associated with the Property in proportion to the co-owner's undivided interest in the Property. Neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.

.09 Proportionate Sharing of Debt. The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

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.10 Options. A co-owner may issue an option to purchase the co-owner's undivided interest (call option), provided that the exercise price for the call option reflects the fair market value of the Property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the Property is equal to the co-owner's percentage interest in the Property multiplied by the fair market value of the Property as a whole. A co-owner may not acquire an option to sell the co-owner's undivided interest (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.

.11 No Business Activities. The co-owners activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). See Rev. Rul. 75-374, 1975-2 C.B. 261. Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in 511(a)(2) from qualifying as rent under 512(b)(3)(A) and the regulations thereunder. In determining the co-owners activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the Property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the Property will be taken into account in determining whether the co-owners activities are customary activities. However, activities of a co-owner or a related person with respect to the Property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the Property for less than 6 months.

.12 Management and Brokerage Agreements. The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. The management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the Property against any revenues before disbursing each co-owner's share of net revenues. In all events, however, the manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the Property. In addition, the management agreement may authorize the manager to obtain or modify insurance on the Property, and to negotiate modifications of the terms of any lease or any indebtedness encumbering the Property, subject to the approval of the co-owners. (See section 6.05 of this revenue procedure for conditions relating to the approval of lease and debt modifications.) The determination of any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived by any person from the Property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

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.13 Leasing Agreements. All leasing arrangements must be bona fide leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the Property. The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the Property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). See section 856(d)(2)(A) and the regulations thereunder. Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the Property, cash flow, increases in equity, or similar arrangements.

.14 Loan Agreements. The lender with respect to any debt that encumbers the Property or with respect to any debt incurred to acquire an undivided interest in the Property may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the Property.

.15 Payments to Sponsor. Except as otherwise provided in this revenue procedure, the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the Property.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2000-46 is superseded. Rev. Proc. 2002-3 is modified by removing sections 5.03 and 5.06.

SECTION 7. DRAFTING INFORMATION

The principal authors of this revenue procedure are Jeanne Sullivan and Deane Burke of the Office of Associate Chief Counsel (Pass throughs and Special Industries). For further information regarding this revenue procedure, contact Ms. Sullivan or Mr. Burke at (202) 622-3070 (not a toll-free call).

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Internal Revenue Service
Revenue Procedure 2005-14

Revenue Procedure 2005-14: Combination Sections 1031 and 121
Internal Revenue Service (I.R.S.)

Rev. Proc. 2005-14. I.R.B. 2005-7, January 27, 2005. Internal Revenue Code Sections 121 and 1031. Exclusion from income: Gain from sale or exchange: Ownership and use test: Like-kind exchanges: Residences.

A homeowner who may exclude gain from a sale or exchange of a primary residence may also benefit from a deferral of gain from a like-kind exchange with respect to the same property. In such cases, the property must have been used consecutively or concurrently as a home and a business. Rev. Proc. 2005-14 is effective January 27, 2005; however, taxpayers may apply it to taxable years for which the period of limitations on refund or credit under Code Sec. 6511 has not expired.

SECTION 1. PURPOSE

This revenue procedure provides guidance on the application of Sections 121 and 1031 of the Internal Revenue Code to a single sale or exchange of property.

SECTION 2. BACKGROUND

.01 Section 121(a) provides that a taxpayer may exclude gain realized on the sale or exchange of property if the property was owned and used as the taxpayer's principal residence for at least 2 years during the 5-year period ending on the date of the sale or exchange. Section 121(b) provides generally that the amount of the exclusion is limited to $250,000 ($500,000 for certain joint returns). Under §121(d)(6), any gain attributable to depreciation adjustments (as defined in §1250(b)(3)) for periods after May 6, 1997, is not eligible for the exclusion. This limitation applies only to depreciation allocable to the portion of the property to which the §121 exclusion applies. See §121-1(d)(1).

.02 Section 121(d), as amended by § 840 of the American Jobs Creation Act of 2004, Pub. L. 108-357, provides that, if a taxpayer acquired property in an exchange to which § 1031 applied, the § 121 exclusion will not apply if the sale or exchange of the property occurs during the 5-year period beginning on the date of the acquisition of the property. This provision is effective for sales or exchanges after October 22, 2004.

.03 Under §1.121-1(e) of the Income Tax Regulations, a taxpayer who uses a portion of a property for residential purposes and a portion of the property for business purposes is treated as using the entire property as the taxpayer's principal

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residence for purposes of satisfying the 2-year use requirement if the residential and business portions of the property are within the same dwelling unit. The term "dwelling unit" has the same meaning as in §280A(f)(1), but does not include appurtenant structures or other property. If, however, the business portion of the property is separate from the dwelling unit used for residential purposes, the gain allocable to the business portion of the property is not excludable unless the taxpayer has also met the 2-year use requirement for the business portion of the property.

.04 Section 1.121-1(e)(3) provides that, for purposes of determining the amount of gain allocable to the residential and business portions of the property, the taxpayer must allocate the basis and the amount realized using the same method of allocation the taxpayer used to determine depreciation adjustments (as defined in §1250(b)(3)). Allocation based on the square footage of the residential and business portions of the property is an appropriate method of allocating the basis and the amount realized. *Poague v. United States*, 66 A.F.T.R.2d (RIA) 5825 (E.D. Va. 1990), *aff'd*, 947 F.2d 942 (4th Cir. 1991).

.05 Section 1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment (relinquished property) if the property is exchanged solely for property of like kind (replacement property) that is to be held either for productive use in a trade or business or for investment. Under §1031(b), if a taxpayer also receives cash or property that is not like-kind property (boot) in an exchange that otherwise qualifies under §1031(a), the taxpayer must recognize gain to the extent of the boot. Section 1031 does not apply to property that is used solely as a personal residence.

.06 Section 1012 provides that the basis of property is its cost. The basis of property acquired in an exchange is its fair market value, unless otherwise provided in the Code or regulations (for example, §1031(d)). See *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954).

.07 Under §1031(d), the basis of the replacement property is the same as the basis of the relinquished property, decreased by the amount of cash received and increased by the amount of gain recognized by the taxpayer in the exchange.

.08 Neither §121 nor §1031 addresses the application of both provisions to a single exchange of property. Section 121(d)(5)(B), however, provides rules for applying §121 and another nonrecognition provision, §1033, to a single replacement of property. Under §1033, in general, gain is recognized only to the extent the amount realized from a compulsory or involuntary conversion of property exceeds the cost of qualifying replacement property, and the basis of the replacement property is its cost reduced by the amount of the gain not recognized.

.09 Section 121(d)(5)(B) provides that, in applying §1033, the amount realized from the sale or exchange of property is treated as the amount determined without regard to §121, reduced by the amount of gain excluded under §121. Under

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§121(d)(5)(B), the amount realized from an exchange of a taxpayer's principal residence for purposes of applying §1033 is the fair market value of the relinquished property reduced by the amount of the gain excluded from gross income under §121. Thus, Congress concluded that for exchanges meeting the requirements of both §121 and §1033, (1) the §121 exclusion should be applied to gain from the exchange before the application of §1033, (2) for purposes of determining gain that may be deferred under §1033, the §121 exclusion should be applied first against amounts received by the taxpayer that are not reinvested in the replacement property (amounts equivalent to boot that would result in gain recognition absent the application of §121), and (3) the gain excluded under §121 should be added in the calculation of the taxpayer's basis in the replacement property. See S. Rep. No. 830, 88th Cong., 2d Sess. 52-53, 1964-1 C.B. (Part 2) 505, 556-7 ("the basis of the taxpayer in the newly acquired residence will be his basis for the old residence increased by any exclusion of gain obtained by him under the provision which is reinvested in the new residence"); H.R. Rep. No. 749, 88th Cong., 1st Sess. 47, 1964-1 C.B. (Part 2) 125, 171.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers who exchange property that satisfies the requirements for both the exclusion of gain from the exchange of a principal residence under §121 and the nonrecognition of gain on the exchange of like-kind properties under §1031. Thus, this revenue procedure applies only to taxpayers who satisfy the held for productive use in a trade or business or for investment requirement of §1031(a)(1) with respect to the relinquished business property and the replacement business property (as defined below).

SECTION 4. APPLICATION

.01 *In general*. Taxpayers within the scope of this revenue procedure may apply both the exclusion of gain from the exchange of a principal residence under §121 and the nonrecognition of gain from the exchange of like-kind properties under §1031 to an exchange of property by applying the procedures set forth in this section 4.

.02 *Computation of gain*.

(1) *Application of §121 before §1031*. Section 121 must be applied to gain realized before applying §1031.

(2) *Application of §1031 to gain attributable to depreciation*. Under §121(d)(6), the §121 exclusion does not apply to gain attributable to depreciation deductions for periods after May 6, 1997, claimed with respect to the business or investment portion of a residence. However, §1031 may apply to such gain.

(3) *Treatment of boot*. In applying §1031, cash or other non-like kind property (boot) received in exchange for property used in the taxpayer's trade or business or held for investment (the relinquished business property), is taken into account only to

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the extent the boot exceeds the gain excluded under §121 with respect to the relinquished business property.

.03 *Computation of basis*. In determining the basis of the property received in the exchange to be used in the taxpayer's trade or business or held for investment (the replacement business property), any gain excluded under §121 is treated as gain recognized by the taxpayer. Thus, under §1031(d), the basis of the replacement business property is increased by any gain attributable to the relinquished business property that is excluded under §121.

SECTION 5. EXAMPLES

In each example below, the taxpayer is an unmarried individual and the property or a portion of the property has been used in the taxpayer's trade or business or held for investment within the meaning of §1031(a) as well as used as a principal residence as required under §121.

Example 1. (i) Taxpayer A buys a house for $210,000 that A uses as A's principal residence from 2000 to 2004. From 2004 until 2006, A rents the house to tenants and claims depreciation deductions of $20,000. In 2006, A exchanges the house for $10,000 of cash and a townhouse with a fair market value of $460,000 that A intends to rent to tenants. A realizes gain of $280,000 on the exchange.

(ii) A's exchange of a principal residence that A rents for less than 3 years for a townhouse intended for rental and cash satisfies the requirements of both §§121 and 1031. Section 121 does not require the property to be the taxpayer's principal residence on the sale or exchange date. Because A owns and uses the house as A's principal residence for at least 2 years during the 5-year period prior to the exchange, A may exclude gain under §121. Because the house is investment property at the time of the exchange, A may defer gain under §1031.

(iii) Under section 4.02(1) of this revenue procedure, A applies §121 to exclude $250,000 of the $280,000 gain before applying the nonrecognition rules of §1031. A may defer the remaining gain of $30,000, including the $20,000 gain attributable to depreciation, under §1031. See section 4.02(2) of this revenue procedure. Although A receives $10,000 of cash (boot) in the exchange, A is not required to recognize gain because the boot is taken into account for purposes of §1031(b) only to the extent the boot exceeds the amount of excluded gain. See section 4.02(3) of this revenue procedure.

These results are illustrated as follows:

Amount realized	$470,000
Less: Adjusted basis	$190,000
Realized gain	$280,000

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Less: Gain excluded under §121	$250,000
Gain to be deferred	$ 30,000

(iv) A's basis in the replacement property is $430,000, which is equal to the basis of the relinquished property at the time of the exchange ($190,000) increased by the gain excluded under §121 ($250,000), and reduced by the cash A receives ($10,000)). See section 4.03 of this revenue procedure.

Example 2. (i) Taxpayer B buys a property for $210,000. The property consists of two separate dwelling units (within the meaning of §1.121-1(e)(2)), a house and a guesthouse. From 2001 until 2006, B uses the house as B's principal residence and uses the guesthouse as an office in B's trade or business. Based on the square footage of the respective parts of the property, B allocates 2/3 of the basis of the property to the house and 1/3 to the guesthouse. In 2006, B exchanges the entire property for a residence and a separate property that B intends to use as an office. The total fair market value of B's replacement properties is $360,000. The fair market value of the replacement residence is $240,000 and the fair market value of the replacement business property is $120,000, which is equal to the fair market value of the relinquished business property. From 2001 to 2006, B claims depreciation deductions of $30,000 for the business use. B realizes gain of $180,000 on the exchange.

(ii) Under §121, B may exclude gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000) because B meets the ownership and use requirements for that portion of the property. Because the guesthouse is business property separate from the dwelling unit and B has not met the use requirements for the guesthouse, B may not exclude the gain allocable to the guesthouse under §1.121-1(e). However, because the fair market value of the replacement business property is equal to the fair market value of the relinquished business property and B receives no boot, B may defer the remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis, which is 1/3 of $210,000 basis, or $70,000, adjusted by $30,000 depreciation) under §1031.

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These results are illustrated as follows:

	Total property	*2/3 residential property*	*1/3 business property*
Amount realized	$360,000	$240,000	$120,000
Basis	$210,000	$140,000	$70,000
Depreciation adjustment	$30,000		$30,000
Adjusted basis	$180,000	$140,000	$40,000
Realized gain	$180,000	$100,000	$80,000
Gain excluded under §121	$100,000	$100,000	
Gain deferred under §1031	$80,000		$80,000

(iii) Because no portion of the gain attributable to the relinquished business property is excluded under §121 and B receives no boot and recognizes no gain or loss in the exchange, B's basis in the replacement business property is equal to B's basis in the relinquished business property at the time of the exchange ($40,000). B's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000).

Example 3. (i) Taxpayer C buys a property for $210,000. The property consists of a house that constitutes a single dwelling unit under §1.121-1(e)(2). From 2001 until 2006, C uses 2/3 of the house (by square footage) as C's principal residence and uses 1/3 of the house as an office in C's trade or business. In 2006, C exchanges the entire property for a residence and a separate property that C intends to use as an office in C's trade or business. The total fair market value of C's replacement properties is $360,000. The fair market value of the replacement residence is $240,000 and the fair market value of the replacement business property is $120,000, which is equal to the fair market value of the business portion of the relinquished property. From 2001 to 2006, C claims depreciation deductions of $30,000 for the business use. C realizes gain of $180,000 on the exchange.

(ii) Under §121, C may exclude the gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000) because C meets the ownership and use requirements for that portion of the property.

(iii) The remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis, which is 1/3 of $210,000 basis, or $70,000, adjusted by $30,000 depreciation) is allocable to the business portion of the house (the office). Under section 4.02(1) of this revenue procedure, C applies §121 before applying the nonrecognition rules of §1031. Under §1.121-1(e), C may exclude $50,000 of the gain allocable to the office because the office and residence are part of a single dwelling unit. C may not exclude that portion of the gain ($30,000)

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attributable to depreciation deductions, but may defer the remaining gain of $30,000 under §1031.

These results are illustrated as follows:

	Total property	*2/3 residential property*	*1/3 business property*
Amount realized	$360,000	$240,000	$120,000
Basis	$210,000	$140,000	$70,000
Depreciation adjustment	$30,000		$30,000
Adjusted basis	$180,000	$140,000	$40,000
Realized gain	$180,000	$100,000	$80,000
Gain excluded under §121	$150,000	$100,000	$50,000
Gain deferred under §1031	$30,000		$30,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000). C's basis in the replacement business property is $90,000, which is equal to C's basis in the relinquished business property at the time of the exchange ($40,000), increased by the gain excluded under §121 attributable to the relinquished business property ($50,000). See section 4.03 of this revenue procedure.

Example 4. (i) The facts are the same as in *Example 3* except that C also receives $10,000 of cash in the exchange and the fair market value of the replacement business property is $110,000, which is $10,000 less than the fair market value of the business portion of the relinquished property ($120,000).

(ii) Under §121, C may exclude the gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000).

(iii) The remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. Under section 4.02(1) of this revenue procedure, C applies §121 to exclude gain before applying the nonrecognition rules of §1031. Under §1.121-1(e), C may exclude $50,000 of the gain allocable to the business portion of the house but may not exclude the $30,000 of gain attributable to depreciation deductions. Under section 4.02(2) of this revenue procedure, C may defer the $30,000 of gain under §1031. Although C receives $10,000 of cash (boot) in the exchange, C is not required to recognize gain because the boot is taken into account for purposes of §1031(b) only to the extent the boot exceeds the amount of excluded gain attributable to the relinquished business property. See 4.02(3) of this revenue procedure.

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These results are illustrated as follows:

	Total property	*2/3 residential property*	*1/3 business property*
Amount realized	$360,000	$110,000 + $240,000	10,000
Basis	$210,000	$140,000	$70,000
Depreciation adjustment	$30,000		$30,000
Adjusted basis	$180,000	$140,000	$40,000
Realized gain	$180,000	$100,000	$80,000
Gain excluded under §121	$150,000	$100,000	$50,000
Gain deferred under §1031	$30,000		$30,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000). C's basis in the replacement business property is $80,000, which is equal to C's basis in the relinquished business property ($40,000), increased by the gain excluded under §121 ($50,000), and reduced by the cash ($10,000) received. See section 4.03 of this revenue procedure.

Example 5. (i) The facts are the same as in *Example 3* except that the total fair market value of the replacement properties is $540,000. The fair market value of the replacement residence is $360,000, the fair market value of the replacement business property is $180,000, and C realizes gain of $360,000 on the exchange.

(ii) Under §121, C may exclude the gain of $220,000 allocable to the residential portion of the house (2/3 of $540,000 amount realized, or $360,000, minus 2/3 of $210,000 basis, or $140,000).

(iii) The remaining gain of $140,000 (1/3 of $540,000 amount realized, or $180,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. Under section 4.02(1) of this revenue procedure, C excludes the gain before applying the nonrecognition rules of §1031. Under §1.121-1(e), C may exclude $30,000 of the gain allocable to the business portion, at which point C will have excluded the maximum limitation amount of $250,000. C may defer the remaining gain of $110,000 ($140,000 realized gain minus the $30,000 gain excluded under §121), including the $30,000 gain attributable to depreciation, under §1031.

These results are illustrated as follows:

	Total property	*2/3 residential property*	*1/3 business property*

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Amount realized	$540,000	$360,000	$180,000
Basis	$210,000	$140,000	$70,000
Depreciation adjustment	$30,000		$30,000
Adjusted basis	$180,000	$140,000	$40,000
Realized gain	$360,000	$220,000	$30,000
Gain excluded under §121	$250,000	$220,000	$30,000
Gain deferred under §1031	$110,000		$110,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($360,000). C's basis in the replacement business property is $70,000, which is equal to C's basis in the relinquished business property ($40,000), increased by the amount of the gain excluded under §121 ($30,000). See section 4.03 of this revenue procedure.

Example 6. (i) The facts are the same as in *Example 3* except that the total fair market value of the replacement properties is $750,000. The fair market value of the replacement residence is $500,000, the fair market value of the replacement business property is $250,000, and C realizes gain of $570,000 on the exchange.

(ii) The gain allocable to the residential portion is $360,000 (2/3 of $750,000 amount realized, or $500,000, minus 2/3 of $210,000 basis, or $140,000). C may exclude gain of $250,000 from gross income under §121. C must include in income the gain of $110,000 allocable to the residential portion that exceeds the §121(b) exclusion limitation amount.

(iii) The remaining gain of $210,000 (1/3 of $750,000 amount realized, or $250,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. C may defer the $210,000 of gain, including the $30,000 gain attributable to depreciation, under §1031.

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These results are illustrated as follows:

	Total property	*2/3 residential property*	*1/3 business property*
Amount realized	$750,000	$500,000	$250,000
Basis	$210,000	$140,000	$70,000
Depreciation adjustment	$30,000		$30,000
Adjusted basis	$180,000	$140,000	$40,000
Realized gain	$570,000	$360,000	$210,000
Gain excluded under §121	$250,000	$250,000	
Gain deferred under §1031	$210,000		$210,000
Gain recognized	$110,000	$110,000	

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($500,000). C's basis in the replacement business property is $40,000, which is equal to C's basis in the relinquished business property at the time of the exchange.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective January 27, 2005. However, taxpayers may apply this revenue procedure in taxable years for which the period of limitation on refund or credit under §6511 has not expired.

DRAFTING INFORMATION

The principal author of this revenue procedure is Sara Paige Shepherd of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Ms. Shepherd at (202) 622-4960 (not a toll free call).

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Appendix E

Internal Revenue Service: Revenue Rulings

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Appendix F

Internal Revenue Service: Form 8824

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