PLANNING DEFERRED LIKE-KIND EXCHANGES

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I. INTRODUCTION

A. The Starker Case

Section 1031(a) of the Internal Revenue Code of 1986, as amended, provides that:

> "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 a like kind which is to be held either for productive use in a trade or business or for investment."[1]

This rule has been a part of the Code since the 1920's. However, despite this provision's long history, for many years it was unclear whether a transaction in which the transfer and receipt of the subject properties occurred over a period of time, rather than simultaneously, could (or should) qualify for nonrecognition of gain or loss under Section 1031.

The Internal Revenue Service's (the "IRS's") position that a Section 1031 exchange must occur simultaneously was effectively defeated by the Ninth Circuit's decision in Starker v. United States, 602 F.2d 1341 (9th Cir. 1979). The taxpayer in Starker deeded his property to a third party in exchange for that party's unsecured promise to convey like-kind property at a future date. The property to be received was not identified at the time of the first transfer and no specific time was set forth for the exchange to be completed. The third party had the right (but not the obligation) to satisfy its obligation to the taxpayer by paying cash after five years, but the taxpayer did not have the right to demand cash. The purchase price of the property to be received by the taxpayer was to increase by a growth factor of six percent per year. Like-kind property was received by the taxpayer after several years. Under these facts, the court held that an exchange resulting in nonrecognition of gain or loss under Section 1031 occurred.

B. The Tax Reform Act of 1984

Starker was a major taxpayer victory in this area and provoked a response from Congress in the Tax Reform Act of 1984, Pub. L. No. 980-369, 98 Stat. 494. However, given the uncertainties remaining after the Starker case, legislative restrictions on the use of deferred like-kind exchanges were necessary.

The nonrecognition rules applicable to like-kind exchanges have been justified on the grounds that a taxpayer making a like-kind exchange has not changed its investment and thus a realization event resulting in the recognition of gain or loss should not be considered to have occurred. This rationale for Section 1031 is less applicable in the case of deferred exchanges. To the extent the taxpayer is able to defer completion of the transaction and retains the right to

designate the property to be received at some future time, the transaction resembles a sale more than an exchange. In other words, the greater the taxpayer's discretion to vary the particular property to be received in exchange for the relinquished property and to vary the date on which such property (or money) is to be received, the more the transaction is appropriately treated as a sale and not a like-kind exchange. See Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Reform Act of 1984, pp. 243-7.[2]

Based on the above-referenced policy, Congress enacted Section 77 of the Tax Reform Act of 1984 which added Section 1031(a)(3) to the Code. Section 1031(a)(3) provides that, for purposes of Section 1031(a):

> "[A]ny 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
>
> (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 [Chapter 1 of Subtitle A] for the taxable year in which the transfer of the relinquished property occurs."

Although the enactment of Section 1031(a)(3) provided the basic ground rules for deferred exchanges, a number of unclear areas remained. In particular, taxpayers were unsure what constituted adequate identification of the replacement property, what types of security could be used, and how to compute gain recognized and the basis of the property received in a deferred exchange.

Many of these questions were answered by the publication on May 16, 1990 of proposed regulations interpreting the 1984 amendments to Section 1031. Notice of Proposed Rulemaking (IA-237-84), 50 Fed. Reg. 20278, I.R.B. 1990-26 (June 25, 1990) (the "Notice"). The Notice proposed to add new Section 1.1031(a)-3 to the Income Tax Regulations (the "Proposed Regulations") to govern the tax treatment of deferred exchanges.[3]

The Proposed Regulations were finalized by Treasury Decision 8346 which was adopted on April 25, 1991. Treasury Decision 8346 added new Section 1.1031(k)-1 to the Income Tax Regulations (the "Final Regulations") governing the tax treatment of deferred exchanges.

II. EXPLANATION OF THE DEFERRED EXCHANGE REGULATIONS[4]

As will become increasingly clear with the full explanation of the Final Regulations, prudent taxpayers and tax practitioners should endeavor to structure transactions to meet the rules and safe harbors provided therein. Transactions so structured should be safe from a challenge which could result in disallowance of deferred exchange treatment.

It is important for taxpayers to set up the documentation for a deferred exchange correctly and then to scrupulously follow the terms of the exchange agreement and supporting documents. Failure to follow the terms of the agreements can result in a court denying like-kind exchange treatment by holding that a sale and repurchase rather than an exchange occurred or that the taxpayer has constructively received the cash consideration paid by the buyer for the relinquished property. See, e.g., Joanne H. Greene, T.C. Memo 1991-403.

The general rule under the Code is that, unless a specific exception applies, the entire amount of gain or loss realized on a sale or exchange is recognized. Section 1001(c). The exceptions to this general rule, such as Section 1031, "are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception." Treas. Reg. § 1.1002-1(b). Despite this being the case, the courts have traditionally taken a liberal view on what is necessary for a transaction to qualify as a like-kind exchange. Following in the footsteps of the court cases, the Proposed Regulations took a liberal view regarding what constitutes a deferred like-kind exchange qualifying for nonrecognition of gain or loss under Section 1031. However, given the general strict construction backdrop to the IRS's interpretation of nonrecognition transactions, significant relaxation of the rules contained in the Final Regulations was not expected and did not, in fact, occur.

The Final Regulations contain substantially the same rules as the Proposed Regulations, except that certain rules have been modified or clarified. Indeed, one of the most significant changes was the change in citation from Prop. Reg. § 1.1031(a)-3 to Treas. Reg. § 1.1031(k)-1.

When the Proposed Regulations were issued, a number of tax practitioners believed that they significantly liberalized the rules concerning deferred exchanges. However, in a recent case, an exchange was held to be a good deferred exchange notwithstanding the fact that the intermediary was wholly-owned by the 90% cotenant of the relinquished property. Fred L. Fredericks, T. C. Memo 1994-27. The exchange in Fredericks started in 1983 and thus predates the enactment of Section 1031(a)(3). The case nevertheless points out that the Tax Court may take a more expansive view of what constitutes a good deferred exchange than is contained in the Final Regulations.

A. Definition of Deferred Exchange

Except to the limited extent discussed below, Treas. Reg. § 1.1031(k)-1 only applies in the case of a "deferred exchange." Thus, as an initial matter, a transaction must be structured to fall within this definition in order for the Final Regulations to apply.

Under the Final Regulations, a "deferred exchange" is defined as:

> "[A]n exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the 'relinquished property'), and subsequently receives property to be held either for productive use in a trade or business or for investment (the 'replacement property')."

Treas. Reg. § 1.1031(k)-1(a).

In order to satisfy this definition (and therefore to have the Final Regulations apply), the taxpayer must ensure that the acts and transactions intended to constitute a like-kind exchange include the following: (1) an exchange; (2) an agreement; and (3) the receipt of the replacement property subsequent to the transfer of the relinquished property.

1. The exchange requirement.

The exchange requirement is both the most obvious and most subtle of the three requirements. Section 1031(a) requires the transaction to constitute an exchange before the section can even apply; however, the distinction between a sale and an exchange has always been slippery at best. In general, an exchange is an exchange of property for property as distinguished from a transfer of property for money. See Treas. Reg. § 1.1031(k)-1(a); Treas. Reg. § 1.1002-1(d); C. Bean Lumber v. U.S., 99-1 USTC ¶ 50,474 (W.D. Ark. 1999) (trucking company’s separate purchase of new trucks and trade-ins of old trucks not like-kind exchanges where transactions were completed independently of each other and company had unfettered use of cash from trade-ins). Taxpayers should be careful to document that they are exchanging property. Thus, there must be an agreement between the taxpayer and another person calling for an exchange of like-kind property. The other person to the exchange agreement must be either a principal in the transaction or a person who is acting as a principal pursuant to the rules for "qualified intermediaries."[5]

Typically, an exchange occurs when there is a reciprocal exchange of property, with the same taxpayer both giving up a property and receiving a property in return.[6] Recently, however, the IRS has approved like-kind exchange treatment for transactions where, in certain circumstances, the replacement property is received by an entity other than the original transferor. In PLR 985001 (Aug. 31, 1998), the taxpayer corporation ("TP") relinquished a hotel property to a qualified intermediary and directed the intermediary to transfer the replacement property to a single-member limited liability company ("LLC") owned by TP. Before LLC received the replacement property, TP liquidated into its parent corporation, H, in a tax-free liquidation under Section 332. H then merged with and into its sister corporation, S, in a merger

qualifying as a Section 368(a)(1)(A) reorganization. The IRS held, first, that TP's right to receive the replacement property in a nonrecognition transaction was a tax attribute of TP that could be acquired and used by an acquiror of TP in a tax-free liquidation or reorganization, in the same manner tax attributes are acquired by the survivors of such transactions under Section 381. Second, the receipt of the replacement property by LLC was immaterial because, as a single-member entity, the existence of LLC would be ignored for purposes of determining ownership of the property. The replacement property was thus deemed to be received by S, the successor to TP's tax attributes in the liquidation and reorganization. See also PLR 9751012 (same result with similar facts); PLR 9807013 (deeming replacement property received by a single-member LLC owned by the transferor to be received by the transferor).

2. **The agreement requirement**.

The agreement requirement should be seen as a requirement for the taxpayer to have documentary evidence that an exchange occurred. Prudent taxpayers will always have a written exchange agreement, even though, except for exchanges using a qualified intermediary, the Final Regulations do not explicitly require one. The exchange and agreement requirements when placed together work to distinguish between exchanges complying with the requirements of Section 1031(a)(3) and sales of property followed by purchases of replacement property which happen to meet that section's timing requirements for the identification and receipt of the replacement property. See Treas. Reg. § 1.1031(k)-1(a).

3. **The "subsequently receives" requirement**.

The requirement that the replacement property be received subsequent to the time the relinquished property is transferred results in two classes of like-kind exchanges being outside of the provisions of Treas. Reg. § 1.1031(k)-1: simultaneous exchanges and reverse exchanges.

a. **Simultaneous exchanges**.

Although the identification and receipt of Section 1031(a)(3) are obviously of no relevance in a simultaneous exchange, the safe harbors to actual and constructive receipt are important in structuring simultaneous exchanges.[7]

Treas. Reg. § 1.1031(b)-2 (which was also adopted by T.D. 8346) allows taxpayers to take advantage of the qualified intermediary safe harbor of Treas. Reg. § 1.1031(k)-1(g)(4) in structuring simultaneous exchanges. The other safe harbors to actual and constructive receipt contained in Treas. Reg. § 1.1031(k)-1(g) were not made available for simultaneous exchanges because the IRS did not believe that such an extension was "necessary." T.D. 8346. Although this may seem to be overly restrictive, the rest of the safe harbors are important only when receipt of the replacement property is delayed. In such cases the transaction should come within the definition of a deferred exchange. The IRS's decision thus seems to be correct.

b. **Reverse exchanges.**[8]

i. **In general.**

A reverse exchange is an exchange where the taxpayer receives the replacement property prior to the date on which the taxpayer transfers the relinquished property. Reverse exchanges are becoming an increasingly popular device because, for example, they give the taxpayer the ability to acquire property currently at a favorable price while deferring the transfer of the relinquished property to a time when, hopefully, a better price can be obtained. Such transactions become more frequent in depressed real estate markets. Although reverse exchanges occur, many taxpayers are unwilling to do them directly because of concerns that the IRS will challenge whether such transactions qualify for nonrecognition under Section 1031. Thus, most reverse exchanges occur through the use of cumbersome (and costly) parking or lease-option arrangements.

In a typical parking arrangement, the taxpayer enters into a simultaneous exchange with an intermediary which then holds the relinquished property until a buyer is found. Alternatively, the intermediary may acquire and hold the replacement property until a buyer for the relinquished property is found and then enter into a simultaneous exchange with the taxpayer. Although such arrangements appear to literally satisfy the requirements of Section 1031, unless carefully structured, they raise significant issues regarding agency and whether the intermediary is the true owner of the property it holds. From a non-tax perspective, a wholly-owned corporation or other affiliated entity is the logical choice for the parking intermediary. However, because of the potential application of the related person rules of Section 1031(f), only entities not bearing a relationship to the taxpayer described in either Section 267(b) or 707(b) should be used.[9] Generally, this requires common ownership of 50 percent or less.

In a lease-option arrangement, the taxpayer leases the replacement property with an option to buy and then enters into a simultaneous exchange when the purchase option is exercised. Such arrangements must be carefully structured to avoid recharacterization of the lease-option as a current sale.

As discussed above, it is settled law that an exchange need not occur simultaneously in order for Section 1031 to apply. It should, therefore, naturally follow that reverse exchanges are also within the nonrecognition provisions of Section 1031.[10] This proposition can be illustrated by the following example:

> Example (1). A holds Blackacre, which is unencumbered raw land, for investment. B holds Whiteacre, which is also unencumbered raw land, for investment. Blackacre and Whiteacre each have a fair market value of $100,000. If A and B simultaneously exchange Blackacre for Whiteacre and A and B each intend to hold their respective new properties for investment, then the exchange clearly qualifies for nonrecognition under Section 1031(a)(1) as to both A and B.
>
> Now, assume that A transfers Blackacre to B on day 1, but that B does not transfer Whiteacre to A until day 5 and that the exchange agreement makes no

provisions for cash payments to either party. As to A, the exchange is a deferred exchange and, because the requirements of Section 1031(a)(3) are complied with, the exchange qualifies for nonrecognition under Section 1031(a)(1). As to B, the exchange is a reverse exchange and the requirements of Section 1031(a)(3) are irrelevant. See T.D. 8346.

The issue presented in the above example is whether B's exchange qualifies for nonrecognition under Section 1031(a)(1). Substantively, all that has happened is that B's transfer of Whiteacre has been delayed. However, nothing in the statute or the regulations makes this point significant. B has not "cashed out" of its investment and was at no point in time in actual or constructive receipt of money or property not of a like kind. Indeed, as an interpretative matter, there appears to be no reason to believe that a court would hold differently in B's case than it did in Starker.

The facts of the above example are similar to those of Bernie D. Rutherford, T.C. Memo 1978-505 (Tannenwald, J.). In Rutherford, Wardlaw transferred 12 half-blood heifers to Rutherford on November 13, 1973. Per their agreement, Rutherford transferred 12 three-quarter blood heifers to Wardlaw during 1974, 1975 and 1976. The agreement contained no provision for Rutherford to pay money to Wardlaw in the event he could not deliver the 12 three-quarter blood heifers. Under these facts, the Tax Court held that, as to Rutherford, the transaction constituted a nontaxable exchange under Section 1031(a).[11]

More recently, the IRS approved, in a private letter ruling, a reverse exchange involving a swap of utility easements. In PLR 9823045 (March 10, 1998), the IRS considered a proposed transaction in which the taxpayer would accept a new easement on land owned by another company, Company F, upon which the taxpayer would construct new transmission lines. Once the lines were built, energized, and tested, so that the taxpayer was satisfied with the transmission lines' future performance, the taxpayer would relinquish to Company F an old utility easement also located on land owned by Company F. The IRS held that the exchange would qualify for like-kind exchange treatment. The ruling did not discuss whether the exchange of easements would be subject to any time limit.

However, in four cases the Tax Court has denied nonrecognition under Section 1031 to purported reverse exchanges. In Bezdjian v. Commissioner, 845 F.2d 217 (9th Cir. 1988), the Bezdjians received an offer to purchase a gas station they operated under a lease. The seller refused to accept a rental property owned by the Bezdjians in exchange. The Bezdjians purchased the gas station and, about three weeks later, sold the rental property to an unrelated party. Under these facts, the Ninth Circuit affirmed the Tax Court in holding that there was no exchange qualifying for nonrecognition under Section 1031. Bezdjian is, however, clearly distinguishable from Rutherford. First, the Bezdjians did not enter into an agreement for the exchange of properties with anybody. Second, they did not transfer the relinquished property to the same person from whom they received the replacement property. Thus, Bezdjian cannot be said to undermine the basic proposition that a properly structured reverse exchange qualifies for nonrecognition under Section 1031.

In Edward C. Lee, T.C. Memo 1985-294, the taxpayers purchased a farm in November 1977. In June 1978, the taxpayers sold five parcels to five different purchasers and directed that the sale proceeds be transferred directly to the seller of the farm. The Tax Court held that the sale of the five parcels did not qualify for nonrecognition under Section 1031 because there was no evidence that the purchase and sales were interdependent parts of an overall plan to exchange properties. In other words, this case suffered from the same infirmities as did Bezdjian. Similarly, in Disby v. Commissioner, T.C. Memo 1995-477, the Tax Court denied nonrecognition under Section 1031 to a couple who sold their old liquor store in March, 1989, about six months after they had purchased a new liquor store. Proceeds from the sale of the old store were used to retire debt the taxpayers had incurred to purchase the new store. The purchaser of the old store and the seller of the new store were not the same person. As in Bezdjian and Lee, the contracts of sale, escrow agreements and other documents for the purchase and sale did not mention that an exchange of properties was contemplated.

Finally, in Lincoln v. Commissioner, T.C. Memo 1998-421, the Tax Court denied like-kind exchange treatment to a couple who sold a parcel of rental real estate about six months after purchasing another parcel for development as rental property. The taxpayers directed the buyers of the first parcel to pay the purchase price into a credit union account controlled by the taxpayers, who then used the money to reimburse themselves for the purchase price of the second parcel and the cost of certain improvements. The Tax Court found that the transaction did not qualify for nonrecognition under Section 1031 because (1) none of the documentation for the two purchases indicated that any party intended for there to be an exchange of the properties, (2) the taxpayers did not consider a like-kind exchange until after they had completed the purchase of the first parcel, and (3) the taxpayers had control over the funds in the credit union account and could have used the money for other purposes.

Based on the foregoing, it appears that a properly structured reverse exchange should qualify for nonrecognition under Section 1031(a)(1). Properly structured means that the replacement and relinquished properties are transferred pursuant to a written exchange agreement, the same person transfers the replacement property to and receives the relinquished property from the taxpayer, and the other requirements of Section 1031 are satisfied.

Nevertheless, substantial problems remain, both for taxpayers and for the IRS. In particular, because there is only limited authority specifically authorizing reverse exchanges, taxpayers should be wary of undertaking these transactions. On the other hand, the IRS should be concerned that, without guidelines, taxpayers are free to construct open-ended reverse exchanges which could lead to the same problems that were created by the Starker case.

ii. **The Report's proposal**.

The Report contains a proposal that would permit reverse exchanges to qualify for like-kind exchange treatment in a manner that is similar to the rules for deferred exchanges using a qualified intermediary under Treas. Reg. § 1.1031(k)-1(g)(4).[12]

Under the Report's proposal, the taxpayer would enter into a "reverse exchange agreement" with a qualified intermediary whereby the qualified intermediary would purchase the replacement property and transfer it to the taxpayer in exchange for the taxpayer's promise to transfer the relinquished property to the qualified intermediary at a later date. The taxpayer could advance the funds necessary to purchase the replacement property (including acquisition financing secured by the replacement property) to the qualified intermediary. After a buyer for the relinquished property is found, the taxpayer would transfer the relinquished property to the qualified intermediary who would then sell the relinquished property to the buyer.

Several distinctions from the deferred exchange rules should be noted. First, unlike a deferred exchange, the subject property would not have to be identified within 45 days. Second, there would be a safe harbor for reverse exchanges completed (i.e., the date on which the relinquished property is transferred) before the due date (including extensions) for the taxpayer's tax return for the year in which the replacement property is acquired. In other words, in the case of an individual taxpayer, if the replacement property was acquired in 1993, the relinquished property would have to be transferred by October 15, 1994 in order for the reverse exchange to qualify for like-kind exchange treatment under the safe harbor (assuming the taxpayer properly requested extensions to file his tax return). Third, the taxpayer could not take depreciation or other cost recovery deductions with respect to the relinquished property from and after the date on which the taxpayer acquired the replacement property.

If the IRS adopts a rule that is similar to the proposal contained in the Report, then reverse exchanges should become as easy to structure as has been the case with deferred exchanges since the publication of the Final Regulations in 1991. Except in unusual cases, parking and lease-option arrangements would no longer be necessary.

B. **Identification and receipt requirements**

1. **Identification period and exchange period**.

Treas. Reg. § 1.1031(k)-1(b)(1) provides that, in the case of a deferred exchange, any replacement property received by the taxpayer will be treated as property which is not of a like kind to the relinquished property if:

(a) the replacement property is not "identified" before the end of the "identification period," or

(b) the identified replacement property is not received before the end of the "exchange period."

The "identification period" begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th day thereafter. The "exchange period" begins on the date the taxpayer transfers the relinquished property and ends on the earlier of midnight on the 180th day thereafter or midnight on the due date (including extensions) for the taxpayer's income tax return for the taxable year in which the transfer of the relinquished property occurs.[13] Treas. Reg. § 1.1031(k)-1(b)(2). These requirements follow directly from the statutory provisions of Section 1031(a)(3).

No provision is made for the extension of the identification period or the exchange period. Indeed, T.D. 8346 provides that "because the timing requirements relating to the identification and exchange periods are statutory, requests for extension of the identification period or the exchange period through administrative relief under [Treas. Reg.] § 1.9100 will not be granted." On the same grounds, the Tax Court has refused to extend the exchange period even when circumstances beyond the taxpayers' control prevented the purchase of the replacement property within the required time limit. Knight v. Commissioner, T.C. Memo 1998-107 (taxpayers failed the 180-day receipt requirement when the seller of the replacement property canceled the transaction on the 179th day).

Three important additional rules should be noted when determining when the identification and exchange periods begin and end. First, if as part of the same deferred exchange the taxpayer transfers more than one relinquished property and such properties are transferred on different dates, then the identification period and the exchange period are determined by reference to the earliest date on which any of the relinquished properties are transferred. Treas. Reg. § 1.1031(k)-1(b)(2)(iii).

It is unclear when properties are transferred "as part of the same deferred exchange." This will be reasonably clear in most situations; however, some additional guidelines would have been helpful. Presumably, merely transferring property pursuant to separate exchange agreements would not, by itself, be sufficient to create different deferred exchanges.[14]

As a general matter, the rule starting both the identification period and the exchange period with the date of the first transfer should simplify significantly the structuring and analysis of deferred exchanges. However, taxpayers should take care not to inadvertently fail to identify or receive replacement property in a timely fashion as a result of the application of this rule.

Second, under the IRS's (but not the Tax Court's) interpretation of Section 7503, the identification period and exchange period are not extended to the next succeeding day if the last day falls on a Saturday, Sunday, or legal holiday.[15] Compare Snyder, TC Memo 1981-216, with Rev. Rul. 83-116, 1983-2 C.B. 264.

> Example (2). M, a corporation with the calendar year as its taxable year, transfers properties A, B, and C to N as part of the same deferred exchange. Property A is transferred on November 17, 1991, property B on November 20, and property C on December 3. With respect to all three relinquished properties, the identification period ends at midnight on January 1, 1991 (even though it is New

> Year's Day) and the exchange period ends at midnight on March 16, 1992 (the due date for M's income tax return) unless M applies for and receives the automatic six-month filing extension, in which case the exchange period ends on May 16, 1992. See Treas. Reg. § 1.1031(k)-1(b)(3).

If a taxpayer identifies replacement property after the end of the identification period or receives replacement property after the end of the exchange period, he could still claim that the deferred exchange was valid based on Snyder (assuming the provisions of Section 7503 otherwise apply). However, prudent taxpayers should not plan into such a situation. Of course, if the IRS revokes Rev. Rul. 83-116 and decides to follow Snyder, then the applicability of Section 7503 will follow naturally.

Third, for purposes of determining when the running of the identification and exchange periods begins, property is treated as "transferred" when it is disposed of within the meaning of Section 1001(a). Treas. Reg. § 1.1031(k)-1(b)(2)(iv). In most cases, this will occur when legal title is transferred. Taxpayers should note that the general rule under Section 1001(a) is that the taxpayer transfers property at the time the benefits and burdens of ownership are transferred or received (which may or may not coincide with the transfer and receipt of legal title). For example, in real estate transactions, an installment sale is sometimes structured as a "land sale contract" wherein physical possession passes at the time of sale but legal title does not pass until all payments have been made. In such cases, tax ownership precedes the receipt of legal title.

Finally, although not explicitly stated in the Final Regulations, the running of the identification period and exchange period are presumably triggered only with the transfer of property which is subject to nonrecognition under Section 1031 and not with the taxpayer's transfer of boot or the payment of cash as part of the deferred exchange.

2. **Identification of replacement property.**

As noted above, the greater the taxpayer's discretion to vary the particular property to be received in exchange for the relinquished property after the transfer of the relinquished property, the more the transaction appears to be a sale rather than an exchange. The policy underlying the identification requirement of Section 1031(a)(3)(A) is thus to retain the exchange character of the transaction by requiring taxpayers to identify the replacement property by the end of the identification period. This purpose is best served by requiring the identification of the replacement property to be as specific as possible. See Notice.

Treas. Reg. § 1.1031(k)-1(c) provides rules for determining whether the taxpayer has identified replacement property before the end of the identification period. These rules are intended to balance the underlying policy of the exchange requirement with the difficulties taxpayers may face in trying to identify specifically the particular property to be received in the exchange within the identification period. See Notice.

a. **<u>Manner of identifying replacement property</u>.**

Replacement property is treated as identified for purposes of Section 1031(a)(3) only if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to:

(i) the person obligated to transfer the replacement property to the taxpayer (regardless of whether such person is a "disqualified person"), or

(ii) a person involved in the exchange other than the taxpayer or a "disqualified person."[16]

The term "person involved in the exchange" includes any of the parties to the exchange, an intermediary, an escrow company and a title company. Treas. Reg. § 1.1031(k)-1(c)(2).

The Final Regulations contain two exceptions to the general rule for the manner in which to identify replacement property. First, any replacement property that is received by the taxpayer before the end of the identification period need not be separately identified. Treas. Reg. § 1.1031(k)-1(c)(1). And second, an identification of replacement property may be made in a written agreement if it is signed by all the parties thereto before the end of the identification period. Treas. Reg. § 1.1031(k)-1(c)(2)(last sentence).

In the case where all the parties to the deferred exchange are "disqualified persons," taxpayers should either make the identification in the written agreement for the exchange of properties or send the identification of the replacement property to the person obligated to transfer the replacement property to the taxpayer.

In cases where the replacement property is direct deeded to the taxpayer, it is unclear whether the person obligated to transfer the replacement to the taxpayer is its owner or the intermediary. The answer most consistent with the structure of the Final Regulations is the intermediary. However, until clarified, perhaps the identification should be sent to both persons.

Tax practitioners should take care to avoid obvious mistakes such as not having the taxpayer sign the identification document, not sending the identification to a proper person, or sending the identification by telex or telegram.

Two recent Tax Court cases addressed the identification requirement in exchanges of property occurring prior to the enactment of the Final Regulations. In <u>Dobrich v. Commissioner</u>, T.C. Memo 1997-477, the Tax Court held that a couple who claimed to have decided to purchase a particular replacement property, but who did not tell anyone of their decision until after the expiration of the identification period, did not make a proper identification of the replacement property. Similarly, the Tax Court held in <u>Smith v. Commissioner</u>, T.C. Memo 1997-109, that a taxpayer who claimed to have orally identified a replacement property to a real estate broker prior to the expiration of the identification period failed to satisfy the identification requirement. The taxpayer had reported a different (and late) identification date on his tax return.

b. **Description of replacement property.**

In order for the identification of the replacement property to be valid, the replacement property must be "unambiguously described" in the written document or agreement. Treas. Reg. § 1.1031(k)-1(c)(3).

As a general rule, real property will be considered unambiguously described if it is described by a legal description, street address or distinguishable name. However, taxpayers should try to make the identification as specific as possible in order to avoid problems. In addition, if the taxpayer is acquiring a portion of a building (e.g., a condominium unit), then the portion to be acquired should be described (as opposed to providing merely the street address).

The "distinguishable name" description is of limited applicability, and contains a potential trap. For example, in Los Angeles, there are several "Oakwood Apartments." Therefore, identifying the "Oakwood Apartments" as replacement property is likely to be considered ambiguous, at least in Los Angeles.

One type of impermissible identification of replacement property is the identification of a large tract where only a small portion is to be acquired. For example, if the taxpayer identifies Manhattan as the replacement property, then the replacement property to be received (e.g., a building in Manhattan) has not been unambiguously described. See Treas. Reg. § 1.1031(k)-1(c)(7), Example 3.

c. **Identifying alternative or multiple properties.**

In many circumstances, the taxpayer may wish to identify a number of properties in the alternative as replacement properties. Indeed, this is often a prudent safeguard because taxpayers often find that the property they wish to acquire cannot be acquired within the exchange period. In addition, a taxpayer that is "trading up," may wish to identify a number of properties all of which are to be acquired.

The legislative history to Section 1031(a)(3) specifically contemplated that taxpayers should be able to identify properties in the alternative:

> "It is anticipated that the designation requirement will be satisfied if the contract between the parties specifies a limited number of properties that may be transferred and the particular property to be transferred will be determined by contingencies beyond the control of both parties. For example, if A transferred real estate in exchange for a promise by B to transfer Property 1 to A if zoning changes are provided and Property 2 if they are not, the exchange would qualify for like-kind treatment."

Conference Report, H. Rep. No. 98-861, 1984-3 C.B. Vol. 2, 120.

The Conference Report provided little guidance for taxpayers, in part because the Committee did not define what it meant by a `limited number' of identified replacement

properties. With respect to exchanges occurring before the enactment of the Final Regulations, the Tax Court has interpreted this language as permitting taxpayers to identify up to 20 properties. St. Laurent v. Commissioner, T.C. Memo 1996-150 (taxpayer identified 20 replacement properties); See also Christensen v. Commissioner, T.C. Memo 1996-254 (taxpayer identified 19 properties).

In addition, the question of whether the transfer of a particular replacement property was "determined by contingencies beyond the control of both parties" was fraught with uncertainty for both the taxpayer and the IRS. The Tax Court determined that this condition would not be read into the statutory requirements for nonrecognition under Section 1031(a)(3). St. Laurent, T.C. Memo 1996-150. The Final Regulations do not require taxpayers either to prioritize their choices or state conditions for determining which replacement property is to be received.

i. The 3-property rule and the 200-percent rule.

The Final Regulations do not distinguish between alternative and multiple identifications. Under the Final Regulations, regardless of the number of relinquished properties transferred by the taxpayer as part of the same deferred exchange, the maximum number of replacement properties that the taxpayer may identify is: (a) three properties of any fair market value (the "3-property rule"), or (b) any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer (the "200-percent rule"). Treas. Reg. § 1.1031(k)-1(c)(4)(i).

The 3-property rule is provided to allow taxpayers flexibility in simple cases such as the exchange of apartment buildings.

Example (3). A transfers an apartment building to B. Under the 3-property rule, A may identify up to three apartment buildings as replacement property, regardless of whether A intends to acquire one, two or all three buildings.

The 200-percent rule is provided to allow taxpayers to identify a group of properties where they expect to receive only a portion of the identified group and to allow taxpayers to identify properties in cases where the 3-property rule cannot apply because the identified replacement property consists of a large number of assets.

Example (4). A transfers five trucks worth $100x to B. Under the 200-percent rule, A may identify ten trucks worth up to $200x as replacement property even though A intends to acquire only seven of the identified trucks.

Example (5). A transfers a casino consisting of real property and assorted personal property worth $100x to B. Under the 200-percent rule, A may identify another casino worth up to $200x as replacement property even though the casino, as an operating business, consists of more than three properties.[17]

With two exceptions, if, as of the end of the identification period, the taxpayer has identified more properties as replacement properties than is permitted under either the 3-property rule or the 200-percent rule, the taxpayer is treated as if no replacement property has been identified (and therefore no portion of the deferred exchange will qualify for nonrecognition under Section 1031). Treas. Reg. § 1.1031(k)-1(c)(4)(ii). These rules therefore create a cliff where a misstep results in complete gain recognition.

The 3-property rule and the 200-percent rule are applied regardless of the number of relinquished properties transferred as part of the same deferred exchange. As was discussed above, it is unclear when the transfer of several properties will be considered to be part of different deferred exchanges. Careful planning is required to create opportunities to identify safely the maximum number of properties and to avoid the pitfall of identifying too many properties.

It is also unclear what is a "property" for purposes of the 3-property rule. A contiguous parcel that has not been subdivided is clearly one property. It is, however, unclear whether the answer changes if the property has been subdivided such that more than one deed is necessary to transfer all of it.

> Example (6). Taxpayer identifies building A as replacement property. Building A consists of 30 condominium units each of which will be acquired from its owner. Has Taxpayer identified one property or 30? Does the answer change if the same person currently owns all 30 units?

It should be noted that the limits on identifying alternative or multiple replacement properties apply only to property intended to be like-kind to a relinquished property. Therefore, the identification of property that is "boot" or the designation of the amount of cash to be received should be irrelevant for purposes of determining whether the 3-property rule or the 200-percent rule has been satisfied.

> Example (7). Taxpayer transfers an apartment building to B. Taxpayer identifies three apartment buildings, eight trucks and $100,000 as the consideration to be received in exchange for the apartment building. Because the trucks and cash are not replacement property, the identification satisfies the 3-property rule.

An additional complexity is the need to determine fair market value as of the end of the identification period for purposes of the 200-percent rule. As a general rule, the listing price of the property should be a good indication of the upper bounds of its fair market value in all but the hottest of real estate markets.

ii. Exceptions.

Even if the identification of replacement property fails to satisfy either the 3-property rule or the 200-percent rule, a valid identification is still possible:

(a) with respect to any replacement property received by the taxpayer before the end of the identification period; and

(b) if the taxpayer receives identified replacement property constituting at least 95 percent of the aggregate fair market value of all identified replacement property before the end of the exchange period (the "95-percent rule").

Treas. Reg. § 1.1031(k)-1(c)(4)(ii). These exceptions relax the draconian effects of failure to comply with the 3-property rule and the 200-percent rule in situations where there is little opportunity for abuse.[18]

With respect to the 95-percent rule, fair market value is determined as of the earlier of the date the property is received by the taxpayer or the last day of the exchange period. Treas. Reg. § 1.1031(k)-1(c)(4)(ii) (last sentence). A better rule would have been to determine fair market value, for this purpose, as of the time of identification. If this were the rule, taxpayers would not be adversely affected by fluctuations in value between the end of the identification period and the end of the exchange period.

iii. <u>Fair market value</u>.

For purposes of applying the 200-percent rule and the 95-percent rule, fair market value is gross fair market value, as opposed to net equity. Treas. Reg. § 1.1031(k)-1(m). This rule is easier to comply with (and harder to manipulate) than a net equity rule, particularly when you consider that the amount of liabilities to be assumed with respect to the replacement properties may not be known at the time of identification.

d. <u>Incidental property</u>.

Treas. Reg. § 1.1031(k)-1(c)(5) simplifies the identification requirement with respect to property that is incidental to a larger item of property. Property is "incidental 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 such property does not exceed 15 percent of the aggregate fair market value of the larger item of property."

Treas. Reg. § 1.1031(k)-1(c)(5)(i).[19]

If property is incidental property, then it need not be separately identified for purposes of the identification requirement and, together with the larger item of property, counts as one property for purposes of the 3-property rule. <u>See</u> Treas. Reg. § 1.1031(k)-1(c)(5)(ii), Examples 1 and 2. This rule is merely for purposes of determining whether an item of property has been properly identified; it has no effect with respect to whether the item is like-kind property or the extent to which Section 1031 applies to the transaction.

Example (8). M is exchanging raw land with a fair market value of $100x for an apartment building (including the underlying land) owned by P with a total fair market value of $100x. Although the identification document merely provides the legal description of the replacement property, M and P intend that the furniture and laundry machines contained in the apartment building also will be transferred to M. Assume that the furniture and laundry machines have a fair market value of $50,000. Although the furniture and laundry machines are incidental property (50,000/950,000 = 5.25%), they are not of a like kind to the raw land.

e. Revocation of identifications.

All identifications of replacement property that have been made and not revoked by the end of the identification period are taken into account in determining whether the 3-property rule or the 200-percent rule has been met. Treas. Reg. § 1.1031(k)-1(c)(4)(iii). It is therefore important for taxpayers to revoke timely and properly all identifications of replacement property which the taxpayer does not wish to acquire.

An identification of replacement property may be revoked at any time prior to the end of the identification period. However, a revocation is effective only if it is:

(i) made in a written document signed by the taxpayer; and

(ii) sent to the person to whom the identification of the replacement property was sent.

If the identification of replacement property was made in a written agreement, then the revocation is effective only if it is made in a written amendment to such agreement or in a written document signed by the taxpayer and sent to all of the parties to the agreement. Treas. Reg. § 1.1031(k)-1(c)(6).

3. **Receipt of replacement property.**

The second requirement set forth in Section 1031(a)(3) is that the identified replacement property must be received before the end of the exchange period. The Final Regulations expand on this requirement by clarifying that the property received must also be "substantially the same property as identified." Treas. Reg. § 1.1031(k)-1(d)(1). These requirements apply separately with respect to each identified replacement property. Therefore, subject to the 95-percent rule, any properly identified replacement property received before the end of the exchange period may qualify under Section 1031 if it is otherwise like-kind property and if it is substantially the same property as identified. See Treas. Reg. § 1.1031(k)-1(d)(2), Example 1.

The "substantially the same" standard provides additional flexibility to the identification requirements without opening the door to abuse. For example, if raw land is identified and, during the exchange period, a fence is built on the land, the property received is treated as substantially the same as the property identified. Conversely, if the identified property was an apartment building and, during the exchange period, the apartment building is demolished and a warehouse is built, the property received should not be treated as substantially the same as the property identified. Compare Examples 2 and 3 of Treas. Reg. § 1.1031(k)-1(d)(2). These examples state an implicit rule whereby the "substantially the same" standard is met if the changes in the identified property do not change its "basic nature or character."[20]

Another example in the regulations demonstrates that, with respect to raw land, the "substantially the same" standard is met if 75 percent (by value) of the identified property is received. Treas. Reg. § 1.1031(k)-1(d)(2), Example 4. Example 4 is important where the taxpayer is acquiring an undivided interest in the replacement property. For example, if the taxpayer identifies the replacement property as an "80% undivided interest in property Z," then receipt of a 60 percent to 80 percent undivided interest in property Z should satisfy the "substantially the same" standard.

The only general proposition that can be gleaned from these examples is that qualification under the "substantially the same standard" is based on all the facts and circumstances.

4. **Special rules for property to be produced.**

The proposed regulations provide special rules for the identification and receipt of replacement property where the replacement property is not in existence or is being produced or constructed at the time the identification is made. Treas. Reg. § 1.1031(k)-1(e). The term "produced" includes constructed, built, installed, manufactured, developed, or improved. See Section 263A(g)(1). For a recent private letter ruling on this issue, see PLR 9428007 (April 13, 1994).

i. **Identification**.

In order to identify replacement property that is to be produced, the taxpayer generally follows the identification rules of Treas. Reg. § 1.1031(k)-1(c).[21] With respect to real property to be produced, this requires the taxpayer to provide the legal description, street address or distinguishable name for the underlying land and to describe the improvements that are to be produced in as much detail as is "practicable." Treas. Reg. § 1.1031(k)-1(e)(2)(i).

How much detail is enough (or is "practicable") is unclear. Prudent taxpayers should provide as much detail as they can, bearing in mind that merely stating that a building is to be constructed, without more, is likely to be insufficient. The foregoing notwithstanding, taxpayers should be wary of the possibility that providing too much detail could result in the exchange not meeting the "substantially the same" standard for receipt of the identified replacement property.

For purposes if determining the fair market value of property to be produced (which is necessary for applying the 200-percent and incidental property rules), taxpayers are required to use the property's estimated fair market value as of the date it is expected to be received by the taxpayer. Treas. Reg. § 1.1031(k)-1(e)(2)(ii).

ii. **Receipt**.

Several special rules are provided for determining whether the taxpayer has received substantially the same property as identified (which is required by Treas. Reg. § 1.1031(k)-1(d)(1)(ii)). First, variations due to usual or typical production changes are not taken into account. Second, with respect to personal property, production must be complete on or before the date the property is received by the taxpayer. And third, with respect to real property the production of which is not complete on or before the date the taxpayer receives the property, the replacement property received must constitute real property which, had production been completed, would have been substantially the same property as identified. Treas. Reg. § 1.1031(k)-1(e)(3).

> Example (9). M identifies land A and a 3-story office building to be constructed thereon as replacement property. On the date the property is received by M, it consists of land A and a partially completed warehouse. Under these facts, the property, had it been complete would have been a warehouse, which is not substantially the same as an office building. The transaction thus does not qualify under Section 1031(a)(3).

iii. **Production services**.

The value of additional production occurring with respect to the replacement property after it is received by the taxpayer constitutes the receipt of boot. Treas. Reg. § 1.1031(k)-1(e)(4).

> Example (10). M transfers real property with a fair market value of $100x to N and identifies as replacement property land A and a 3-story office building to be

constructed. Before the end of the exchange period, N transfers to M land A and a partially completed 3-story office building with a fair market value of $90x. Subsequent to the date the property is received, N, at no cost to M, completes construction of the building which increases its value by $10x. M is treated as receiving boot in the amount of $10x.

C. Receipt of Money or Other Property.

1. In general.

Section 1031(a) requires that the relinquished property be transferred solely for property of a like kind. If an exchange would be within the provisions of Section 1031(a) but for the fact that the property received in exchange consists not only of property of a like kind but also of money or other property, Section 1031(b) provides that the gain, if any, to the taxpayer is recognized in an amount not in excess of the sum of such money and the fair market value of such other property. If an exchange would be within the provisions of Section 1031(a) but for the fact that the property received in exchange consists not only of property of a like kind but also of money or other property, Section 1031(c) provides that no loss from the exchange is recognized. See Treas. Reg. § 1.1031(a)-1.

The rules of Section 1031(a), (b), and (c) apply with equal force regardless of whether the transaction at issue is a deferred exchange. However, the application of these rules is of particular importance to deferred exchanges. For example, after a taxpayer has transferred the relinquished property, the taxpayer typically is unwilling to rely on the transferee's unsecured promise to transfer the like-kind replacement property. Thus, taxpayers often structure deferred exchanges so that the transferee's obligation to transfer the like-kind replacement property to the taxpayer is guaranteed or secured. In addition, taxpayers often receive interest or a growth factor to compensate them for the time value of money for the period between the date on which they transfer the relinquished property and the date on which they receive the replacement property. Finally, in many deferred exchanges the person who desires to purchase the taxpayer's property may be unwilling or unable to acquire the replacement property. In such cases, the deferred exchange may be facilitated by the use of an intermediary (i.e., a person with whom the taxpayer can consummate a deferred exchange in a transaction that otherwise involves the sale of the taxpayer's property and the purchase of the replacement property). See Notice; T.D. 8346.

An important issue in deferred exchanges is, therefore, the conditions under which transactions such as those described in the previous paragraph should be treated as sales rather than as deferred exchanges. The primary determination of whether a transaction constitutes a sale rather than a deferred exchange involves the application of the doctrines of actual and constructive receipt. See Treas. Reg. § 1.1031(k)-1(f).

2. <u>Actual and constructive receipt</u>.

The Final Regulations provide a deceptively simple rule for distinguishing between deferred exchanges and sales:

> "[I]n 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 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."

Treas. Reg. § 1.1031(k)-1(f)(1).

This rule is deceptively simple because the most common structures of deferred exchanges create either very difficult questions regarding the application of the rules of actual and constructive receipt or constitute transactions in which actual or constructive receipt has almost certainly occurred prior to the receipt of the like-kind replacement property.

As an aid to taxpayers, Treas. Reg. § 1.1031(k)-1(f)(2) briefly describes some of the general principles for applying the doctrines of actual and constructive receipt to deferred exchanges.

Taxpayers should take care to avoid the most common constructive receipt pitfall: the ability to demand cash. If the taxpayer has an unrestricted right to demand the payment of cash at any time after the transfer of the relinquished property but before the receipt of the replacement property, then the exchange will not qualify for nonrecognition under Section 1031. <u>See</u> Treas. Reg. §§ 1.1031(k)-1(f)(3) and 1.1031(k)-1(j)(3), Examples 2, 3 and 4.

A simple form of security device that is not specifically sanctioned by the Final Regulations is the joint signature account. Under a joint signature account, the funds held by the other party to the exchange are held in a bank account which provides that funds may not be withdrawn without the signature of both the taxpayer and the other party. Such an arrangement should not, by itself, result in the taxpayer being in actual or constructive receipt of the funds held in the joint signature account. As a result, joint signature accounts are a cheap and generally effective security device for deferred exchanges. Care, should, however, be taken to ensure that the taxpayers rights to the funds held in the joint signature account are limited in the same manner as is discussed below for qualified escrow accounts and qualified trusts.

3. <u>Safe harbors</u>.

Because of the difficulties inherent in trying to apply the rules regarding actual and constructive receipt to real world deferred exchanges, virtually all deferred exchanges should be

structured to fall within one or more of the safe harbors described in Treas. Reg. § 1.1031(k)-1(g)(2)-(5). The safe harbors, however, should not be followed blindly because they are only limited safe harbors.

The safe harbors are safe harbors only with respect to the IRS (or a court) not being able to find actual or constructive receipt of money or other property based on the existence of a certain fact or set of rights with respect to the transaction. Treas. Reg. § 1.1031(k)-1(g)(1). Therefore, even if a transaction is within the safe harbors, if the taxpayer has, for example, the ability or unrestricted right to demand the payment of cash at any time, then the transaction, as a whole, still will not qualify for nonrecognition of gain or loss under Section 1031. See, e.g., Treas. Reg. § 1.1031(k)-1(g)(2)(ii), (3)(iv) and (4)(vi).

a. Security or guarantee arrangements.

Under the first safe harbor, 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 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:

(i) a mortgage, deed of trust, or other security interest in property (other than cash or a cash equivalent);

(ii) a standby letter of credit (as defined in Treas. Reg. § 15A.453-1(b)(3)(iii)); or

(iii) a guarantee of a third party.

Treas. Reg. § 1.1031(k)-1(g)(2)(i).[22] However, this safe harbor 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. Treas. Reg. § 1.1031(k)-1(g)(2)(ii).

This safe harbor is derived from the rules for determining when payment has been received for purposes of the installment sale rules. See Treas. Reg. § 15A.453-1(b)(3).

This safe harbor is essentially unchanged from the Proposed Regulations. Compare Former Prop. Reg. § 1.1031(a)-3(g)(2). The Final Regulations should have expanded and clarified this safe harbor. Such clarifications should have included providing that a transaction is within this safe harbor if the security or guarantee secures more than just the taxpayer's transferee's obligation to transfer the replacement property to the taxpayer. For example, it should be clarified that the taxpayer is permitted to realize on the collateral if the taxpayer's transferee defaults in its obligation to pay cash to the taxpayer if the taxpayer's rights to receive cash were limited to the "(g)(6) circumstances."[23]

In addition, the letter of credit rules should have been clarified to provide that, consistent with standard commercial practices, the taxpayer need only present a certificate to the issuing

bank to draw upon the letter of credit. (This clarification should also be made to the installment sales regulations.) Such additional guidance will now need to wait for future rulings and case law.

b. Qualified escrow accounts and qualified trusts.

Under the second safe harbor, 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 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 a qualified trust. Treas. Reg. § 1.1031(k)-1(g)(3)(i).

In order for an escrow account or trust to be "qualified," the escrow holder or trustee must not be the taxpayer or a "disqualified person," and the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of the cash or cash equivalent held in escrow or trust must be limited to the circumstances described in Treas. Reg. § 1.1031(k)-1(g)(6) (the "(g)(6) circumstances"). Treas. Reg. § 1.1031(k)-1(g)(3)(ii) and (iii).

Three special rules are provided. First, this safe harbor 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 funds held in the qualified escrow account or qualified trust. Treas. Reg. § 1.1031(k)-1(g)(3)(iv). See Hillyer v. Commissioner, T. C. Memo 1996-214 (holding that the taxpayer's control over funds held in escrow resulted in constructive receipt over such funds and thus prevented the transaction from qualifying for nonrecognition of gain under Section 1031); Keith E. Klein, T. C. Memo 1993-491 (same).

Second, rights conferred upon the taxpayer under state law to terminate or dismiss the escrow holder or trustee are disregarded. Treas. Reg. § 1.1031(k)-1(g)(3)(iv). This rule is necessary because, under certain states' laws, the escrow holder or trustee may be treated as the taxpayer's agent thus conferring the right to dismiss the escrow holder or trustee at will. In such case, the taxpayer could be considered to have an unrestricted right to the funds held in the escrow account or trust and it would therefore be impossible for taxpayers in such states to use this safe harbor. See T.D. 8346. As a result, agreements creating qualified escrow accounts and qualified trusts may provide that the escrow holder or trustee is the taxpayer's agent, so long as the agreement disclaims the taxpayer's right to dismiss the escrow holder or trustee or to unilaterally modify the agreement (even if such restrictions are unenforceable under local law).

And third, a taxpayer may receive money or other property directly from a party to the exchange, but not from the qualified escrow account or qualified trust, without affecting to applicability of this safe harbor. Treas. Reg. § 1.1031(k)-1(g)(3)(v). However, in such case, the receipt of the money or other property will constitute boot.

It should be emphasized that this safe harbor is intended to apply where an escrow account or trust is used merely as a security device akin to the use of a pledge holder to hold collateral. Because an escrow account or trust is not an entity or person, there still needs to be

someone with respect to which the taxpayer is contracting to consummate an exchange (i.e., the taxpayer's transferee cannot be the escrow account or the trust).

i. Definition of "disqualified person."

The definition of the term "disqualified person" is crucial to qualification not only under this safe harbor, but also with respect to the qualified intermediary safe harbor and other portions of the Final Regulations (such as the identification rules). Under Treas. Reg. § 1.1031(k)-1(k), a person is a "disqualified person if:

> (1) The person is the agent of the taxpayer at the time of the transaction (Treas. Reg. § 1.1031(k)-1(k)(2));
>
> (2) 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 (Treas. Reg. § 1.1031(k)-1(k)(3)); or
>
> (3) The person and a person described in paragraph (1) above 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 (Treas. Reg. § 1.1031(k)-1(k)(4)).

A number of special rules are provided which clarify the definition of who is a disqualified person.

In determining whether a person is the agent of the taxpayer at the time of the exchange, the following rules apply. First, "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." Second, services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition under Section 1031 are not taken into account. And third, routine financial, title insurance, escrow or trust services for the taxpayer by a financial institution, title insurance company or escrow company are not taken into account. Treas. Reg. § 1.1031(k)-1(k)(2).[24]

In a recent private letter ruling, the IRS ruled that a qualified intermediary would not be a "disqualified person" if, in addition to purchasing replacement properties, it purchased other real estate for the taxpayer that was not used as replacement property. The IRS held that the only service provided by the qualified intermediary in this situation with respect to the non-replacement real estate was making purchase payments, and that these were "routine financial services" for purposes of Treas. Reg. § 1.1031(k)-1(k)(2). PLR 9826033 (March 27, 1998).

In addition, in applying the relationship tests of Section 267(b), the relationship between the taxpayer and the trustee created by the qualified trust is not taken into account. Treas. Reg. § 1.1031(k)-1(g)(3)(iii)(A).

The Fredericks case, supra, raises the possibility that the Tax Court may consider a transaction to constitute a good deferred exchange, notwithstanding the fact that the transaction did not comply with the disqualified person requirement of a safe harbor.

ii. The "(g)(6) circumstances."

The other important portion of this safe harbor is that the taxpayer's rights to the funds held in the qualified escrow account or qualified trust must be limited to the so-called "(g)(6) circumstances." A taxpayer's rights to property or funds are limited to the (g)(6) circumstances if the relevant agreement provides that the taxpayer has no rights to receive, pledge, borrow or otherwise obtain the benefits of other property or money before the end of the exchange period, except in the following circumstances:

> (1) 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 otherwise obtain the benefits of money or other property at any time after the end of the identification period;
>
> (2) 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 of a material and substantial contingency that--
>
> (i) Relates to the deferred exchange,
>
> (ii) Is provided for in writing, and
>
> (iii) Is beyond the control of the taxpayer and of any disqualified person, other than the person obligated to transfer the replacement property to the taxpayer.

Treas. Reg. § 1.1031(k)-1(g)(6).

The occurrence of any of these circumstances results in a condition in which the taxpayer can no longer receive like-kind replacement property. Thus, it is reasonable for the Final Regulations to provide that the ability of the taxpayer to receive cash if such circumstances occur should not disqualify the transaction ab initio from qualifying for nonrecognition of gain or loss under Section 1031.

Example 2 of Treas. Reg. § 1.1031(k)-1(g)(8) clarifies that material and substantially contingencies that are beyond the taxpayer's control include the destruction, seizure, requisition

or condemnation of the replacement property, zoning changes, and the receipt of certain regulatory approvals. Note that such contingencies still must relate to the deferred exchange and be provided for in writing.

c. Qualified intermediaries.

As noted above, it is common for deferred exchanges to be facilitated by an intermediary with whom the taxpayer consummates the deferred exchange. It has been suggested that such transactions should qualify as deferred exchanges so long as the intermediary is not acting as the taxpayer's agent. (If the intermediary is the taxpayer's agent, this argument runs, an exchange between the taxpayer and the intermediary is not possible.) Unfortunately, the law of agency is often of uncertain application and, in virtually all deferred exchanges using an intermediary, such a rule would provide little guidance. Primarily for this reason, the Final Regulations' safe harbor for intermediaries, which does not rely upon an agency analysis, is a major step in simplifying the deferred exchange rules.

Under this third safe harbor, "[i]n 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 is treated as an exchange, and the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer." Treas. Reg. § 1.1031(k)-1(g)(4)(i).

Four additional rules apply. First, this safe harbor only applies if the agreement between the taxpayer and the qualified intermediary (which must be in writing) 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 to the (g)(6) circumstances. Treas. Reg. § 1.1031(k)-1(g)(4)(ii). Second, this safe harbor 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. For purposes of the preceding sentence, rights under local law to terminate or dismiss the qualified intermediary are disregarded. Treas. Reg. § 1.1031(k)-1(g)(4)(vi). And third, the taxpayer may receive money or other property directly from a party to the transaction other than the qualified intermediary without affecting the application of this safe harbor. Treas. Reg. § 1.1031(k)-1(g)(4)(vii).

A "qualified intermediary" is defined as a person who is not the taxpayer or a disqualified person[25] and who:

> "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."

Treas. Reg. § 1.1031(k)-1(g)(4)(iii).

This rule is similar to the qualified intermediary safe harbor that was contained in the Proposed Regulations. Compare Former Prop. Reg. § 1.1031(a)-3(g)(4). A number of commentators expressed concern over what was meant by the Proposed Regulations use of the term "acquire" and over what the underlying documents needed to provide. In an attempt to clarify the operation of this safe harbor, the Final Regulations added the rules contained in Treas. Reg. §1.1031(k)-1(g)(4)(iv) and (v).

The special rules for determining whether the intermediary has "acquired" property are as follows. These rules apply regardless of whether the intermediary would be considered to have acquired or transferred property under general tax principles. First, an intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property. Treas. Reg. § 1.1031(k)-1(g)(4)(iv)(A). Presumably this rule is met even if the intermediary is, in fact, an agent and thus acquires and transfers only bare legal title.

Second, "[a]n 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." Treas. Reg. § 1.1031(k)-1(g)(4)(iv)(B).

Third, "[a]n 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." Treas. Reg. § 1.1031(k)-1(g)(4)(iv)(C).

These last two rules allow taxpayers and intermediaries to direct deed the relinquished and replacement properties from their current to their ultimate owners, without the necessity of the intermediary going "on title." This has the advantage of (hopefully) avoiding multiple transfer taxes and, for the intermediary, potential environmental liability.

And fourth, "an intermediary is treated as entering into an agreement if the rights of a party 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 relevant transfer of property." Treas. Reg. § 1.1031(k)-1(g)(4)(v). This last rule allows the taxpayer to negotiate and to enter into purchase and sale agreements directly with the buyer of the relinquished property and the seller of the replacement property. In such cases, the agreements must be assigned to the intermediary on or before the closing date (with appropriate notifications). The IRS has recently confirmed that a naked assignment of rights suffices under this rule, i.e., the intermediary need not assume any of the taxpayer's obligations under the purchase or sale agreement.[26]

The Final Regulations thus remove all of the substance from deferred exchanges occurring through intermediaries. All that matters is that the intermediary not be a disqualified person, the identification and receipt requirements be met, the relinquished and replacement properties be of a like kind (and not be described in Section 1031(a)(2)), the holding requirements be satisfied, and the transaction be documented correctly. This last point cannot be over emphasized. All persons either entering into deferred exchanges or acting as intermediaries must make sure that their documents conform to the Final Regulations.

The use of a qualified intermediary, however, will not save an exchange that fails to qualify for nonrecognition treatment for other reasons. For example, the IRS has denied nonrecognition treatment to an exchange of real estate involving a qualified intermediary between parties who were related to each other for purposes of Section 1031(f), on the grounds that an intermediary could not be used to avoid the restrictions of that Section. PLR 9748006 (Aug. 25, 1997).

The IRS has ruled that a qualified intermediary may make improvements to the replacement property before transferring it to the taxpayer. PLR 9428007 (April 13, 1994). See also Fredericks, supra.

d. Interest and growth factors.

Under the fourth (and last) safe harbor, 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 is 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; provided the taxpayer's rights to receive the interest or growth factor are limited to the (g)(6) circumstances. Treas. Reg. § 1.1031(k)-1(g)(5).

The terms "interest" and "growth factor" are defined very broadly to include any money or property that the taxpayer is entitled to receive which varies based on time. Treas. Reg. § 1.1031(k)-1(h)(1). Such interest or growth factor is, in effect, separated from the exchange transaction and is treated as interest regardless of whether it is paid in cash or property (including property of a like kind). Treas. Reg. § 1.1031(k)-1(h)(2). See also PLR 8915032 (Jan. 13, 1989).

> Example (11). Taxpayer transfers an apartment building worth $100,000 to B on November 1, 1991 and identifies an apartment building worth $100,000 as replacement property. The exchange agreement provides that if B does not transfer the replacement property to Taxpayer by December 1, B must pay to Taxpayer at the time of the completion of the exchange $2,000 plus 2,000 for each additional month of delay. On February 28, B transfers the apartment building to Taxpayer together with $4,000. Taxpayer is treated as having received $4,000 interest income (rather than having $4,000 of boot).

The Final Regulations do not address the proper manner for reporting interest income earned on money held in a qualified escrow account or a qualified trust. Such reporting can, in some cases, be complicated and guidance in this area is needed. T.D. 8346 provides that such guidance will be in future regulations under Section 468B(g).

On February 1, 1999, the IRS issued proposed regulations on the treatment of property held in a qualified escrow account or qualified trust. The proposed regulations treat the property as owned by the taxpayer. Thus, the taxpayer is taxable on the income earned with respect to the property and must take into account all items of income, deduction and credit of the qualified escrow account or qualified trust. Prop. Treas. Reg. § 1.468B-6(c)(1). However, if the transferee of the qualified intermediary has all of the beneficial use and enjoyment of the property held in a qualified escrow account or qualified trust, then the property of such escrow account or trust are treated as owned by the transferee or qualified intermediary, and the income earned with respect to the property is taxable to such transferee or qualified intermediary. Prop. Treas. Reg. § 1.468B-6(c)(2). The escrow holder of a qualified escrow account or trustee of a qualified trust are required to report the income of the escrow account or trust on Forms 1099 and, in general, show the escrow holder or trustee as the payor and the taxpayer as the payee unless the parties to the transaction provide a statement to the escrow holder or trustee indicating that the transferee or the qualified intermediary is the payee. Prop. Treas. Reg. § 1.468B-6(e).

e. Combining safe harbors.

It is not necessary for a deferred exchange to fall within only one of the safe harbors. Taxpayers can, and often will want to, combine several safe harbors in order to maximize their comfort level and the after-tax value of entering into a deferred exchange. For example, a deferred exchange may use a qualified intermediary which places the money obtained from its sale of the relinquished property in a qualified escrow account with respect to which the taxpayer is entitled to the interest. See PLR 9448010 (August 29, 1994); PLR 9428007 (April 13, 1994).

Two words of caution should be made. First, with most safe harbors in the Internal Revenue Code and Income Tax Regulations, if the taxpayer falls within one safe harbor, the effects of failing to qualify under another safe harbor are ignored. This is not the case under the Final Regulations where the terms and conditions of each applicable safe harbor must be separately satisfied. Treas. Reg. § 1.1031(k)-1(g)(1). For example, if the taxpayer uses a qualified intermediary but the intermediary places cash for the taxpayer's benefit in an escrow account that is not a qualified escrow account and, under general tax rules, the taxpayer would be considered to be in actual or constructive receipt of the funds held in the escrow account, then the transaction does not qualify for nonrecognition under Section 1031.

And second, the Notice provided that the IRS expects deferred exchange transactions to be structured to come within the safe harbors and that it will carefully scrutinize transactions that do not come within them.[27] Therefore, taxpayers are advised to use the safe harbors and not to rely on the general rules of actual and constructive receipt to protect the tax deferral of their deferred exchanges.

f. **Treatment of closing costs and similar items.**

The Final Regulations relax the requirements that, in order to take advantage of the qualified escrow account, qualified trust, qualified intermediary and interest and growth factor safe harbors, the taxpayers must not have the immediate ability or unrestricted right to receive, pledge, borrow or otherwise obtain the benefits of money or other property except as provided in the (g)(6) circumstances. In particular, the taxpayer's receipt or right to receive the following items are 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 statement as the responsibility of a buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees)."

Treas. Reg. § 1.1031(k)-1(g)(7).

Unfortunately, this provision does not cover the treatment of deposits. For example, the taxpayer may have to place deposits on a property prior to closing. If the property cannot be acquired (under circumstance which allows the taxpayer to select an alternative property) it is unclear whether the deposit can be returned to, for example, the qualified escrow account. Presumably deposits can be released from qualified escrow accounts and qualified trusts and by qualified intermediaries without running afoul of the applicable safe harbor, but even this is unclear under the Final Regulations.

D. **Gain or Loss and Basis Computations for Deferred Exchanges.**

1. **In general.**

In general, the amount of gain or loss recognized and the basis of property received in a deferred exchange is determined by applying the existing rules of Section 1031 and the regulations thereunder. Treas. Reg. § 1.1031(k)-1(j). See Reg. §§ 1.1031(b)-1, 1.1031(c)-1, 1.1031(d)-1, 1.1031(d)-1T, and 1.1031(d)(2) and 1.1031(j)-1.

The examples contained in Treas. Reg. § 1.1031(k)-1(j)(3) should be carefully reviewed by tax practitioners because they illustrate certain quirks in the basis and gain computations as applied to deferred exchanges. Note also that the exchanges described in these examples do not involve any of the safe harbors (i.e., they are not transactions using qualified intermediaries).

2. **Netting boot.**

Example 5 of Treas Reg. § 1.1031(k)-1(j)(3) clarifies that the taxpayer may offset liabilities relieved by liabilities assumed as part of the exchange in calculating the amount of money or other property received.

When a deferred exchange is both being facilitated by the use of an intermediary and financed by new acquisition indebtedness, there is an issue regarding whether the acquisition indebtedness must be incurred by the intermediary and then transferred to the taxpayer in order for the taxpayer to able to offset liabilities relieved by liabilities assumed. If the acquisition indebtedness can be incurred directly by the taxpayer, then the documentation for the deferred exchange can be substantially simplified.

Example (2) of Treas. Reg. § 1.1031(d)-2 provides that liabilities relieved may be offset by either cash paid or liabilities assumed. In TAM 8003004 (Sept. 19, 1979), the IRS held that, pursuant to that regulation, acquisition indebtedness incurred directly by the taxpayer is netted against liabilities relieved in the exchange because such indebtedness is treated as either liabilities assumed or cash paid by the taxpayer. See also Commissioner v. North Shore Bus Co., Inc., 143 F.2d 114 (2d Cir. 1944). The same rule should apply in the case of a deferred exchange. See Treas. Reg. § 1.1031(k)-1(j)(1).[28]

If a partnership enters into a deferred exchange, the mere fact that the partnership may net liabilities in computing the amount of gain recognized under Section 1031 may not be sufficient to avoid gain at the partner level. Under Section 752, increases and decreases of partnership level debt are treated as deemed distributions and contributions. Thus, for purposes of Section 752, unless the liabilities assumed in a deferred exchange may be netted against the liabilities relieved, the deemed distribution could cause gain recognition at the partner level even if no gain is recognized under Section 1031.

Taxpayers can take the position that the increases and decreases in partnership level liabilities should be netted under Section 752 under two theories. First, the two legs of a deferred exchange should be treated as part of a "single transaction" with the result that the liabilities would be netted pursuant to Treas. Reg. § 1.752-1(f). Second, Rev. Rul. 94-4, 1994-1 C.B. 145, provides that deemed distributions should be taken into account not when the liability is reduced but at the end of the taxable year. The analysis of this ruling should be equally applicable to deferred exchanges that close with one taxable year.[29] However, the mere fact that the liabilities assumed relieved in a deferred exchange may also be netted under Section 752 does not mean that the partners will not recognize gain under Section 752. The rules set forth in the Section 752 regulations must still be applied to determine each partners net increase or decrease in its share of liabilities. For example, replacement of nonrecourse debt with recourse debt is likely to result in gain recognition to limited partners, even if the liability netting rule results in no gain recognition under Section 1031.[30]

3. **Installment sales.**

On November 2, 1992, the IRS published Prop. Reg. § 1.1031(k)-1(j)(2) (IA-107-91) coordinating the deferred exchange and installment sale rules.[31] These regulations were finalized on April 19, 1994, without substantial changes. T.D. 8535. Nevertheless, the regulations provide important clarifications and planning opportunities with respect to deferred like-kind exchanges.

a. **Simultaneous exchanges and installment sales.**

In order to best understand how the IRS has coordinated the deferred exchange and installment sale rules, it is important to first understand the coordination between the simultaneous exchange and installment sale rules.

Under Section 453, in the case of a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs, income may be taken into account under the "installment method." The installment method is a method under which the gain recognized for a taxable year from a disposition of property is the proportion of the payments received in such year which the gross profit bears to the total contract price. A number of limitations and special rules apply.[32]

> Example (12). A sells unimproved real estate with a basis of $40,000 and a fair market value of $100,000 for $80,000 of cash and a note for $20,000 payable in one year with interest at 10%.[33] A's gross profit is $60,000 and the total contract price is $100,000, resulting in a gross profit ratio of 60%. A therefore recognizes $48,000 of gain in the year of sale (60% of $80,000) and $12,000 of gain one year later (60% of $20,000). A will also have $2,000 of interest income.

Section 453(f)(6) coordinates the installment sale rules with the rules for simultaneous exchanges by providing that, in the case of a like-kind exchange with boot the installment method is applied with the following adjustments: (1) the total contract price is reduced to take into account the fair market value of any property permitted to be received under Section 1031 without the recognition of gain (i.e., like-kind property); (2) the gross profit from the exchange is reduced to take into account any amount not recognized by reason of Section 1031; and (3) any property permitted to be received in the exchange without recognition of gain is not treated as a payment for purposes of Section 453. Prop. Reg. § 1.453-1(f) was published by the IRS on May 3, 1984 (CR-186-80) and provides additional details and examples regarding the application of Section 453(f)(6).

> Example (13). A exchanges unimproved real estate with a basis of $40,000 and a fair market value of $100,000 for like-kind real estate with a fair market value of $80,000 and a note for $20,000 payable in one year with interest at 10%. Under Sections 1031(b) and 453(f)(6), A does not recognize any gain the year of the exchange and, under Section 1031(d), takes the real estate received in exchange with a basis of $40,000. Under Section 453, A's contract price is $20,000 ($100,000 less $80,000) and A's gross profit is $20,000 ($60,000 of gain realized less the $40,000 of gain deferred under Section 1031),

resulting in a gross profit ratio of 100%. A therefore recognizes $20,000 of gain one year later. A will also have $2,000 of interest income.[34]

b. Deferred exchanges and installment sales.

Coordination between the deferred exchange and installment sales rules is needed in two circumstances: (1) when the deferred exchange (or attempted deferred exchange) straddles the end of a taxable year; and (2) when a deferred exchange is facilitated by the use of a "qualified intermediary" and some or all of the boot received consists of an installment note.

i. Deferred exchanges straddling year-end.

When a deferred exchange straddles the end of a taxable year, the question arises regarding whether boot received in the second taxable year may be taken into account under the installment method. Assuming the requirements of Section 453 and the regulations thereunder are otherwise met, the boot received in the second taxable year should be eligible to be taken into account under the installment method provided the boot did not constitute a "payment" in the first taxable year.

Treas. Reg. § 15A.453-1(b)(3) defines the term "payment" to include amounts actually or constructively received by the taxpayer and amounts that are secured, directly or indirectly, by cash or a cash equivalent. Example (8) of Treas. Reg. § 15A.453-1(b)(5) holds that, for purposes of the installment sales rules, amounts secured by cash or cash equivalents that are held in escrow constitute current payments. Taxpayers and the Service have, however, often litigated this issue, with mixed results.[35] In addition, receipt of payment by the taxpayer's agent constitutes a current payment to the taxpayer for purposes of the installment sales rules.[36]

The types of security arrangements and guaranties allowed under the first safe harbor (discussed at II.C.3.a.) should not constitute "payments" for purposes of the installment sales rules. Treas. Reg. § 15A.453-1(b)(3). Therefore, if a deferred exchange which complies with only the first safe harbor straddles the end of the taxable year, any boot received in the second taxable year should be eligible to be taken into account under the installment method. Similarly, if such a deferred exchange fails entirely (i.e., no like-kind replacement property is received), use of the installment method should still be permitted (assuming the other requirements of Section 453 are met). Note, however, that even under the first safe harbor it is possible for the IRS to seek to deny use of the installment method on the grounds that the taxpayer actually or constructively received the boot in the first taxable year.

On the other hand, the types of security arrangements allowed under the second safe harbor (qualified escrow accounts and qualified trusts, discussed at II.C.3.b.) would likely be challenged by the IRS as constituting a current payment for purposes of the installment sales rules. The IRS could also take the position that, for purposes of the installment sales rules, a qualified intermediary is the agent of the taxpayer and any funds held by the qualified intermediary that are not used to acquire replacement constitute a current payment.

Treas. Reg. § 1.1031(k)-1(j)(2)(i) eliminates the risks identified in the preceding paragraph with respect to exchanges using qualified escrow accounts and qualified trusts by providing that "in the case of a taxpayer's transfer of relinquished property in which the obligation of the taxpayer's 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 [the installment sale rules] 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." Treas. Reg. § 1.1031(k)-1(j)(2)(ii) eliminates those risks with respect to exchanges using qualified intermediaries by providing that "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 [the installment sale rules] is made as if the qualified intermediary is not the agent of the taxpayer."

> Example (14). On December 1, 1993, A exchanges unimproved real estate with a fair market value of $100,000 with intermediary Q. Q sells the property to B for $100,000 and places the funds in a qualified escrow account. On January 10, 1994, A identifies like-kind real estate owned by C as the replacement property. On May 30, 1994 (the end of the exchange period),[37] Q purchases the replacement property from C for $80,000 and transfers the property and $20,000 to A. Assuming the transaction otherwise satisfies the requirements of the deferred exchange and installment sale rules, under Treas. Reg. §§ 1.1031(k)-1(j)(2)(i) and (ii), A may take the $20,000 into account under the installment method.[38]

The rules contained in Treas. Reg. § 1.1031(k)-1(j)(2)(i) and (ii) apply even if the exchange fails and no replacement property is acquired by the taxpayer. This result is surprising because, in such a situation, the transaction is wholly outside the ambit of Section 1031 and, pursuant to Treas. Reg. § 15A.453-1(b)(3) and Example (8) of Treas. Reg. § 15A.453-1(b)(5), one would have expected the IRS to hold that the funds held by the qualified intermediary or in a qualified escrow or trust account constituted a current payment.

> Example (15). Assume the same facts as in Example (14), except that C refuses to sell the property and on May 30, 1994, Q transfers $100,000 to A. Under Treas. Reg. §§ 1.1031(k)-1(j)(2)(i) and (ii), A is permitted to take the $100,000 into account under the installment method.[39]

Three restrictions apply to the rules provided in Treas. Reg. §§ 1.1031(k)-1(j)(2)(i) and (ii). First, the rules cease to apply at the earlier of: (1) the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property held in the qualified escrow account or qualified trust or by the qualified intermediary; or (2) the end of the exchange period.[40] Second, the rules do not apply if the relinquished property was not held for productive use in a trade or business or for investment or is property that is described in Section 1031(a)(2).[41] Third, the rules do not apply unless the taxpayer has a "bona fide intent" to enter into a deferred exchange at the beginning of the exchange period.[42] The first two restrictions are also circumstances in which the deferral afforded by Section 1031 would cease to apply.

A taxpayer is "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."[43] Two examples attempt to clarify the scope of the bona fide intent test. In the first example, a corporation's board of directors authorizes a like-kind exchange and an exchange agreement is entered into. Later on, the board decides that, based on a business downturn reflected in preliminary financial reports, not to acquire replacement property.[44] In the second example, the rezoning of the replacement property is a stated contingency for receipt of the replacement property. When the zoning board decides not to rezone any of the identified replacement properties, the taxpayer receives the cash held in the qualified escrow.[45] In both of these examples, the taxpayer is found to have satisfied the bona fide intent test.

Depending upon your viewpoint, the bona fide intent test is either an opportunity to obtain deferral of gain for what would otherwise be treated as a cash sale or a trap in which IRS agents will seek to deny installment sale treatment in the case of every failed exchange. Despite the lack of guidance on the application of the bona fide intent test, the outside parameters of the test are reasonably clear. As an initial matter, the test should be satisfied in any case in which some replacement property is received. On the other hand, where the taxpayer enters into an exchange agreement but makes no attempt to acquire any replacement property, the test should not be satisfied.

Prudent taxpayers should take steps to document their efforts to acquire replacement property in order to avoid a later assertion by the IRS that, in the case of a failed exchange, the taxpayer did not have a bona fide intent to enter into a deferred exchange. First, the taxpayer should enter into an exchange agreement containing normal commercial terms. Using a qualified intermediary would be a positive factor because of the extra costs involved. Second, replacement property should be identified. Third, at least one legitimate offer to purchase a replacement property should be made. A taxpayer who complies with the above-described steps should be treated as having had a bona fide intent to enter into a deferred exchange.

ii. Buyer note rule.

Under Section 453(f)(3), the installment method cannot be used if the maker of the installment note is not the purchaser of the property. See also Treas. Reg. § 15A.453-1(b)(3)(i). This requirement is not an issue in the case of three-party exchanges where the purchaser of the relinquished property is also the person facilitating the exchange. In such a case, both the maker of the installment note and the person from whom the taxpayer acquires the replacement property can be the same person. Uncertainty is created where a simultaneous or deferred exchange is facilitated by the use of a qualified intermediary. In such a case, prior to the publication of Treas. Reg. § 1.1031(k)-1(j)(2), two results were possible. First, the intermediary could be ignored for purposes of applying the installment sale rules with the result that the installment note would be eligible for reporting under the installment method if the buyer of the relinquished property (as opposed to the seller of the replacement property) was treated as the person with whom the taxpayer was doing the exchange. Second, the intermediary could be treated as the person with whom the taxpayer was doing the exchange with the result that the installment note would not be eligible for reporting under the installment method because the

intermediary rather than the transferee of the replacement property would be treated as the purchaser.

Prior to the publication of Treas. Reg. § 1.1031(k)-1(j)(2), conservative practitioners avoided this interpretative problem by either bifurcating the transaction into a part-sale/part-exchange or having the intermediary issue an installment note to the taxpayer (and securing the intermediary's note with the note made by the transferee of the replacement property to the intermediary). Treas. Reg. § 1.1031(k)-1(j)(2) (iii) resolves this problem in the taxpayer's favor by providing that "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" the installment sale rules.[46] The same rule applies in the case of a simultaneous exchange.[47]

> Example (16). On December 1, 1993, A exchanges unimproved real estate with a fair market value of $100,000 with qualified intermediary Q. Q sells the property to B for $80,000 in cash and a $20,000 note with 10% interest and payable in five years executed by B. On January 10, 1994, A identifies like-kind real estate owned by C as the replacement property. On May 30, 1994 (the end of the exchange period), Q purchases the replacement property from C for $80,000 and transfers the property and the $20,000 note to A. Assuming the transaction otherwise satisfies the requirements of the deferred exchange and installment sale rules, under Prop. Reg. § 1.1031(k)-1(j)(2)(ii), A may take the payments to be under the $20,000 note into account under the installment method.[48]

This rule would also apply even if the exchange fails and no replacement property is acquired by the taxpayer.

> Example (17). Assume the same facts as in Example (16), except that C refuses to sell the property and on May 30, 1994, Q transfers $80,000 and the $20,000 note to A. Under Treas. Reg. § 1.1031(k)-1(j)(2)(ii), A would be permitted to take both the $80,000 and the $20,000 note into account under the installment method.

c. <u>Unresolved Issues</u>.

Commentators on the proposed regulation requested a number of clarifications to the Buyer Note Rule. Unfortunately, except for the expansion of the rule to cover simultaneous exchanges, none of the requested clarifications were made. As a result, a number of important issues remain unresolved. Certain of these issues are discussed below.

Under Section 108(e)(5), if the debt of a purchaser of property to the seller of the property which debt arose out of the sale of the property is reduced, the reduction does not occur as part of a bankruptcy case or when the purchaser is insolvent, and the reduction would otherwise constitute income from the discharge of indebtedness, then such reduction is treated as a purchase price adjustment and not as income from the discharge of indebtedness. The legislative history indicates that Section 108(e)(5) does not apply if either the debt or the property has been transferred.[49] Therefore, use of Section 108(e)(5) may not be available to a taxpayer who is reducing purchase money indebtedness that the taxpayer obtained as part of a

like-kind exchange that used a qualified intermediary. Similarly, use of Section 1038(a) (which provides that no gain or loss is recognized if a sale of real property gives rise to indebtedness to the seller which is secured by the real property sold and the seller of such property reacquires it in full or partial satisfaction of such indebtedness) may not be available if the indebtedness arose out of an exchange of property facilitated by the use of a qualified intermediary.[50] It is, of course, possible that a court would rise above such technical deficiencies and hold Sections 108(e)(5) and 1038 to be applicable, even in the absence of the IRS providing additional guidance.

More importantly, it is unclear whether, in order for the Buyer Note Rule to apply, the purchaser must make the note payable to the taxpayer (as opposed to the qualified intermediary). If the note must be made payable to the taxpayer, then, presumably, the principal amount of the note would always constitute boot and be subject to tax pursuant to Section 453(f)(6). It would, however, make more sense for it to be immaterial whether the note is made payable to the taxpayer or to the qualified intermediary. As an initial matter, who the note is made payable is a formalism of a type which the recent regulations under Section 1031 have striven to overcome. In addition, allowing the note to be made payable to the qualified intermediary would allow taxpayers to increase their ability to use the provisions of Section 1031 to defer gain and thus increase their ability to reinvest in new property.

If the note may be made payable to the qualified intermediary, then, while the intermediary holds the note (i.e., during the exchange period), two things could be done to increase the amount of cash held by the intermediary (typically called the "exchange balance") and thus increase the taxpayer's potential down payment on the replacement property. First, the intermediary could sell the note. Because the sale would occur while the taxpayer did not have access to the funds held by the intermediary,[51] the sale should be treated in the same manner as if the transferee of the relinquished property had paid the purchase price in cash.[52]

Second, the qualified intermediary could, during the exchange period, receive principal and interest payments on the note from the purchaser of the relinquished property. In general, any principal payments received by the qualified intermediary should be treated as additional cash paid by the purchaser of the relinquished property and thus constitute boot to the taxpayer only to the extent that cash is ultimately distributed to the taxpayer at the end of the exchange. Interest should be treated in the manner provided in Treas. Reg. § 1.1031(k)-1(h)(2), and thus be taxable as interest income to the person to whom the interest is to be paid (usually the exchange's "taxpayer"). Section 453(f)(6) would then be applied to the note, not as originally issued by the purchaser of the relinquished property, but as the note exists on the date it is distributed to the taxpayer. Of course, until the ramifications of the Buyer Note Rule are worked out by the IRS or the courts, other interpretations and results are possible.

In the case of an installment sale, all Section 1245 and 1250 recapture income must be recognized in the year of sale and only the gain in excess of the recapture income is taken into account under the installment method.[53] Conversely, in the case of a like-kind exchange, the amount of Section 1245 recapture income is limited to the sum of the amount of gain recognized under Section 1031(b) plus the fair market value of like-kind property received that is not "section 1245 property."[54] Under Section 1250(d)(4), a similar rule applies to compute the

amount of Section 1250 recapture income in the case of a like-kind exchange. If section 1245 or section 1250 property is exchanged for like-kind property and an installment note, then it is unclear how Section 453(i) should be coordinated with Sections 1245(b)(4) and 1250(d)(4). It would make the most sense to apply Sections 1245(b)(4) and 1250(d)(4) and make Section 453(i) inapplicable to such transactions. Otherwise, application of Section 453(i) could have the result of eviscerating the deferral afforded by Section 1031, which would be inconsistent with the provisions of Section 453(f)(6). Such a result may, however, not be possible in the absence of a statutory or regulatory change, and a court (or the IRS) may well require taxpayers to apply both sets of rules by making an allocation among the various items transferred and received.

Uncertainties are also present when the relinquished property is encumbered. Under Treas. Reg. § 1.1031(b)-1(c), in determining the amount of boot in a like-kind exchange, the taxpayer is required to net the amount of liabilities of which the taxpayer is relieved against the amount of liabilities assumed, with the result that the amount of boot is equal the net amount of liabilities of which the taxpayer is relieved. This rule applies regardless of whether the exchange is a simultaneous or a deferred exchange.[55] In the case of a deferred exchange straddling the end of a taxable year, is this gain to be recognized in the first or the second taxable year? Although the answer is unclear, consistency with the proposed regulations would seem to indicate that the gain should be recognized in the second taxable year. A similar problem is present when an exchange that straddles the end of a taxable year fails and the amount of liabilities assumed by the purchaser exceeds the taxpayer's basis in the relinquished property. Under Treas. Reg. § 15A.453-1(b)(3)(i), the excess of the liabilities assumed by the purchaser over the basis of the relinquished property is treated as a payment in the year of disposition. Although such a result seems to be inconsistent with the rules contained in Prop. Reg. § 1.1031(k)-1(j)(2) for failed exchanges, the proposed regulations do not appear to have been intended to change the general rule that the excess of the liabilities of which the taxpayer is relieved over the basis of the relinquished property is treated as a payment in the year of disposition.

E. **Effective Date.**

The Final Regulations are effective for transfers of property made by a taxpayer on or after June 10, 1991. Treas. Reg. § 1.1031(k)-1(o). The 45-day delay in the effective date was presumably intended to allow taxpayers a period of time to become informed of the provisions of the Final Regulations and to avoid adversely affecting transactions which close after the date of publication but before the provisions of the regulations were generally known to taxpayers. A similar effective date rule was contained in the Proposed Regulations.

The prospective effective date of the Proposed Regulations combined with their general liberal approach to the tax treatment of deferred exchanges led a number of commentators to request that taxpayers be allowed to elect to have the regulations apply retroactively. A number of commentators also raised questions regarding what the IRS's audit and litigating position will be for deferred exchanges occurring before the effective date of the Proposed Regulations.

As a general rule, the IRS tends not to disallow tax treatment that, but for a prospective effective date of a regulation, would have been permissible. It is therefore unlikely that an election to apply the Proposed or Final Regulations retroactively was necessary.

Consistent with this policy, the Final Regulations specifically provide that transfers of property made by a taxpayer on or after May 16, 1990 (the general proposed effective date contained in the Proposed Regulations) but before June 10, 1991, will be treated as complying with Section 1031(a)(3) and the deferred exchange regulations if the deferred exchange satisfies the provisions of either the Proposed or the Final Regulations.

Treas. Reg. § 1.103(k)-1(j)(2) is effective for transfers of property occurring on or after April 20, 1994. Taxpayers may apply this provision to a transfer occurring prior to that date if: (1) in the case of transfer occurring on or after June 10, 1991, the transfer otherwise met the requirements of Treas. Reg. § 1.1031(k)-1; or (2) in the case of a transfer occurring before June 10, 1991 but on or after May 16, 1990, the transfer otherwise met the requirements of Treas. Reg. § 1.103(k)-1 or the Proposed Regulations.

III. CONCLUSION

In conclusion, the Final Regulations greatly simplify and rationalize the structuring of deferred exchanges. Application of these rules by careful tax practitioners should result in deferred exchange transactions which contain little of the uncertainty that was previously present. Similarly, the proposed regulations coordinating the deferred exchange and installment sale rules are quite generous to taxpayers and create interesting new planning possibilities. However, a number of areas need additional clarification prior to the publication of these regulations as final regulations. Such clarifications will allow taxpayers to apply these rules with less risk of falling into an unexpected trap.

1. Unless otherwise provided, all "Section" references are to the Internal Revenue Code of 1986, as amended.

2. Commentators have questioned the rationale for the nonrecognition of gain or loss provided by Section 1031, believing it to be an irrational or nonsensical exception to the general rule that gains and losses should be recognized when a realization event has occurred. This argument fails to consider that the underlying rationale for the realization system of taxation is one of administrative convenience--not theoretical purity. Thus, I would argue that Section 1031 should be judged on whether it makes economic or administrative sense, not on whether it makes sense as a "policy matter." In other words, the nonrecognition afforded by Section 1031 should be judged on substantially the same criteria as the nonrecognition afforded to corporate reorganizations.

3. For a more detailed explanation of the Proposed Regulations, see Von Gal, "Proposed Regulations Both Clarify and Complicate Deferred Like-Kind Exchanges," 73 J. Tax. 196 (Oct. 1990).

4. For a summary explanation of the Final Regulations, see Handler, "Final Regs. on Deferred Like-Kind Exchanges Provide Additional Clarifications," 75 J. Tax. 10 (July 1991).

5. Qualified intermediaries are discussed at II.C.3.c. See also Treas. Reg. § 1.1031(k)-1(g)(4).

6. See Treas. Reg. § 1.1002-1(d).

7. The safe harbors to the rules regarding actual and constructive receipt are discussed at II.C.3.c. See also Treas. Reg. § 1.1031(k)-1(g)(4).

8. The following discussion was derived from Section of Taxation American Bar Association, "Report on the Application of Section 1031 to Reverse Exchanges," 21 J. Real Estate Tax. 44 (Fall 1993) (the "Report"). The author was the principal author of the Report.

9. In general, under Section 1031(f), if the taxpayer exchanges property with a related person and, within two years of the date of the exchange, either the taxpayer or the related person disposes of property involved in the exchange, then the gain deferred under Section 1031(a) is recognized as of the date of the disposition.

10. Some commentators have raised the argument that Section 1031(a)(3) was intended to be the exclusive vehicle for nonsimultaneous exchanges to be within Section 1031(a). In this regard, it should be noted that, by its terms, Section 1031(a)(3) merely narrows the definition of like-kind property. In addition, the IRS has stated that Section 1031(a)(3) does not apply to reverse exchanges and that the qualification of reverse exchanges for nonrecognition of gain or loss is to be determined by reference to Section 1031(a)(1). T.D. 8346, 1991-1 C.B. 150.

11. A heifer is a young cow. Therefore, the exception contained in Section 1031(e) (related to exchanges of livestock of different sexes) does not apply to an exchange of heifers.

12. The following discussion uses terms that are defined in Treas. Reg. § 1.1031(k)-1(g)(4) and are discussed at II.C.3.c.

13. The exchange period will be extended only if the taxpayer actually applies for and is granted a filing extension. The exchange period is not extended because the taxpayer is simply entitled to a filing extension, even if the filing extension would have been granted automatically if requested. See Christensen v. Commissioner, T.C. Memo 1996-254, aff'd in unpub. op., No. 96-70741 (9th Cir. 4/10/98).

14. See American Bar Association Tax Section, "Comments Concerning Open Issues in Section 1031 Like Kind Exchanges," July 14, 1995 (95 TNT 155-22) (the "Open Issues Report") at Q/A-9.

15. Former Prop. Reg. § 1.1031(a)-3(b)(2)(iii) specifically provided that Section 7503 did not apply in determining the end of the identification and exchange periods. Although this rule was deleted in the Final Regulations, T.D. 8346 makes it clear that this deletion was not intended to change the IRS's position.

16. The definition of "disqualified person" is discussed at II.C.3.b.i. See also Treas. Reg. § 1.1031(k)-1(k).

17. In the case of an exchange of businesses, such as the casinos in this example, the regulations regarding personal property exchanges and exchanges of multiple properties apply. See T.D. 8343 which adopted Treas. Reg. §§ 1.1031(a)-2 and 1.1031(f)-1.

18. For an example of the application of the first exception, see PLR 9826033 (March 27, 1998) (3-property rule and 200-percent rule do not apply when replacement property is received before the end of the replacement period).

19. See discussion at II.B.2.c.iii. and Treas. Reg. § 1.1031(k)-1(m) for determination of fair market value.

20. The term "nature or character" also appears in the definition of the term "like kind" contained in Treas. Reg. § 1.1031(a)-1(b). However, Example 3 of Treas. Reg. § 1.1031(k)-1(d)(2) gives the term a narrower meaning. Query whether this is an attempt by the IRS to narrow the definition of like-kind real property.

21. See discussion at II.B.2.

22. The Proposed Regulations defined "taxpayer's transferee" as the person to whom the taxpayer transfers the relinquished property. Former Prop. Reg. § 1.1031(a)-3(g)(1). For no known reason, the Final Regulations omit this definition.

23. The "(g)(6) circumstances" are discussed at II.C.3.b.ii. See also Treas. Reg. § 1.1031(k)-1(g)(6).

24. See also Open Issues Report at Q/A-12 and Q/A-13.

25. The definition of "disqualified person" is discussed at II.C.3.b.i. See also Treas. Reg. § 1.1031(k)-1(k).

26. Letter dated August 1, 1995, from Jody J. Brewster, Assistant Chief Counsel (Income Tax & Accounting), IRS, to Howard J. Levine, Adam M. Handler and James F. Miller.

27. This warning was not repeated in the Final Regulations, so it is unclear whether this statement still constitutes the IRS's position.

28. The Tax Court initially reached the opposite conclusion in Wittig v. Commissioner, T.C. Memo 1995-461, in which the Court held that the taxpayer could not (in an exchange taking place before the enactment of the Final Regulations) offset against boot received in the form of relief of liabilities the amount of two purchase money mortgages secured by the replacement property. Following an uproar in the exchange industry, the opinion was withdrawn and the case was settled on the basis that such liabilities could be netted against boot received in the form of relief of liabilities. See "Real Estate Industry Saves Itself and Unwitting Wittig," Tax Notes, Nov. 27, 1995 p. 1068.

29. Rev. Rul. 94-4 would not resolve this issue with respect to deferred exchanges that straddle the end of a taxable year. With respect to deferred exchanges straddling the end of a taxable year, there is also an issue regarding whether a minimum gain chargeback would occur. See Treas. Reg. § 1.704-2. Such a result (which is technically mandated by the regulations) would have the bizarre result of triggering a minimum gain chargeback even though the partnership ends up with no net reduction in minimum gain.

30. For a more detailed discussion, see American Bar Association Tax Section, "Comments Concerning Partnerships: Like-Kind Exchanges of Encumbered Property," December 21, 1994 (95 TNT 12-30).

31. For a discussion of these proposed regulations, see Handler, "Proposed Regs. Coordinate Deferred Exchange and Installment Sale Rules," 79 J. Tax. 44 (July 1993).

32. See Sections 453, 453A and 453B.

33. It will be assumed herein that 10% constitutes adequate stated interest for purposes of Sections 483 and 1274.

34. See Prop. Reg. § 1.453-1(f)(1)(iv), Example (1).

35. Compare J. Earl Oden, 56 T.C. 569 (1971); Everett Pozzi, 49 T.C. 119 (1967) with Reed v. Commissioner, 723 F.2d 138 (1st Cir. 1983); Grannemann v. United States, 649 F. Supp. 949 (E.D. Mo. 1987).

36. See Reed, supra, and the cases cited therein.

37. It will be assumed herein that, if necessary to extend the exchange period, A receives an extension to file its tax returns.

38. See Treas. Reg. § 1.1031(k)-1(j)(2)(v), Examples 1 and 2.

39. See Treas. Reg. § 1.1031(k)-1(j)(2)(v), Example 3.

40. Treas. Reg. §§ 1.1031(k)-1(j)(2)(i) and (ii).

41. Treas. Reg. § 1.1031(k)-1(j)(2)(v). Property described in Section 1031(a)(2) is stock in trade or other property held primarily for sale, stock, bonds, or notes, other securities or evidence of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action.

42. Treas. Reg. § 1.1031(k)-1(j)(2)(iv).

43. Treas. Reg. § 1.1031(k)-1(j)(2)(iv).

44. Treas. Reg. § 1.1031(k)-1(j)(2)(v), Example 5.

45. Treas. Reg. § 1.1031(k)-1(j)(2)(v), Example 6.

46. This rule is referred to herein as the "Buyer Note Rule."

47. Treas. Reg. § 1.1031(b)-2(b).

48. See Treas. Reg. § 1.1031(k)-1(j)(2)(v), Example 4.

49. S. Rep. No. 96-1035, 96th Cong. 2d Sess. (1980), 1980-2 C.B. 620, 628. See also Armco Inc. v. Glenfed Financial Corporation, 720 F.Supp. 1129, 1135 n.10 (D. N.J. 1989).

50. Treas. Reg. § 1.1038-1(a)(4) expands the definition of the term "purchaser" for purposes of Section 1038. This expansion does not, however, appear to be broad enough to encompass exchanges involving qualified intermediaries.

51. See Treas. Reg. §§ 1.1031(k)-1(g)(4)(ii) and (6).

52. It is, however, likely that the note would have to be sold at a discount. The amount of the discount should be treated as a reduction in the sale price for the relinquished property as it is economically equivalent (as regards the taxpayer) to the situation where the purchaser borrowed the lower amount from a third party and then paid a lower price for the property. The purchaser's higher basis in the relinquished property is offset by the market discount on the note in the hands of the new holder. As a mere stakeholder, the qualified intermediary should not have to recognize any gain or loss on such a sale.

53. Section 453(i).

54. Section 1245(b)(4).

55. See Treas. Reg. § 1.1031(k)-1(j)(3), Example 5.