1031 Update – Advanced
hange Strategies for Attorneys

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IPX 1031 Investment Property Exchange Services, Inc.

Basic Rules of §1031 (Time Frames)

The Exchanger must identify the property to be purchased within 45 days following the sale of the Relinquished Property.

Rules of Identification

3 Property Rule

200% Rule

95% Rule

Exchanger must obtain the Replacement Property within 180 days following the sale of the relinquished property.

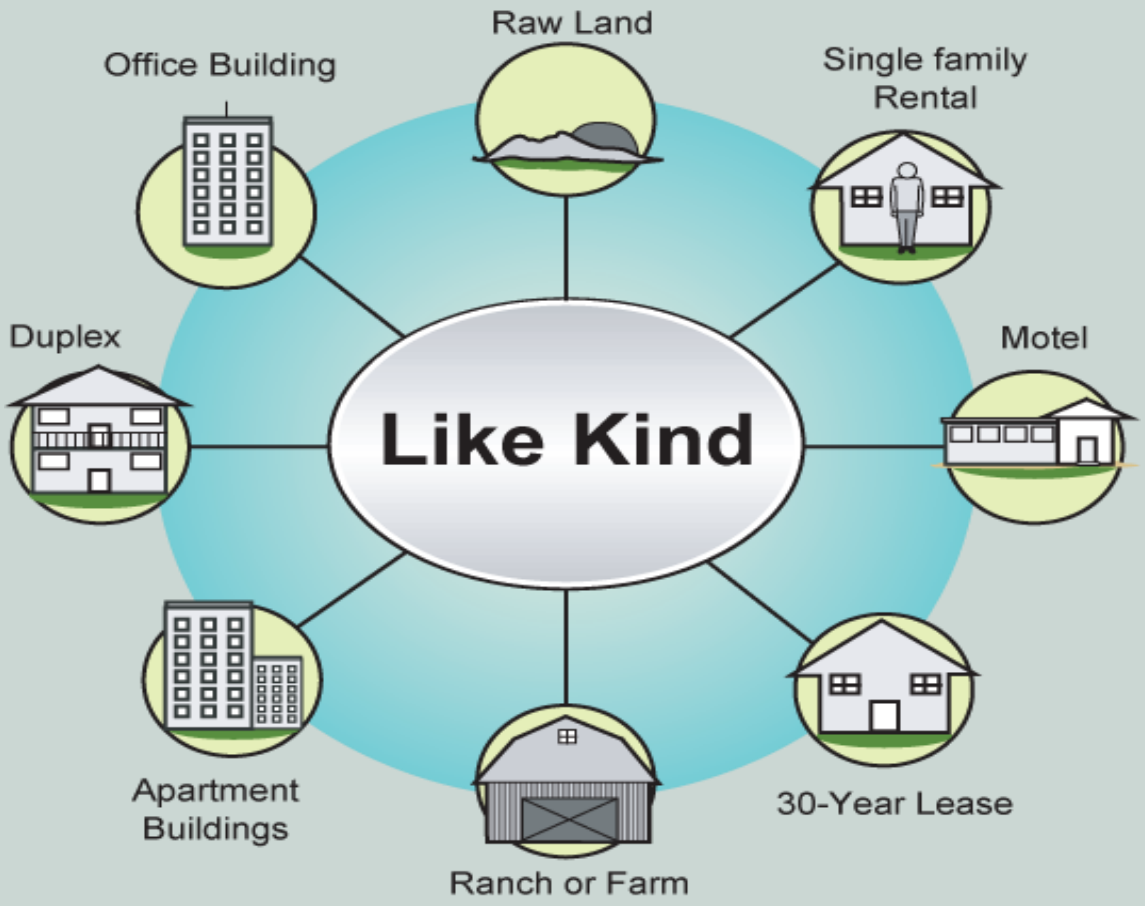
Saturdays, Sundays, and legal holidays do not extend the time period.

Since 9/11 Congress issues 120 day extensions for tax payers affected within federal disasters areas by presidential order. The exchanger receives the extension if one of the following is within the affected area; 1) exchange properties 2) Exchanger's principal residence 3) Exchanger's tax preparer 4) Q.I.

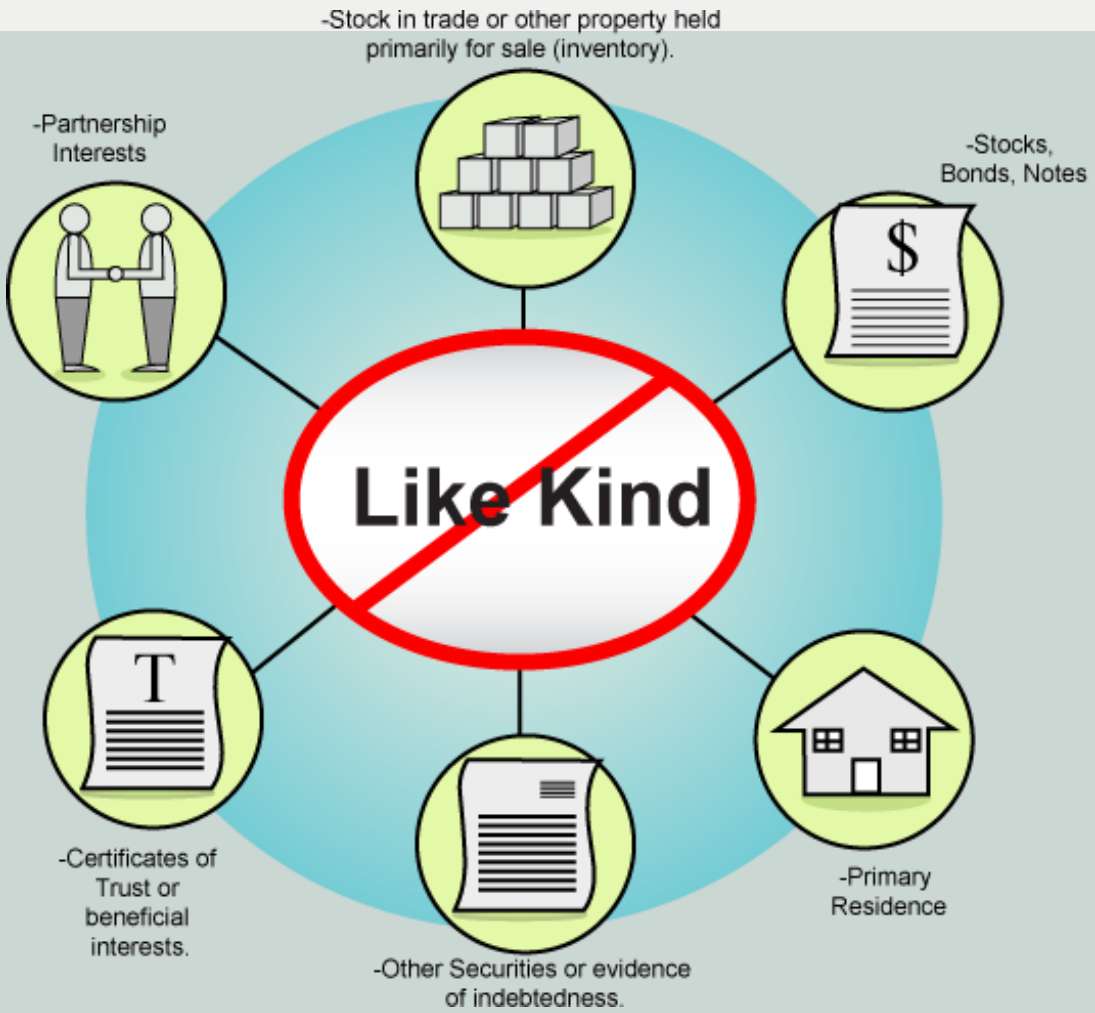
Equal or Greater Value

- **The purchase price of the Replacement Property must be at least as much as the sale price of the Relinquished Property (or pay tax on the difference).**
- **All cash proceeds from the sale of the Relinquished Property must be reinvested in the Replacement Property (minus non-recurring ordinary closing costs) (or pay tax on the difference).**
- **Debt on the replacement property must be equal or greater to the debt paid off at closing on the Relinquished Property (Exception: Debt can be replaced with outside cash) (or pay tax on the difference).**
- **For safe harbor protection, exchange funds should be held by a Qualified Intermediary.**

What is Like Kind?



What is NOT Like Kind?



Partnership Issues

Problem Presented

A Partnership or LLC can complete an exchange

- However, §1031(a)(2)(D) prevents a partner from exchanging its interest in a Partnership

An multi-member LLC is treated (for federal tax purposes) as a partnership or an association taxable as a corporation

- Both are excluded from being like kind

In summary, an interest in a partnership or an LLC membership is NEVER like kind

Disregarded Entities

- A disregarded entity exists
  for federal tax purposes only
  - Examples
    - Single Member LLC
    - H & W LLC in a community property state (9 of them)
      - LA, TX, NM, AZ, CA, NV, WA, ID & WI
      - In the remaining 41 "common law" states it is a partnership for Federal tax purposes
      - To be disregarded the property **and** couple need to be in a community property state
    - Revocable Living Trust (a/k/a Grantor Trust)

Partnership Issues

Drop & Swap and Swap & Drop

Very risky – especially in California

Many will argue they are safe

- The last 1031 they may have done was years ago (when they were common)
- TP must admit doing a D & S on their partnership return (Form 1065)

Purchase Interest of Retiring Partner

Before the Exchange

- Partners who wish to exchange add equity which is used to buyout retiring partner
- Once this occurs partnership performs exchange
- Must acquire RPL of same or greater value of RLQ to avoid gain

After the Exchange

- Partnership completes the exchange
- Then it secures a cash-out refinance of the Replacement property and buys out retiring partner

Relinquished Property Sold for Cash and Installment Note

Buyer of Relinquished property pays with cash and an installment note (payable to the partnership)

- The cash is used in the exchange by the partnership
- Retiring partner receives the installment note
  - Is boot but receives installment treatment

At least one true payment has to be in next year

- Practical suggestion - put at least 5% into next year

Related Party Exchanges
(3 Types)

1. Deed Swap

Father ← → Son

Each must hold for two years

"If a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment, and the original exchange should not be accorded non-recognition treatment."
H.R. Rep. No. 247, 101st Cong. 1st Sess. 1340 (1989).

Related Party Exchanges
(3 Types)

2. Selling To a Related Party

Selling to Father

Buying from unrelated Third Party

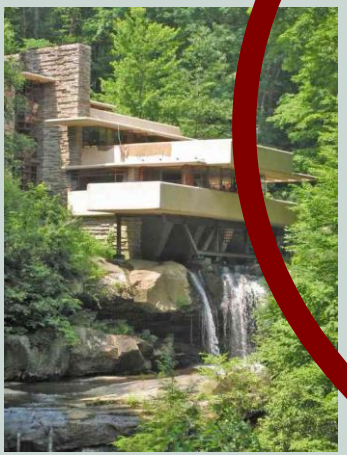
Son
(exchanger)

Father needs to buy at FMV

Related Party Exchanges
(3 Types)

3. Buying From a Related Party

Selling to unrelated Third Party



Buying from Father

Son
(exchanger)

Exchanging into a higher basis property

Related Party Exchanges

Example of lower to higher basis RP exchange
(Basis shift)

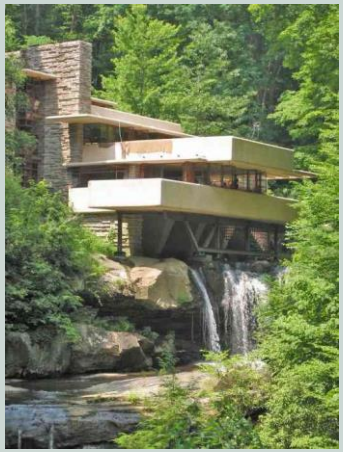
Unrelated
Third Party

Father

(cashing out and

paying little or no tax)

#1



#2

Son

(exchanger deferring large gain)

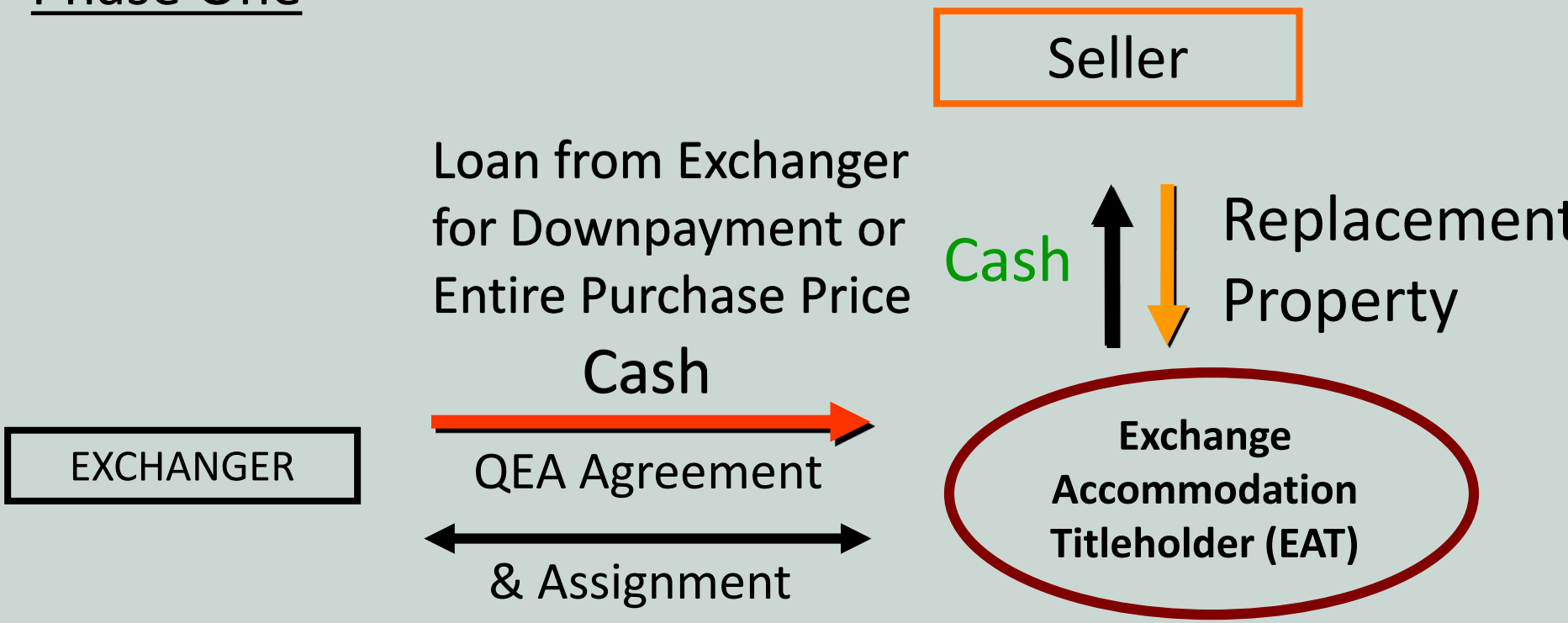
Property #1 Fair Market Value = $300K Adj Basis = $100K

Property #2 Fair Market Value = $300K Adj Basis = $200K

Reverse Exchange

Parking Title to the Replacement Property

Phase One

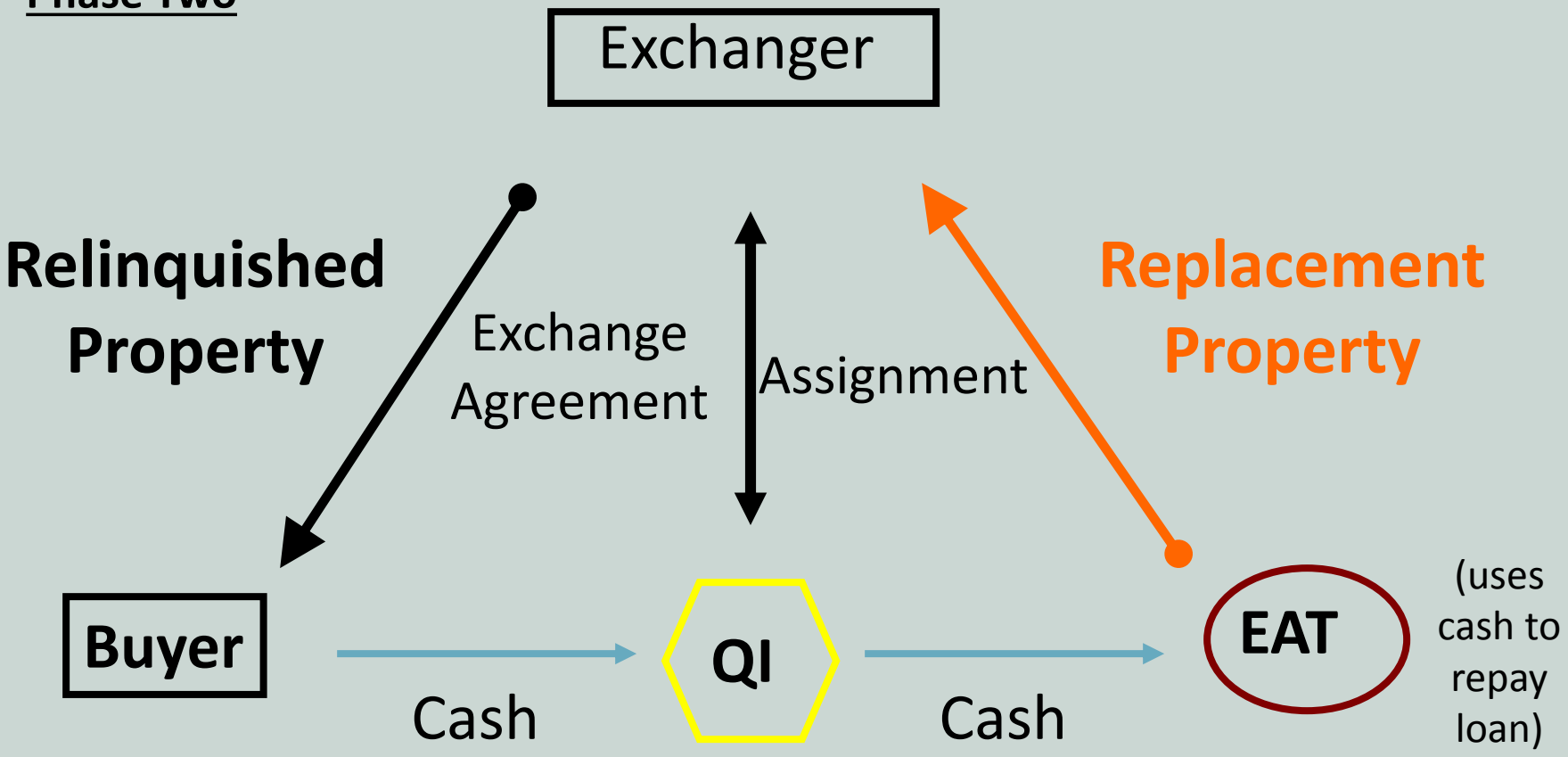


EAT holds title to Exchanger's Replacement Property until the Relinquished is sold

Reverse Exchange

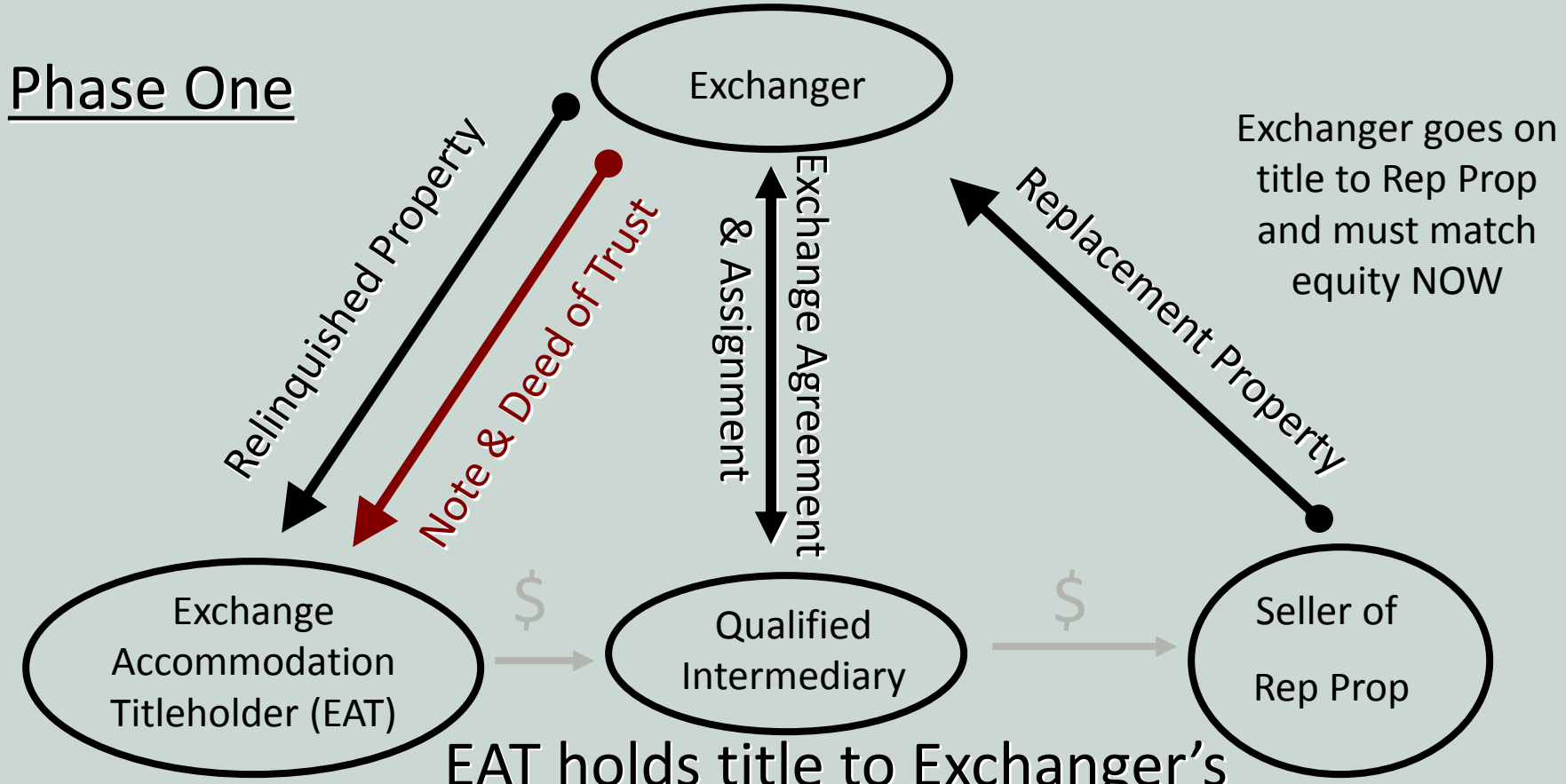
Parking Title to the Replacement Property

Phase Two



Reverse Exchange

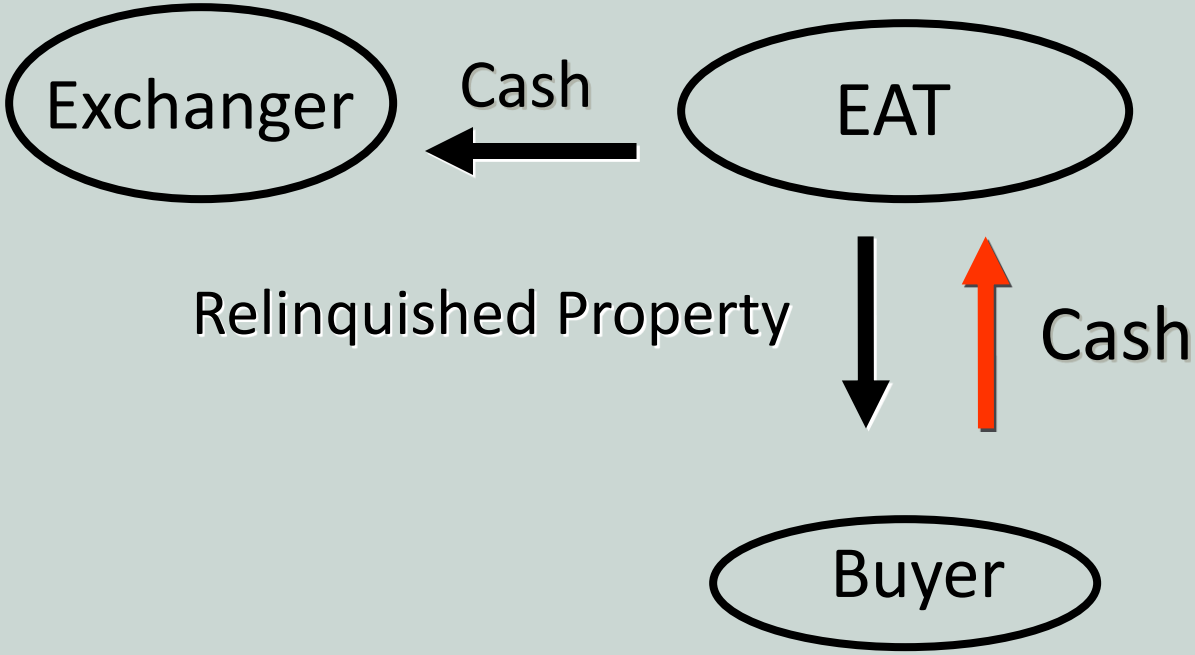
Parking Title to the Relinquished Property



EAT holds title to Exchanger's Relinquished Property until it can be sold

Reverse Exchange

Parking Title to the Relinquished Property

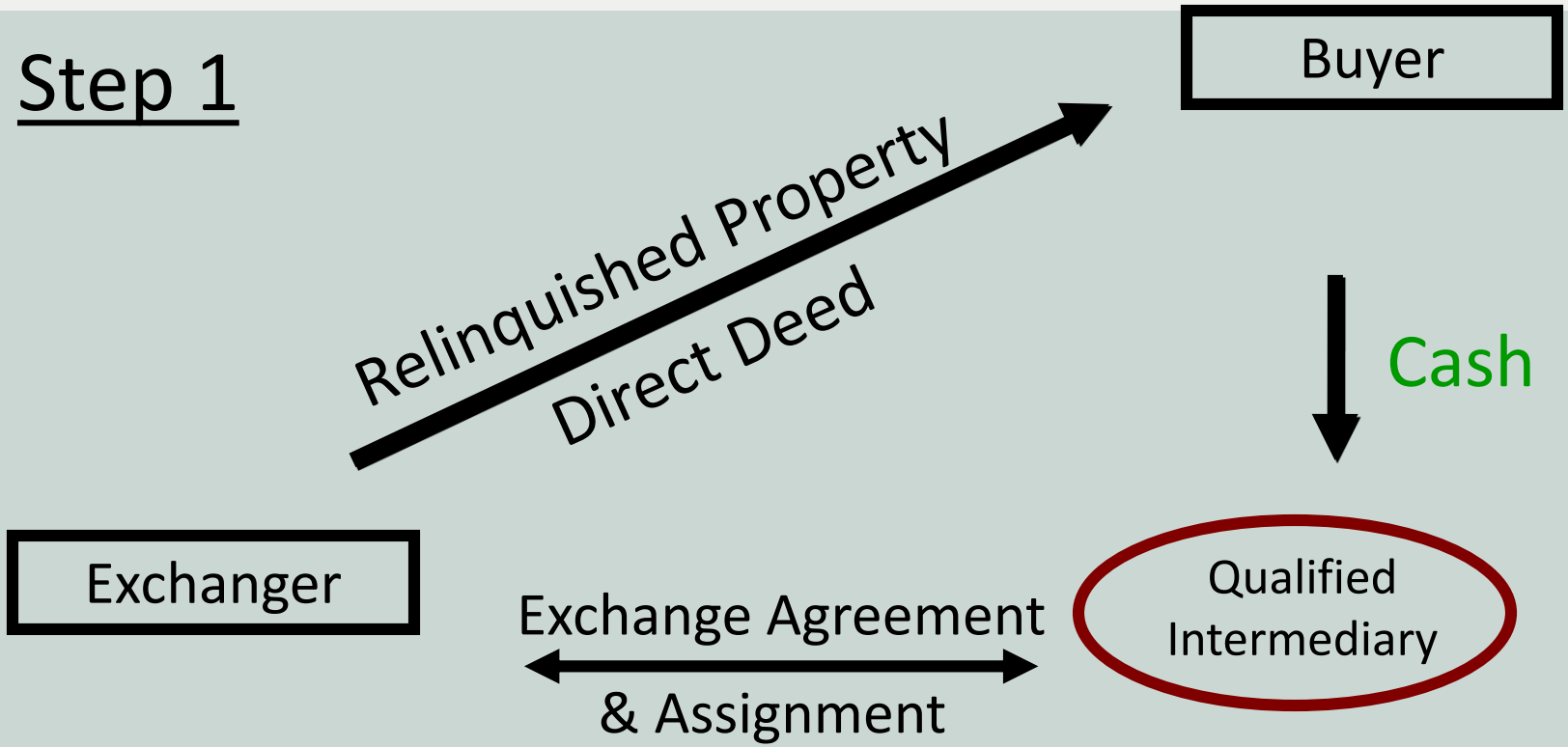


Phase Two

Used to Repay Exchanger for the EAT's loan to purchase the Relinquished Property

When Relinquished Property is sold
EAT transfers title to Buyer

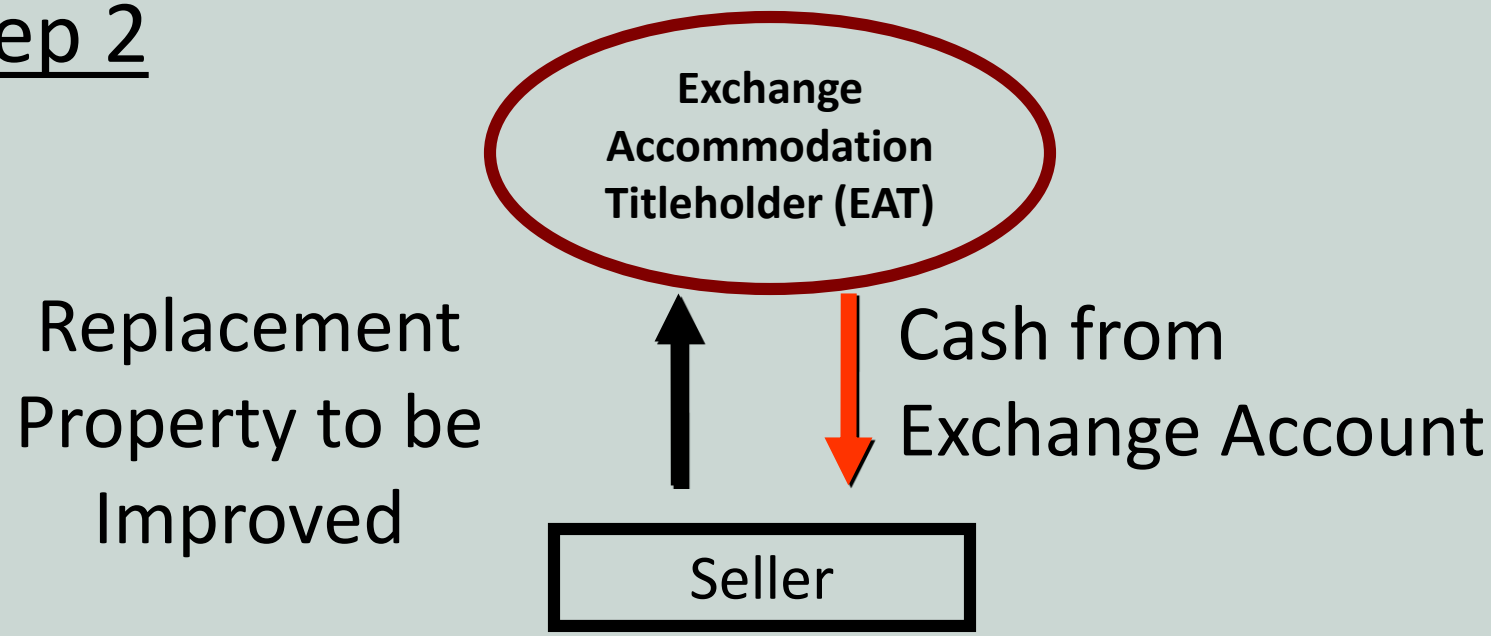
Build-to-Suit Exchange



Exchanger Assigns Purchase Agreement for Replacement Property to Intermediary

Build-to-Suit Exchange

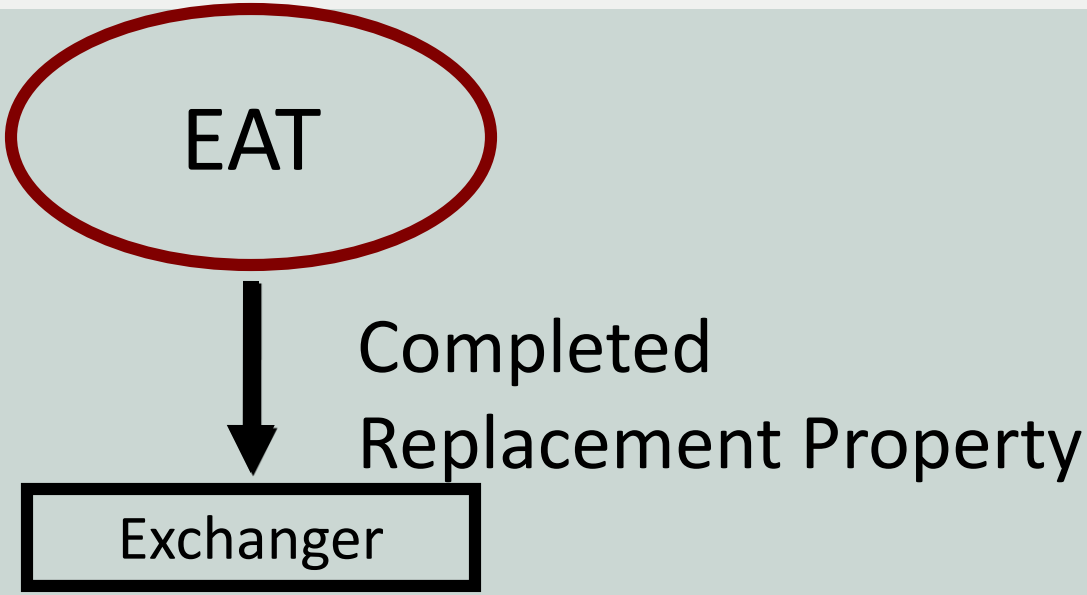
Step 2



EAT holds title to the Replacement Property while it is being improved with Exchange Funds

Build-to-Suit Exchange

Step 3



There can be no more than 180 days between steps 1 and 3 in order to remain within the safe harbor

Build to Suit on Tax Payer Owned Property

(Rev Proc 2004-51)

Leasehold Interest

Leaseholds 30 years or greater is like-kind to fee-title

Short-term leasehold is like-kind to other leaseholds with similar terms

Use a Lease Option to give exchanger more time

- QI should hold option money
- Or bring option money back into the exchange
- Option money left out is taxable boot

Related Party Exchanges

PLR201408019
(Building on land owned by a related party)

Facts

- TP disposed of REL to an unrelated third party using a QI
- TP set up a BTS parking arrangement where EAT leased land for over 30 years and built improvements on it
- Ground lease and improvements constructed on it were transferred to TP
- *Neither TP or Ground Lessee (related party to TP) will dispose of either of their interests within 2 years*

Why is the ruling surprising?

IRS applied Rev. Proc. 2004-51 narrowly

- Held the safe harbor of Rev. Proc. 2000-37 (reverse and BTS) does not apply if TP owns the RPL within 180 days prior to its transfer to the EAT

IRS did not extend Rev Proc 2004-51 to property owned by a related party

Did not discuss or apply 1031(f)(4) – which prohibits a structure intended to avoid related party restriction

- Usually related parties are considered the same economic unit

Notable Points in the PLR

Section 1031(f)(1) held not to be applicable because neither of the related parties will be cashing out within two years of the exchange

Rev. Proc. 2004-51 does not apply because the RPL has not been owned by TP

How to Select a Qualified Intermediary

Security: Security is your most important issue.
IPX 1031® provides;
- $100 Million Fidelity Bond
- Third Party Written Guarantee of Funds
- $30 Million Errors & Omissions Professional Liability Coverage

Service: Be sure that they provide top customer service.
IPX 1031® provides;
- 14 Regional Processing Centers managed by an experienced attorney and a competent exchange processing staff
- 24 Regional Sales Offices

Experience: 26 Regional Attorneys with substantial experience in facilitating all aspects of real estate and personal property exchanges –
- Delayed ("Starker") Exchanges
- Simultaneous Exchanges
- Build-To-Suit Parking Transactions
- Reverse Parking Transactions
- Multiple Asset and Mass Asset Exchanges
- Workout/Foreclosure Exchanges

Questions ???

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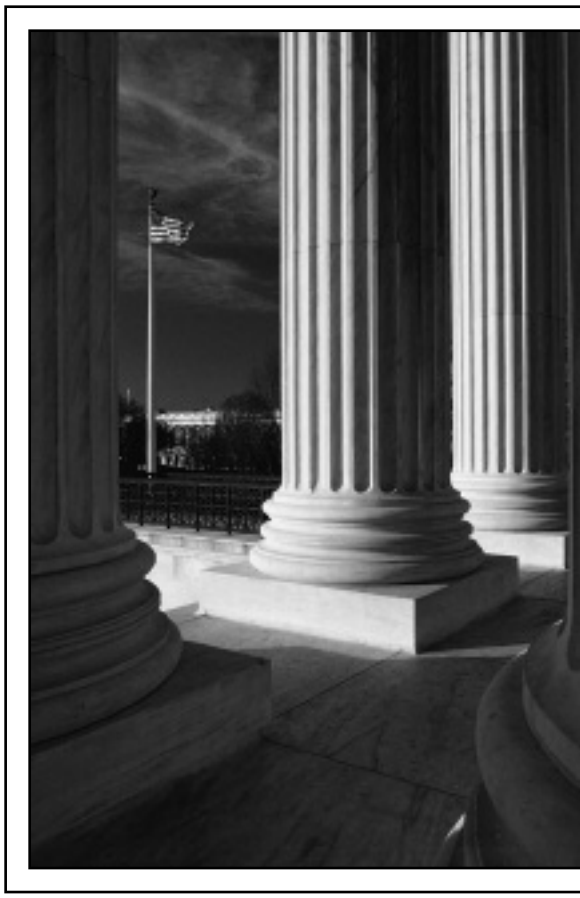
Tax Reference Manual for IRC §1031



IPX 1031℠

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Qualified Intermediary

INTRODUCTION

Investment Property Exchange Services, Inc. (IPX1031®) has been assisting clients with their real estate and personal property tax deferred exchanges since 1988. Through our national network of regional offices and our knowledgeable, experienced staff, we have consistently demonstrated a commitment to unsurpassed service with integrity. We provide clients with an unparalleled professional team which has earned an outstanding reputation as the industry leader in IRC §1031 Qualified Intermediary services.

IPX1031® is a subsidiary of Fidelity National Financial, Inc. (NYSE:FNF), a Fortune 500 company and a leading provider of title insurance, mortgage services and diversified services. Fidelity National Financial, Inc. (NYSE:FNF), is a leading provider of title insurance, mortgage services and diversified services. FNF is the nation's largest title insurance company through its title insurance underwriters - Fidelity National Title, Chicago Title, Commonwealth Land Title and Alamo Title - that collectively issue more title insurance policies than any other title company in the United States. Our corporate strength permits IPX1031® to offer the highest level of financial security in the industry to ensure the safety of our clients' exchange funds. Exchange accounts held by IPX1031® are protected with a $100 million fidelity bond, a $50 million written third party corporate performance guarantee, and a $30 million professional liability insurance policy.

IPX1031® facilitates thousands of tax deferred exchange transactions every year. Our substantial expertise in facilitating exchanges, combined with the industry's most experienced team of exchange specialists, brings multidimensional insights to structuring even the most challenging exchanges. We handle all types of real estate and personal property exchanges, including simultaneous, delayed, multiple asset, artwork and collectables exchanges, and exchange accommodation titleholder transactions for safe harbor reverse and build-to-suit exchanges.

Each of our regional offices is managed by staff experienced in handling all phases of exchange transactions. While we do not provide legal or tax advice, in our role as Qualified Intermediary, we expertly guide our clients through the exchange process, providing information about exchange requirements, generating exchange documents, and safely handling exchange funds.

Our staff of trained professionals regularly conducts accredited continuing education courses throughout the country. Many of the country's most respected real estate companies, law firms and accounting firms consistently rely upon IPX1031® as a valuable educational resource. IPX1031® is active in the Federation of Exchange Accommodators ("FEA"), the national industry trade association representing Qualified Intermediary companies, serving on the Board of Directors for more than a decade. As a member of the FEA, IPX1031® continually participates in new industry developments and legislation regarding tax deferred exchanges and tax related issues.

In our continuing effort to bring value to our clients, we provide this booklet that explains the key requirements and issues concerning IRC §1031 tax deferred exchanges. These Brief Exchanges are intended to provide a technical overview and an understanding of the advantages of utilizing a tax deferred exchange as an investment strategy for acquiring and disposing of investment or business-use assets. Most of these chapters focus on real estate investments due to the greater prevalence of real property exchanges. While the general requirements of IRC §1031 apply equally to exchanges of real estate or personal property, additional rules and regulations specific to personal property exchanges are discussed in the Personal Property Brief Exchange. For recent updates and a more complete set of the Brief Exchanges, please visit our web site at www.ipx1031.com.

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INTERNAL REVENUE CODE — SECTION 1031

Sec. 1031
Exchange of property held for productive use or investment

(a) Nonrecognition of gain or loss from exchanges solely in kind

(1) In general

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

(2) Exception. This subsection shall not apply to any exchange of—

(A) stock in trade or other property held primarily for sale,

(B) stocks, bonds, or notes,

(C) other securities or evidences of indebtedness or interest,

(D) interests in a partnership,

(E) certificates of trust or beneficial interests, or

(F) choses in action.

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

(3) Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property. For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if—

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

(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 exchange, or

(ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

(b) Gain from exchanges not solely in kind

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

(c) Loss from exchanges not solely in kind

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

(d) Basis

If property was acquired on an exchange described in this section, section 1035(a), section 1036(a), or section 1037(a), then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by this section, section 1035(a), section 1036(a), or section 1037(a), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. For purposes of this section, section 1035(a), and section 1036(a), where as part of the consideration to the taxpayer another party to the exchange assumed (as determined under section 357(d)) a liability of the taxpayer, such assumption shall be considered as money received by the taxpayer on the exchange.

(e) Exchanges of livestock of different sexes

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

(f) Special rules for exchanges between related persons

(1) In general

If—

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

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

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

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

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

(2) Certain dispositions not taken into account

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

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

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

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

(3) Related person

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

(4) Treatment of certain transactions

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

(g) Special rule where substantial diminution of risk

(1) In general

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

(2) Property to which subsection applies

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

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

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

(C) a short sale or any other transaction.

(h) Special rules for foreign real and personal property

For purposes of this section—

(1) Real property

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

(2) Personal property

(A) In general

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

(B) Predominant use

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

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

(ii) in the case of the property acquired in the exchange, the 2-year period beginning on the date of such acquisition.

(C) Property held for less than 2 years

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

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

(ii) only the periods the property was held by the person acquiring the property (or any related person) shall be taken into account under subparagraph (B)(ii).

(D) Special rule for certain property

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

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Sec. 1.1031(a)-1

Property held for productive use in trade or business or for investment.

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

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

(ii) Stocks, bonds, or notes;

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

(iv) Interests in a partnership;

(v) Certificates of trust or beneficial interests; or

(vi) Choses in action.

Section 1031(a)(1) does not apply to any exchange of interests in a partnership regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or in different partnerships. An interest in a partnership that has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K is treated as an interest in each of the assets of the partnership and not as an interest in a partnership for purposes of section 1031(a)(2)(D) and paragraph (a)(1)(iv) of this section. An exchange of an interest in such a partnership does not qualify for nonrecognition of gain or loss under section 1031 with respect to any asset of the partnership that is described in section 1031(a)(2) or to the extent the exchange of assets of the partnership does not otherwise satisfy the requirements of section 1031(a)(2) exchanges of property not solely for property of a like kind. A transfer is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or property which does not meet the requirements of section 1031(a), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). Similarly, a transfer is not within the provisions of section 1031(a) if, as part of the consideration, the other party to the exchange assumes a liability of the taxpayer (or acquires property from the taxpayer that is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). A transfer of property meeting the requirements of section 1031(a) may be within the provisions of section 1031(a) even though the taxpayer transfers in addition property not meeting the requirements of section 1031(a) or money. However, the nonrecognition treatment provided by section 1031(a) does not apply to the property transferred which does not meet the requirements of section 1031(a).

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

(c) Examples of exchanges of property of a "like kind." No gain or loss is recognized if

(1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or

(2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

(d) Examples of exchanges not solely in kind. Gain or loss is recognized if, for instance, a taxpayer exchanges

(1) Treasury bonds maturing March 15, 1958, for Treasury bonds maturing December 15, 1968, unless section 1037(a) (or so much of section 1031 as relates to section 1037(a)) applies to such exchange, or

(2) a real estate mortgage for consolidated farm loan bonds.

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

Sec. 1.1031(a)-2

Additional rules for exchanges of personal property.

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

(b) Depreciable tangible personal property—

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

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

The General Asset Classes are as follows:

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

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

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

(iv) Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21),

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

(vi) Buses (asset class 00.23),

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(c) Intangible personal property and nondepreciable personal property--

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

(2) Goodwill and going concern value. The goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business.

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

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

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

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

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

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

(1) In an exchange described in section 1031(a) of property held for investment or productive use in trade or business for property of like kind to be held either for productive use or for investment,

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

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

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

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

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

Example 2.

(a) B, who uses the cash receipts and disbursements method of accounting and the calendar year as his taxable year, has never elected under section 454(a) to include in gross income currently the annual increase in the redemption price of non-interest-bearing obligations issued at a discount. In 1943, for $750 each, B purchased four $1,000 series E U.S. savings bonds bearing an issue date of March 1, 1943.

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

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

Amount realized:

Par value of five series H bonds	$5,000.00
Cash received	$25.60
Total realized	$5,025.60

Less: Adjusted basis of series E bonds surrendered in the exchange:

Three $1,000 series E bonds	$2,250.00
Six $100 series E bonds at $75 each	$450.00
	$2,700.00
Gain realized	$2,325.60

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

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

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Example 3.

(a) The facts are the same as in example (2), except that, as part of the transaction, the $1,000 series E bond is reissued by considering ten $100 series E bonds bearing an issue date of March 1, 1943, to have been issued. Six of the $100 series E bonds so considered to have been issued are surrendered to the United States as part of the exchange qualifying under section 1037(a) and the other four are immediately redeemed.

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

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

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

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

Sec. 1.1031(b)-2
Safe harbor for qualified intermediaries.

(a) In the case of simultaneous transfers of like-kind properties involving a qualified intermediary (as defined in Sec. 1.1031(k)-1(g)(4)(iii)), the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the transfer and receipt of property by the taxpayer is treated as an exchange.

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

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

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

Sec. 1.1031(c)-1
Nonrecognition of loss.

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

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

(a) If, in an exchange of property solely of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), no part of the gain or loss was recognized under the law applicable to the year in which the exchange was made, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange. If additional consideration is given by the taxpayer in the exchange, the basis of the property acquired shall be the same as the property transferred increased by the amount of additional consideration given (see section 1016 and the regulations thereunder).

(b) If, in an exchange of properties of the type indicated in section 1031, section 1035(a), section 1036(a), or section 1037(a), gain to the taxpayer was recognized under the provisions of section 1031(b) or a similar provision of a prior revenue law, on account of the receipt of money in the transaction, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by he amount of gain recognized on the exchange. The application of this paragraph may be illustrated by the following example:

Example: A, an individual in the moving and storage business, in 1954 transfers one of his moving trucks with an adjusted basis in his hands of $2,500 to B in exchange for a truck (to be used in A's business) with a fair market value of $2,400 and $200 in cash. A realizes a gain of $100 upon the exchange, all of which is recognized under section 1031(b). The basis of the truck acquired by A is determined as follows:

Adjusted basis of A's former truck.	$2,500.00
Less: Amount of money received	$200.00
Difference	$2,300.00
Plus: Amount of gain recognized.	$100.00
Basis of truck acquired by A	$2,400.00

(c) If, upon an exchange of properties of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), the taxpayer received other property (not permitted to be received without the recognition of gain) and gain from the transaction was recognized as required under section 1031(b), or a similar provision of a prior revenue law, the

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basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of any money received and increased by the amount of gain recognized, must be allocated to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of the basis of the properties received, there must be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. The application of this paragraph may be illustrated by the following example:

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

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

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

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

Adjusted basis of real estate transferred	$10,000.00
Adjusted basis of stock transferred	$4,000.00
	$14,000.00
Less: Loss recognized on transfer of stock	$2,000.00
Basis of real estate acquired upon the exchange	$12,000.00

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

If the properties exchanged under section 1031 are part of a group of assets which constitute a trade or business under section 1060, the like-kind property and other property or money which are treated as transferred in exchange for the like-kind property shall be excluded from the allocation rules of section 1060. However, section 1060 shall apply to property which is not like-kind property or other property or money which is treated as transferred in exchange for the like-kind property. For application of the section 1060 allocation rules to property which is not part of the like-kind exchange, see Sec. 1.1060-1(b), (c), and (d) Example 1 in Sec. 1.338-6(b), to which reference is made by Sec. 1.1060-1(c)(2).

Sec. 1.1031(d)-2
Treatment of assumption of liabilities.

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

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

Value of property received	$600,000.00
Cash	$50,000.00
Liabilities subject to which old property was transferred	$150,000.00
Total consideration received	$800,000.00
Less: Adjusted basis of property transferred	$500,000.00
Gain realized	$300,000.00

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Under section 1031(b), $200,000 of the $300,000 gain is recognized. The basis of the apartment house acquired by B upon the exchange is $500,000, computed as follows:

Adjusted basis of property transferred	$500,000.00
Less: Amount of money received:	
Cash	$50,000.00
Amount of liabilities subject to which property was transferred	$150,000.00
	$200,000.00
Difference	$300,000.00
Plus: Amount of gain recognized upon the exchange	$200,000.00
Basis of property acquired upon the exchange	$500,000.00

Example 2.

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

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

Value of property received	$250,000.00
Cash	$40,000.00
Liabilities subject to which old property was transferred	$80,000.00
Total consideration received	$370,000.00
Less: Adjusted basis of property transferred	$100,000.00
Liabilities to which new property is subject	$150,000.00
	$250,000.00
Gain realized	$120,000.00

For purposes of section 1031(b), the amount of other property or money received by D is $40,000. (Consideration received by D in the form of a transfer subject to a liability of $80,000 is offset by consideration given in the form of a receipt of property subject to a $150,000 liability. Thus, only the consideration received in the form of cash, $40,000, is treated as other property or money for purposes of section 1031(b).) Accordingly, under section 1031(b), $40,000 of the $120,000 gain is recognized. The basis of the apartment house acquired by D is $170,000, computed as follows:

Adjusted basis of property transferred	$100,000.00
Liabilities to which new property is subject	$150,000.00
Total	$250,000.00
Less: Amount of money received: Cash	$40,000.00
Amount of liabilities subject to which property was transferred	$80,000.00
	$120,000.00
Difference	$130,000.00
Plus: Amount of gain recognized upon the exchange	$40,000.00
Basis of property acquired upon the exchange	$170,000.00

(c) E realizes a gain of $75,000 on the exchange, computed as follows:

Value of property received	$220,000.00
Liabilities subject to which old property was transferred	$150,000.00
Total consideration received	$370,000.00
Less: Adjusted basis of property transferred	$175,000.00
Cash	$40,000.00
Liabilities to which new property is subject	$80,000.00
	$295,000.00
Gain realized	$75,000.00

For purposes of section 1031(b), the amount of other property or money received by E is $30,000. (Consideration received by E in the form of a transfer subject to a liability of $150,000 is offset by consideration given in the form of a receipt of property subject to an $80,000 liability and by the $40,000 cash paid by E. Although consideration received in the form of cash or other property is not offset by consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability, consideration given in the form of cash or other property is offset against consideration received in the form of an assumption of liabilities or a transfer of property subject to a liability.) Accordingly, under section 1031(b), $30,000 of the $75,000 gain is recognized. The basis of the apartment house acquired by E is $175,000, computed as follows:

Adjusted basis of property transferred	$175,000.00
Cash	$40,000.00
Liabilities to which new property is subject	$80,000.00
Total	$295,000.00
Less: Amount of money received: Amount of liabilities subject to which property was transferred	$150,000.00
	$150,000.00
Difference	$145,000.00
Plus: Amount of gain recognized upon the exchange	$30,000.00
Basis of property acquired upon the exchange	$175,000.00

Sec. 1.1031(e)-1

Exchange of livestock of different sexes.

Section 1031(e) provides that livestock of different sexes are not property of like kind. Section 1031(e) and this section are applicable to taxable years to which the Internal Revenue Code of 1954 applies.

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Sec. 1.1031(j)-1
Exchanges of multiple properties.

(a) Introduction—(1) Overview. As a general rule, the application of section 1031 requires a property-by-property comparison for computing the gain recognized and basis of property received in a like-kind exchange. This section provides an exception to this general rule in the case of an exchange of multiple properties. An exchange is an exchange of multiple properties if, under paragraph (b)(2) of this section, more than one exchange group is created. In addition, an exchange is an exchange of multiple properties if only one exchange group is created but there is more than one property being transferred or received within that exchange group. Paragraph (b) of this section provides rules for computing the amount of gain recognized in an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031. Paragraph (c) of this section provides rules for computing the basis of properties received in an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031.

(2) General approach.

(i) In general, the amount of gain recognized in an exchange of multiple properties is computed by first separating the properties transferred and the properties received by the taxpayer in the exchange into exchange groups in the manner described in paragraph (b)(2) of this section. The separation of the properties transferred and the properties received in the exchange into exchange groups involves matching up properties of a like kind of like class to the extent possible. Next, all liabilities assumed by the taxpayer as part of the transaction are offset by all liabilities of which the taxpayer is relieved as part of the transaction, with the excess liabilities assumed or relieved allocated in accordance with paragraph (b)(2)(ii) of this section. Then, the rules of section 1031 and the regulations thereunder are applied separately to each exchange group to determine the amount of gain recognized in the exchange. See Secs. 1.1031(b)-1 and 1.1031(c)-1. Finally, the rules of section 1031 and the regulations thereunder are applied separately to each exchange group to determine the basis of the properties received in the exchange. See Secs. 1.1031(d)-1 and 1.1031(d)-2.

(ii) For purposes of this section, the exchanges are assumed to be made at arms' length, so that the aggregate fair market value of the property received in the exchange equals the aggregate fair market value of the property transferred. Thus, the amount realized with respect to the properties transferred in each exchange group is assumed to equal their aggregate fair market value.

(b) Computation of gain recognized—

(1) In general. In computing the amount of gain recognized in an exchange of multiple properties, the fair market value must be determined for each property transferred and for each property received by the taxpayer in the exchange. In addition, the adjusted basis must be determined for each property transferred by the taxpayer in the exchange.

(2) Exchange groups and residual group. The properties transferred and the properties received by the taxpayer in the exchange are separated into exchange groups and a residual group to the extent provided in this paragraph (b)(2).

(i) Exchange groups. Each exchange group consists of the properties transferred and received in the exchange, all of which are of a like kind or like class. If a property could be included in more than one exchange group, the taxpayer may include the property in any of those exchange groups. Property eligible for inclusion within an exchange group does not include money or property described in section 1031(a)(2) (*i.e.,* stock in trade or other property held primarily for sale, stocks, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action). For example, an exchange group may consist of all exchanged properties that are within the same General Asset Class or within the same Product Class (as defined in Sec. 1.1031(a)-2(b)). Each exchange group must consist of at least one property transferred and at least one property received in the exchange.

(ii) Treatment of liabilities.

(A) All liabilities assumed by the taxpayer as part of the exchange are offset against all liabilities of which the taxpayer is relieved as part of the exchange, regardless of whether the liabilities are recourse or nonrecourse and regardless of whether the liabilities are secured by or otherwise relate to specific property transferred or received as part of the exchange. See Secs. 1.1031 (b)-1(c) and 1.1031(d)-2. For purposes of this section, liabilities assumed by the taxpayer as part of the exchange consist of liabilities of the other party to the exchange assumed by the taxpayer and liabilities subject to which the other party's property is transferred in the exchange. Similarly, liabilities of which the taxpayer is relieved as part of the exchange consist of liabilities of the taxpayer assumed by the other party to the exchange and liabilities subject to which the taxpayer's property is transferred.

(B) If there are excess liabilities assumed by the taxpayer as part of the exchange (*i.e.,* the amount of liabilities assumed by the taxpayer exceeds the amount of liabilities of which the taxpayer is relieved), the excess is allocated among the exchange groups (but not to the residual group) in proportion to the aggregate fair market value of the properties received by the taxpayer in the exchange groups. The amount of excess liabilities assumed by the taxpayer that are allocated to each exchange group may not exceed the aggregate fair market value of the properties received in the exchange group.

(C) If there are excess liabilities of which the taxpayer is relieved as part of the exchange (*i.e.,* the amount of liabilities of which the taxpayer is relieved exceeds the amount of liabilities assumed by the taxpayer), the excess is treated as a Class I asset for purposes of making allocations to the residual group under paragraph (b)(2)(iii) of this section.

(D) Paragraphs (b)(2)(ii) (A), (B), and (C) of this section are applied in the same manner even if section 1031 and this section apply to only a portion of a larger transaction (such as a transaction described in section 1060(c) and Sec. 1.1060-1T(b)). In that event, the amount of excess liabilities assumed by the taxpayer or the amount of excess liabilities of which the taxpayer is relieved is determined based on all liabilities assumed by the taxpayer and all liabilities of which the taxpayer is relieve as part of the larger transaction.

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(iii) Residual group. If the aggregate fair market value of the properties transferred in all of the exchange groups differs from the aggregate fair market value of the properties received in all of the exchange groups (taking liabilities into account in the manner described in paragraph (b)(2)(ii) of this section), a residual group is created. The residual group consists of an amount of money or other property having an aggregate fair market value equal to that difference. The residual group consists of either money or other property transferred in the exchange or money or other property received in the exchange, but not both. For this purpose, other property includes property described in section 1031(a)(2) (*i.e.,* stock in trade or other property held primarily for sale, stocks, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action), property transferred that is not of a like kind or like class with any property received, and property received that is not of a like kind or like class with any property transferred. The money and properties that are allocated to the residual group are considered to come from the following assets in the following order: first from Class I assets, then from Class II assets, then from Class III assets, and then from Class IV assets. The terms Class I assets, Class II assets, Class III assets, and Class IV assets have the same meanings as in Sec. 1.338-6(b), to which reference is made by Sec. 1.1060-1(c)(2). Within each Class, taxpayers may choose which properties are allocated to the residual group.

(iv) Exchange group surplus and deficiency. For each of the exchange groups described in this section, an "exchange group surplus" or "exchange group deficiency," if any, must be determined. An exchange group surplus is the excess of the aggregate fair market value of the properties received (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group), in an exchange group over the aggregate fair market value of the properties transferred in that exchange group. An exchange group deficiency is the excess of the aggregate fair market value of the properties transferred in an exchange group over the aggregate fair market value of the properties received (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group) in that exchange group.

(3) Amount of gain recognized.

(i) For purposes of this section, the amount of gain or loss realized with respect to each exchange group and the residual group is the difference between the aggregate fair market value of the properties transferred in that exchange group or residual group and the properties' aggregate adjusted basis. The gain realized with respect to each exchange group is recognized to the extent of the lesser of the gain realized and the amount of the exchange group deficiency, if any. Losses realized with respect to an exchange group are not recognized. See section 1031 (a) and (c). The total amount of gain recognized under section 1031 in the exchange is the sum of the amount of gain recognized with respect to each exchange group. With respect to the residual group, the gain or loss realized (as determined under this section) is recognized as provided in section 1001 or other applicable provision of the Code.

(ii) The amount of gain or loss realized and recognized with respect to properties transferred by the taxpayer that are not within any exchange group or the residual group is determined under section 1001 and other applicable provisions of the Code, with proper adjustments made for all liabilities not allocated to the exchange groups or the residual group.

(c) Computation of basis of properties received. In an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031 and this section, the aggregate basis of properties received in each of the exchange groups is the aggregate adjusted basis of the properties transferred by the taxpayer within that exchange group, increased by the amount of gain recognized by the taxpayer with respect to that exchange group, increased by the amount of the exchange group surplus or decreased by the amount of the exchange group deficiency, and increased by the amount, if any, of excess liabilities assumed by the taxpayer that are allocated to that exchange group. The resulting aggregate basis of each exchange group is allocated proportionately to each property received in the exchange group in accordance with its fair market value. The basis of each property received within the residual group (other than money) is equal to its fair market value.

(d) Examples. The application of this section may be illustrated by the following examples:

Example 1

(i) K exchanges computer A (asset class 00.12) and automobile A (asset class 00.22), both of which were held by K for productive use in its business, with W for printer B (asset class 00.12) and automobile B (asset class 00.22), both of which will be held by K for productive use in its business. K's adjusted basis and the fair market value of the exchanged properties are as follows:

	Adjusted basis	Fair market value
Computer A	$375	$1,000
Automobile A	$1,500	$4,000
Printer B	—	$2,050
Automobile B	—	$2,950

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A and printer B (both are within the same General Asset Class) and, as to K, has an exchange group surplus of $1050 because the fair market value of printer B ($2050) exceeds the fair market value of computer A ($1000) by that amount.

(B) The second exchange group consists of automobile A and automobile B (both are within the same General Asset Class) and, as to K, has an exchange group deficiency of $1050 because the fair market value of automobile A ($4000) exceeds the fair market value of automobile B ($2950) by that amount.

(iii) K recognizes gain on the exchange as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of

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computer A ($1000) over its adjusted basis ($375), or $625. The amount of gain recognized is the lesser of the gain realized ($625) and the exchange group deficiency ($0), or $0.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A ($4000) over its adjusted basis ($1500), or $2500. The amount of gain recognized is the lesser of the gain realized ($2500) and the exchange group deficiency ($1050), or $1050.

(iv) The total amount of gain recognized by K in the exchange is the sum of the gains recognized with respect to both exchange groups ($0 + $1050), or $1050.

(v) The bases of the property received by K in the exchange, printer B and automobile B, are determined in the following manner:

(A) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within the exchange group ($375), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($1050), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $1425. Because printer B was the only property received within the first exchange group, the entire basis of $1425 is allocated to printer B.

(B) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($1500), increased by the amount of gain recognized with respect to that exchange group ($1050), decreased by the amount of the exchange group deficiency ($1050), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $1500. Because automobile B was the only property received within the second exchange group, the entire basis of $1500 is allocated to automobile B.

Example 2.

(i) F exchanges computer A (asset class 00.12) and automobile A (asset class 00.22), both of which were held by F for productive use in its business, with G for printer B (asset class 00.12) and automobile B (asset class 00.22), both of which will be held by F for productive use in its business, and corporate stock and $500 cash. The adjusted basis and fair market value of the properties are as follows:

	Adjusted basis	Fair market value
Computer A	$375	$1,000
Automobile A	3,500	$4,000
Printer B	—	$800
Automobile B	—	$2,950
Corporate stock	—	$750
Cash	—	$500

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A and printer B (both are within the same General Asset Class) and, as to F, has an exchange group deficiency of $200 because the fair market value of computer A ($1000) exceeds the fair market value of printer B ($800) by that amount.

(B) The second exchange group consists of automobile A and automobile B (both are within the same General Asset Class) and, as to F, has an exchange group deficiency of $1050 because the fair market value of automobile A ($4000) exceeds the fair market value of automobile B ($2950) by that amount.

(C) Because the aggregate fair market value of the properties transferred by F in the exchange groups ($5,000) exceeds the aggregate fair market value of the properties received by F in the exchange groups ($3750) by $1250, there is a residual group in that amount consisting of the $500 cash and the $750 worth of corporate stock.

(iii) F recognizes gain on the exchange as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A ($1000) over its adjusted basis ($375), or $625. The amount of gain recognized is the lesser of the gain realized ($625) and the exchange group deficiency ($200), or $200.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A ($4000) over its adjusted basis ($3500), or $500. The amount of gain recognized is the lesser of the gain realized ($500) and the exchange group deficiency ($1050), or $500.

(C) No property transferred by F was allocated to the residual group. Therefore, F does not recognize gain or loss with respect to the residual group.

(iv) The total amount of gain recognized by F in the exchange is the sum of the gains recognized with respect to both exchange groups ($200 + $500), or $700.

(v) The bases of the properties received by F in the exchange (printer B, automobile B, and the corporate stock) are determined in the following manner:

(A) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($375), increased by the amount of gain recognized with respect to that exchange group ($200), decreased by the amount of the exchange group deficiency ($200), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $375. Because printer B was the only property received within the first exchange group, the entire basis of $375 is allocated to printer B.

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(B) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($3500), increased by the amount of gain recognized with respect to that exchange group ($500), decreased by the amount of the exchange group deficiency ($1050), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $2950. Because automobile B was the only property received within the second exchange group, the entire basis of $2950 is allocated to automobile B.

(C) The basis of the property received within the residual group (the corporate stock) is equal to its fair market value or $750. Cash of $500 is also received within the residual group.

Example 3.

(i) J and H enter into an exchange of the following properties. All of the property (except for the inventory) transferred by J was held for productive use in J's business. All of the property received by J will be held by J for productive use in its business.

J Transfers

Property	Adjusted basis	Fair market value
Computer A	$1,500	$5,000
Computer B	$500	$3,000
Printer C	$2,000	$1,500
Real Estate D	$1,200	$2,000
Real Estate E	$0	$1,800
Scraper F	$3,300	$2,500
Inventory	$1,000	$1,700
Total	$9,500	$17,500

H Transfers

Property	Fair Market Value
Computer Z	$4,500
Printer Y	$2,500
Real Estate X	$1,000
Real Estate W	$4,000
Grader V	$2,000
Truck T	$1,700
Cash	$1,800
Total	$17,500

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A, computer B, printer C, computer Z, and printer Y (all are within the same General Asset Class) and, as to J, has an exchange group deficiency of $2500 (($5000 + $3000 + $1500) - ($4500 + $2500)).

(B) The second exchange group consists of real estate D, E, X and W (all are of a like kind) and, as to J, has an exchange group surplus of $1200 (($1000 + $4000) - ($2000 + $1800)).

(C) The third exchange group consists of scraper F and grader V (both are within the same Product Class (NAICS 333120)) and, as to J, has an exchange group deficiency of $500 ($2500 - $2000).

(D) Because the aggregate fair market value of the properties transferred by J in the exchange groups ($15,800) exceeds the aggregate fair market value of the properties received by J in the exchange groups ($14,000) by $1800, there is a residual group in that amount consisting of the $1800 cash (a Class I asset).

(E) The transaction also includes a taxable exchange of inventory (which is property described in section 1031 (a)(2)) for truck T (which is not of a like kind or like class to any property transferred in the exchange).

(iii) J recognizes gain on the transaction as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the aggregate fair market value of the properties transferred in the exchange group ($9500) over the aggregate adjusted basis ($4000), or $5500. The amount of gain recognized is the lesser of the gain realized ($5500) and the exchange group deficiency ($2500), or $2500.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the aggregate fair market value of the properties transferred in the exchange group ($3800) over the aggregate adjusted basis ($1200), or $2600. The amount of gain recognized is the lesser of the gain realized ($2600) and the exchange group deficiency ($0), or $0.

(C) With respect to the third exchange group, a loss is realized in the amount of $800 because the fair market value of the property transferred in the exchange group ($2500) is less than its adjusted basis ($3300). Although a loss of $800 was realized, under section 1031 (a) and (c) losses are not recognized.

(D) No property transferred by J was allocated to the residual group. Therefore, J does not recognize gain or loss with respect to the residual group.

(E) With respect to the taxable exchange of inventory for truck T, gain of $700 is realized and recognized by J (amount realized of $1700 (the fair market value of truck T) less the adjusted basis of the inventory ($1000)).

(iv) The total amount of gain recognized by J in the transaction is the sum of the gains recognized under section 1031 with respect to each exchange group ($2500 + $0 + $0) and any gain recognized outside of section 1031 ($700), or $3200.

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(v) The bases of the property received by J in the exchange are determined in the following manner:

(A) The aggregate basis of the properties received in the first exchange group is the adjusted basis of the properties transferred within that exchange group ($4000), increased by the amount of gain recognized with respect to that exchange group ($2500), decreased by the amount of the exchange group deficiency ($2500), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $4000. This $4000 of basis is allocated proportionately among the assets received within the first exchange group in accordance with their fair market values: Computer Z's basis is $2571 ($4000 x $4500/$7000); printer Y's basis is $1429 ($4000 x $2500/$7000).

(B) The aggregate basis of the properties received in the second exchange group is the adjusted basis of the properties transferred within that exchange group ($1200), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($1200), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $2400. This $2400 of basis is allocated proportionately among the assets received within the second exchange group in accordance with their fair market values: Real estate X's basis is $480 ($2400 x$1000/$5000); real estate W's basis is $1920 ($2400 x $4000/$5000).

(C) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group ($3300), increased by the amount of gain recognized with respect to that exchange group ($0), decreased by the amount of the exchange group deficiency ($500), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $2800. Because grader V was the only property received within the third exchange group, the entire basis of $2800 is allocated to grader V.

(D) Cash of $1800 is received within the residual group.

(E) The basis of the property received in the taxable exchange (truck T) is equal to its cost of $1700.

Example 4

(i) B exchanges computer A (asset class 00.12), automobile A (asset class 00.22) and truck A (asset class 00.241), with C for computer R (asset class 00.12), automobile R (asset class 00.22), truck R (asset class 00.241) and $400 cash. All properties transferred by either B or C were held for productive use in the respective transferor's business. Similarly, all properties to be received by either B or C will be held for productive use in the respective recipient's business. Automobile A, automobile R and truck R are each secured by a nonrecourse liability and are transferred subject to such liability. The adjusted basis, fair market value, and liability secured by each property, if any, are as follows:

	Adjusted basis	Fair market value	Liability
B Transfers			
Computer A	$800	$1,500	$0
Automobile A	$900	$2,500	$500
Truck A	$700	$2,000	$0
C Transfers			
Computer R	$1,100	$1,600	$0
Automobile R	$2,100	$3,100	$750
Truck R	$600	$1,400	$250
Cash	—	$400	—

(ii) The tax treatment to B is as follows:

(A) (1) The first exchange group consists of computers A and R (both are within the same General Asset Class).

(2) The second exchange group consists of automobiles A and R (both are within the same General Asset Class).

(3) The third exchange group consists of trucks A and R (both are in the same General Asset Class).

(B) Under paragraph (b)(2)(ii) of this section, all liabilities assumed by B ($1000) are offset by all liabilities of which B is relieved ($500), resulting in excess liabilities assumed of $500. The excess liabilities assumed of $500 is allocated among the exchange groups in proportion to the fair market value of the properties received by B in the exchange groups as follows:

(1) $131 of excess liabilities assumed ($500 x $1600/$6100) is allocated to the first exchange group. The first exchange group has an exchange group deficiency of $31 because the fair market value of computer A ($1500) exceeds the fair market value of computer R less the excess liabilities assumed allocated to the exchange group ($1600-$131) by that amount.

(2) $254 of excess liabilities assumed ($500 x $3100/$6100) is allocated to the second exchange group. The second exchange group has an exchange group surplus of $346 because the fair market value of automobile R less the excess liabilities assumed allocated to the exchange group ($3100-$254) exceeds the fair market value of automobile A ($2500) by that amount.

(3) $115 of excess liabilities assumed ($500 x $1400/$6100) is allocated to the third exchange group. The third exchange group has an exchange group deficiency of $715 because the fair market value of truck A ($2000) exceeds the fair market value of truck R less the excess liabilities assumed allocated to the exchange group ($1400-$115) by that amount.

(4) The difference between the aggregate fair market value of the properties transferred in all of the

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exchange groups, $6000, and the aggregate fair market value of the properties received in all of the exchange groups (taking excess liabilities assumed into account), $5600, is $400. Therefore there is a residual group in that amount consisting of $400 cash received.

(C) B recognizes gain on the exchange as follows:

(1) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A ($1500) over its adjusted basis ($800), or $700. The amount of gain recognized is the lesser of the gain realized ($700) and the exchange group deficiency ($31), or $31.

(2) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A ($2500) over its adjusted basis ($900), or $1600. The amount of gain recognized is the lesser of the gain realized ($1600) and the exchange group deficiency ($0), or $0.

(3) With respect to the third exchange group, the amount of gain realized is the excess of the fair market value of truck A ($2000) over its adjusted basis ($700), or $1300. The amount of gain recognized is the lesser of gain realized ($1300) and the exchange group deficiency ($715), or $715.

(4) No property transferred by B was allocated to the residual group. Therefore, B does not recognize gain or loss with respect to the residual group.

(D) The total amount of gain recognized by B in the exchange is the sum of the gains recognized under section 1031 with respect to each exchange group ($31 + $0 +$715), or $746.

(E) the bases of the property received by B in the exchange (computer R, automobile R, and truck R) are determined in the following manner:

(1) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($800), increased by the amount of gain recognized with respect to that exchange group ($31), decreased by the amount of the exchange group deficiency ($31), and increased by the amount of excess liabilities assumed allocated to that exchange group ($131), or $931. Because computer R was the only property received within the first exchange group, the entire basis of $931 is allocated to computer R.

(2) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($900), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($346), and increased by the amount of excess liabilities assumed allocated to that exchange group ($254), or $1500. Because automobile R was the only property received within the second exchange group, the entire basis of $1500 is allocated to automobile R.

(3) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group ($700), increased by the amount of gain recognized with respect to that exchange group ($715), decreased by the amount of the exchange group deficiency ($715), and increased by the amount of excess liabilities assumed allocated to that exchange group ($115), or $815. Because truck R was the only property received within the third exchange group, the entire basis of $815 is allocated to truck R.

(F) Cash of $400 is also received by B.

(iii) The tax treatment to C is as follows:

(A) (1) The first exchange group consists of computers R and A (both are within the same General Asset Class).

(2) The second exchange group consists of automobiles R and A (both are within the same General Asset Class).

(3) The third exchange group consists of trucks R and A (both are in the same General Asset Class).

(B) Under paragraph (b)(2)(ii) of this section, all liabilities of which C is relieved ($1000) are offset by all liabilities assumed by C ($500), resulting in excess liabilities relieved of $500. This excess liabilities relieved is treated as cash received by C.

(1) The first exchange group has an exchange group deficiency of $100 because the fair market value of computer R ($1600) exceeds the fair market value of computer A ($1500) by that amount.

(2) The second exchange group has an exchange group deficiency of $600 because the fair market value of automobile R ($3100) exceeds the fair market value of automobile A ($2500) by that amount.

(3) The third exchange group has an exchange group surplus of $600 because the fair market value of truck A ($2000) exceeds the fair market value of truck R ($1400) by that amount.

(4) The difference between the aggregate fair market value of the properties transferred by C in all of the exchange groups, $6100, and the aggregate fair market value of the properties received by C in all of the exchange groups, $6000, is $100. Therefore, there is a residual group in that amount, consisting of excess liabilities relieved of $100, which is treated as cash received by C.

(5) The $400 cash paid by C and $400 of the excess liabilities relieved which is treated as cash received by C are not within the exchange groups of the residual group.

(C) C recognizes gain on the exchange as follows:

(1) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer R ($1600) over its adjusted basis

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($1100), or $500. The amount of gain recognized is the lesser of the gain realized ($500) and the exchange group deficiency ($100), or $100.

(2) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile R ($3100) over its adjusted basis ($2100), or $1000. The amount of gain recognized is the lesser of the gain realized ($1000) and the exchange group deficiency ($600), or $600.

(3) With respect to the third exchange group, the amount of gain realized is the excess of the fair market value of truck R ($1400) over its adjusted basis ($600), or $800. The amount of gain recognized is the lesser of gain realized ($800) and the exchange group deficiency ($0), or $0.

(4) No property transferred by C was allocated to the residual group. Therefore, C does not recognize any gain with respect to the residual group.

(D) The total amount of gain recognized by C in the exchange is the sum of the gains recognized under section 1031 with respect to each exchange group ($100+$600+$0), or $700.

(E) The bases of the properties received by C in the exchange (computer A, automobile A, and truck A) are determined in the following manner:

(1) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($1100), increased by the amount of gain recognized with respect to that exchange group ($100), decreased by the amount of the exchange group deficiency ($100), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $1100. Because computer A was the only property received within the first exchange group, the entire basis of $1100 is allocated to computer A.

(2) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($2100), increased by the amount of gain recognized with respect to that exchange group ($600), decreased by the amount of the exchange group deficiency ($600), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $2100. Because automobile A was the only property received within the second exchange group, the entire basis of $2100 is allocated to automobile A.

(3) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group ($600), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($600), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $1200. Because truck A was the only property received within the third exchange group, the entire basis of $1200 is allocated to truck A.

Example 5

(i) U exchanges real estate A, real estate B, and grader A (NAICS 333120) with V for real estate R and railroad car R (General Asset Class 00.25). All properties transferred by either U or V were held for productive use in the respective transferor's business. Similarly, all properties to be received by either U or V will be held for productive use in the respective recipient's business. Real estate R is secured by a recourse liability and is transferred subject to that liability. The adjusted basis, fair market value, and liability secured by each property, if any, are as follows:

U Transfers	Adjusted basis	Fair market value	Liability
Real Estate A.	$2,000	$5,000	—
Real Estate B.	$8,000	$13,500	—
Grader A	$500	$2,000	—
V Transfers			
Real Estate R.	$20,000	$26,500	$7,000
Railroad car R.	$1,200	$1,000	—

(ii) The tax treatment to U is as follows:

(A) The exchange group consists of real estate A, real estate B, and real estate R.

(B) Under paragraph (b)(2)(ii) of this section, all liabilities assumed by U ($7000) are excess liabilities assumed. The excess liabilities assumed of $7000 is allocated to the exchange group.

(1) The exchange group has an exchange group surplus of $1000 because the fair market value of real estate R less the excess liabilities assumed allocated to the exchange group ($26,500-$7000) exceeds the aggregate fair market value of real estate A and B ($18,500) by that amount.

(2) The difference between the aggregate fair market value of the properties received in the exchange group (taking excess liabilities assumed into account), $19,500, and the aggregate fair market value of the properties transferred in the exchange group, $18,500, is $1000. Therefore, there is a residual group in that amount consisting of $1000 (or 50 percent of the fair market value) of grader A.

(3) The transaction also includes a taxable exchange of the 50 percent portion of grader A not allocated to the residual group (which is not of a like kind or like class to any property received by U in the exchange) for railroad car R (which is not of a like kind or like class to any property transferred by U in the exchange).

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(C) U recognizes gain on the exchange as follows:

(1) With respect to the exchange group, the amount of the gain realized is the excess of the aggregate fair market value of real estate A and B ($18,500) over the aggregate adjusted basis ($10,000), or $8500. The amount of the gain recognized is the lesser of the gain realized ($8500) and the exchange group deficiency ($0), or $0.

(2) With respect to the residual group, the amount of gain realized and recognized is the excess of the fair market value of the 50 percent portion of grader A that is allocated to the residual group ($1000) over its adjusted basis ($250), or $750.

(3) With respect to the taxable exchange of the 50 percent portion of grader A not allocated to the residual group for railroad car R, gain of $750 is realized and recognized by U (amount realized of $1000 (the fair market value of railroad car R) less the adjusted basis of the 50 percent portion of grader A not allocated to the residual group ($250)).

(D) The total amount of gain recognized by U in the transaction is the sum of the gain recognized under section 1031 with respect to the exchange group ($0), any gain recognized with respect to the residual group ($750), and any gain recognized with respect to property transferred that is not in the exchange group or the residual group ($750), or $1500.

(E) The bases of the property received by U in the exchange (real estate R and railroad car R) are determined in the following manner:

(1) The basis of the property received in the exchange group is the aggregate adjusted basis of the property transferred within that exchange group ($10,000), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($1000), and increased by the amount of excess liabilities assumed allocated to that exchange group ($7000), or $18,000. Because real estate R is the only property received within the exchange group, the entire basis of $18,000 is allocated to real estate R.

(2) The basis of railroad car R is equal to its cost of $1000.

(iii) The tax treatment to V is as follows:

(A) The exchange group consists of real estate R, real estate A, and real estate B.

(B) Under paragraph (b)(2)(ii) of this section, the liabilities of which V is relieved ($7000) results in excess liabilities relieved of $7000 and is treated as cash received by V.

(1) The exchange group has an exchange group deficiency of $8000 because the fair market value of real estate R ($26,500) exceeds the aggregate fair market value of real estate A and B ($18,500) by that amount.

(2) The difference between the aggregate fair market value of the properties transferred by V in the exchange group, $26,500, and the aggregate fair market value of the properties received by V in the exchange group, $18,500, is $8000. Therefore, there is a residual group in that amount, consisting of the excess liabilities relieved of $7000, which is treated as cash received by V, and $1000 (or 50 percent of the fair market value) of grader A.

(3) The transaction also includes a taxable exchange of railroad car R (which is not of a like kind or like class to any property received by V in the exchange) for the 50 percent portion of grader A (which is not of a like kind or like class to any property transferred by V in the exchange) not allocated to the residual group.

(C) V recognizes gain on the exchange as follows:

(1) With respect to the exchange group, the amount of the gain realized is the excess of the fair market value of real estate R ($26,500) over its adjusted basis ($20,000), or $6500. The amount of the gain recognized is the lesser of the gain realized ($6500) and the exchange group deficiency ($8000), or $6500.

(2) No property transferred by V was allocated to the residual group. Therefore, V does not recognize gain or loss with respect to the residual group.

(3) With respect to the taxable exchange of railroad car R for the 50 percent portion of grader A not allocated to the exchange group or the residual group, a loss is realized and recognized in the amount of $200 (the excess of the $1200 adjusted basis of railroad car R over the amount realized of $1000 (fair market value of the 50 percent portion of grader A)).

(D) The basis of the property received by V in the exchange (real estate A, real estate B, and grader A) are determined in the following manner:

(1) The basis of the property received in the exchange group is the adjusted basis of the property transferred within that exchange group ($20,000), increased by the amount of gain recognized with respect to that exchange group ($6500), and decreased by the amount of the exchange group deficiency ($8000), or $18,500. This $18,500 of basis is allocated proportionately among the assets received within the exchange group in accordance with their fair market values: real estate A's basis is $5000 ($18,500 x $5000/$18,500); real estate B's basis is $13,500 ($18,500 x $13,500/$18,500).

(2) The basis of grader A is $2000.

(e) Effective date. Section 1.1031 (j)-1 is effective for exchanges occurring on or after April 11, 1991.

[T.D. 8343, 56 FR 14855, Apr. 12, 1991, as amended by T.D. 8858, 65 FR 1237, Jan. 7, 2000; T.D. 8940, 66 FR 9929, Feb. 13, 2001]

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Sec. 1.1031(k)-1
Treatment of deferred exchanges.

(a) Overview. This section provides rules for the application of section 1031 and the regulations thereunder in the case of a "deferred exchange." For purposes of section 1031 and this section, a deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property"). In the case of a deferred exchange, if the requirements set forth in paragraphs (b), (c), and (d) of this section (relating to identification and receipt of replacement property) are not satisfied, the replacement property received by the taxpayer will be treated as property which is not of a like kind to the relinquished property. In order to constitute a deferred exchange, the transaction must be an exchange (*i.e.,* a transfer of property for property, as distinguished from a transfer of property for money). For example, a sale of property followed by a purchase of property of a like kind does not qualify for nonrecognition of gain or loss under section 1031 regardless of whether the identification and receipt requirements of section 1031(a)(3) and paragraphs (b), (c), and (d) of this section are satisfied. The transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or property which does not meet the requirements of section 1031(a), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). See Sec. 1.1031(a)-1(a)(2). In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or property which does not meet the requirements of section 1031(a) before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or property which does not meet the requirements of section 1031(a) in the full amount of the consideration for the relinquished property, the transaction will constitute a sale, and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property. For purposes of this section, property which does not meet the requirements of section 1031(a) (whether by being described in section 1031(a)(2) or otherwise) is referred to as "other property." For rules regarding actual and constructive receipt, and safe harbors therefrom, see paragraphs (f) and (g), respectively, of this section. For rules regarding the determination of gain or loss recognized and the basis of property received in a deferred exchange, see paragraph (j) of this section.

(b) Identification and receipt requirements—

(1) In general. In the case of a deferred exchange, any replacement property received by the taxpayer will be treated as property which is not of a like kind to the relinquished property if—

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

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

(2) Identification period and exchange period.

(i) The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th day thereafter.

(ii) The exchange period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the earlier of the 180th day thereafter or the due date (including extensions) for the taxpayer's return of the tax imposed by chapter 1 of subtitle A of the Code for the taxable year in which the transfer of the relinquished property occurs.

(iii) If, as part of the same deferred exchange, the taxpayer transfers more than one relinquished property and the relinquished properties are transferred on different dates, the identification period and the exchange period are determined by reference to the earliest date on which any of the properties are transferred.

(iv) For purposes of this paragraph (b)(2), property is transferred when the property is disposed of within the meaning of section 1001(a).

(3) Example. This paragraph (b) may be illustrated by the following example.

Example: (i) M is a corporation that files its Federal income tax return on a calendar year basis. M and C enter into an agreement for an exchange of property that requires M to transfer property X to C. Under the agreement, M is to identify like-kind replacement property which C is required to purchase and to transfer to M. M transfers property X to C on November 16, 1992.

(ii) The identification period ends at midnight on December 31, 1992, the day which is 45 days after the date of transfer of property X.

The exchange period ends at midnight on March 15, 1993, the due date for M's Federal income tax return for the taxable year in which M transferred property X. However, if M is allowed the automatic six-month extension for filing its tax return, the exchange period ends at midnight on May 15, 1993, the day which is 180 days after the date of transfer of property X.

(c) Identification of replacement property before the end of the identification period—

(1) In general. For purposes of paragraph (b)(1)(i) of this section (relating to the identification requirement), replacement property is identified before the end of the identification period only if the requirements of this paragraph (c) are satisfied with respect to the replacement property. However, any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

(2) Manner of identifying replacement property. Replacement property is identified only if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either—

(i) The person obligated to transfer the replacement property to the taxpayer (regardless of whether that person is a disqualified person as defined in paragraph (k) of this section); or

(ii) Any other person involved in the exchange other than the taxpayer or a disqualified person (as defined in paragraph (k) of this section). Examples of persons involved in the exchange include any of the parties to the exchange, an intermediary, an escrow agent, and a title company. An identification of replacement property made in a written agreement for the exchange of properties signed by all parties thereto before the end of

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the identification period will be treated as satisfying the requirements of this paragraph (c)(2).

(3) Description of replacement property. Replacement property is identified only if it is unambiguously described in the written document or agreement. Real property generally is unambiguously described if it is described by a legal description, street address, or distinguishable name (*e.g.,* the Mayfair Apartment Building). Personal property generally is unambiguously described if it is described by a specific description of the particular type of property. For example, a truck generally is unambiguously described if it is described by a specific make, model, and year.

(4) Alternative and multiple properties.

(i) The taxpayer may identify more than one replacement property. Regardless of the number of relinquished properties transferred by the taxpayer as part of the same deferred exchange, the maximum number of replacement properties that the taxpayer may identify is—

(A) Three properties without regard to the fair market values of the properties (the "3-property rule"), or

(B) Any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer (the "200-percent rule").

(ii) If, as of the end of the identification period, the taxpayer has identified more properties as replacement properties than permitted by paragraph (c)(4)(i) of this section, the taxpayer is treated as if no replacement property had been identified. The preceding sentence will not apply, however, and an identification satisfying the requirements of paragraph (c)(4)(i) of this section will be considered made, with respect to—

(A) Any replacement property received by the taxpayer before the end of the identification period, and

(B) Any replacement property identified before the end of the identification period and received before the end of the exchange period, but only if the taxpayer receives before the end of the exchange period identified replacement property the fair market value of which is at least 95 percent of the aggregate fair market value of all identified replacement properties (the "95-percent rule"). For this purpose, the fair market value of each identified replacement property is determined as of the earlier of the date the property is received by the taxpayer or the last day of the exchange period.

(iii) For purposes of applying the 3-property rule, the 200-percent rule, and the 95-percent rule, all identifications of replacement property, other than identifications of replacement property that have been revoked in the manner provided in paragraph (c)(6) of this section, are taken into account. For example, if, in a deferred exchange, B transfers property X with a fair market value of $100,000 to C and B receives like-kind property Y with a fair market value of $50,000 before the end of the identification period, under paragraph (c)(1) of this section, property Y is treated as identified by reason of being received before the end of the identification period. Thus, under paragraph (c)(4)(i) of this section, B may identify either two additional replacement properties of any fair market value or any number of additional replacement properties as long as the aggregate fair market value of the additional replacement properties does not exceed $150,000.

(5) Incidental property disregarded.

(i) Solely for purposes of applying this paragraph (c), property that is incidental to a larger item of property is not treated as property that is separate from the larger item of property. Property is incidental to a larger item of property if—

(A) In standard commercial transactions, the property is typically transferred together with the larger item of property, and

(B) The aggregate fair market value of all of the incidental property does not exceed 15 percent of the aggregate fair market value of the larger item of property.

(ii) This paragraph (c)(5) may be illustrated by the following examples.

Example 1. For purposes of paragraph (c) of this section, a spare tire and tool kit will not be treated as separate property from a truck with a fair market value of $10,000, if the aggregate fair market value of the spare tire and tool kit does not exceed $1,500. For purposes of the 3-property rule, the truck, spare tire, and tool kit are treated as 1 property. Moreover, for purposes of paragraph (c)(3) of this section (relating to the description of replacement property), the truck, spare tire, and tool kit are all considered to be unambiguously described if the make, model, and year of the truck are specified, even if no reference is made to the spare tire and tool kit.

Example 2. For purposes of paragraph (c) of this section, furniture, laundry machines, and other miscellaneous items of personal property will not be treated as separate property from an apartment building with a fair market value of $1,000,000, if the aggregate fair market value of the furniture, laundry machines, and other personal property does not exceed $150,000. For purposes of the 3-property rule, the apartment building, furniture, laundry machines, and other personal property are treated as 1 property. Moreover, for purposes of paragraph (c)(3) of this section (relating to the description of replacement property), the apartment building, furniture, laundry machines, and other personal property are all considered to be unambiguously described if the legal description, street address, or distinguishable name of the apartment building is specified, even if no reference is made to the furniture, laundry machines, and other personal property.

(6) Revocation of identification. An identification of replacement property may be revoked at any time before the end of the identification period. An identification of replacement property is revoked only if the revocation is made in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to the person to whom the identification of the replacement property was sent. An identification of replacement property that is made in a written agreement for the exchange of properties is treated as revoked only if the revocation is made in a written amendment to the agreement or in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to all of the parties to the agreement.

(7) Examples. This paragraph (c) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts

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are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. No replacement property is identified in the agreement. When subsequently identified, the replacement property is described by legal description and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold the replacement property received for investment.

Example 1 (i) On July 2, 1991, B identifies real property E as replacement property by designating real property E as replacement property in a written document signed by B and personally delivered to C.

(ii) Because the identification was made after the end of the identification period, pursuant to paragraph (b)(1)(i) of this section (relating to the identification requirement), real property E is treated as property which is not of a like kind to real property X.

Example 2. (i) C is a corporation of which 20 percent of the outstanding stock is owned by B. On July 1, 1991, B identifies real property F as replacement property by designating real property F as replacement property in a written document signed by B and mailed to C.

(ii) Because C is the person obligated to transfer the replacement property to B, real property F is identified before the end of the identification period. The fact that C is a "disqualified person" as defined in paragraph (k) of this section does not change this result.

(iii) Real property F would also have been treated as identified before the end of the identification period if, instead of sending the identification to C, B had designated real property F as replacement property in a written agreement for the exchange of properties signed by all parties thereto on or before July 1, 1991.

Example 3. (i) On June 3, 1991, B identifies the replacement property as "unimproved land located in Hood County with a fair market value not to exceed $100,000." The designation is made in a written document signed by B and personally delivered to C. On July 8, 1991, B and C agree that real property G is the property described in the June 3, 1991 document.

(ii) Because real property G was not unambiguously described before the end of the identification period, no replacement property is identified before the end of the identification period.

Example 4. (i) On June 28, 1991, B identifies real properties H, J, and K as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. The written document provides that by August 1, 1991, B will orally inform C which of the identified properties C is to transfer to B. As of July 1, 1991, the fair market values of real properties H, J, and K are $75,000, $100,000, and $125,000, respectively.

(ii) Because B did not identify more than three properties as replacement properties, the requirements of the 3-property rule are satisfied, and real properties H, J, and K are all identified before the end of the identification period.

Example 5 (i) On May 17, 1991, B identifies real properties L, M, N, and P as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. The written document provides that by July 2, 1991, B will orally inform C which of the identified properties C is to transfer to B. As of July 1, 1991, the fair market values of real properties L, M, N, and P are $30,000, $40,000, $50,000, and $60,000, respectively.

(ii) Although B identified more than three properties as replacement properties, the aggregate fair market value of the identified properties as of the end of the identification period ($180,000) did not exceed 200 percent of the aggregate fair market value of real property X (200% x $100,000 = $200,000). Therefore, the requirements of the 200-percent rule are satisfied, and real properties L, M, N, and P are all identified before the end of the identification period.

Example 6. (i) On June 21, 1991, B identifies real properties Q, R, and S as replacement properties by designating these properties as replacement properties in a written document signed by B and mailed to C. On June 24, 1991, B identifies real properties T and U as replacement properties in a written document signed by B and mailed to C. On June 28, 1991, B revokes the identification of real properties Q and R in a written document signed by B and personally delivered to C.

(ii) B has revoked the identification of real properties Q and R in the manner provided by paragraph (c)(6) of this section. Identifications of replacement property that have been revoked in the manner provided by paragraph (c)(6) of this section are not taken into account for purposes of applying the 3-property rule. Thus, as of June 28, 1991, B has identified only replacement properties S, T, and U for purposes of the 3-property rule. Because B did not identify more than three properties as replacement properties for purposes of the 3-property rule, the requirements of that rule are satisfied, and real properties S, T, and U are all identified before the end of the identification period.

Example 7. (i) On May 20, 1991, B identifies real properties V and W as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. On June 4, 1991, B identifies real properties Y and Z as replacement properties in the same manner. On June 5, 1991, B telephones C and orally revokes the identification of real properties V and W. As of July 1, 1991, the fair market values of real properties V, W, Y, and Z are $50,000, $70,000, $90,000, and $100,000, respectively. On July 31, 1991, C purchases real property Y and Z and transfers them to B.

(ii) Pursuant to paragraph (c)(6) of this section (relating to revocation of identification), the oral revocation of the identification of real properties V and W is invalid. Thus, the identification of real properties V and W is taken into account for purposes of determining whether the requirements of paragraph (c)(4) of this section (relating to the identification of alternative and multiple properties) are satisfied. Because B identified more than three properties and the aggregate fair market value of the identified properties as of the end of the identification period ($310,000) exceeds 200 percent of the fair market value of real

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property X (200% x $100,000 = $200,000), the requirements of paragraph (c)(4) of this section are not satisfied, and B is treated as if B did not identify any replacement property.

(d) Receipt of identified replacement property—

(1) In general. For purposes of paragraph (b)(1)(ii) of this section (relating to the receipt requirement), the identified replacement property is received before the end of the exchange period only if the requirements of this paragraph (d) are satisfied with respect to the replacement property. In the case of a deferred exchange, the identified replacement property is received before the end of the exchange period if—

(i) The taxpayer receives the replacement property before the end of the exchange period, and

(ii) The replacement property received is substantially the same property as identified.

If the taxpayer has identified more than one replacement property, section 1031(a)(3)(B) and this paragraph (d) are applied separately to each replacement property.

(2) Examples. This paragraph (d) may be illustrated by the following examples. The following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. The replacement property is identified in a manner that satisfies paragraph (c) of this section (relating to identification of replacement property) and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

Example 1. (i) In the agreement, B identifies real properties J, K, and L as replacement properties. The agreement provides that by July 26, 1991, B will orally inform C which of the properties C is to transfer to B.

(ii) As of July 1, 1991, the fair market values of real properties J, K, and L are $75,000, $100,000, and $125,000, respectively. On July 26, 1991, B instructs C to acquire real property K. On October 31, 1991, C purchases real property K for $100,000 and transfers the property to B.

(iii) Because real property K was identified before the end of the identification period and was received before the end of the exchange period, the identification and receipt requirements of section 1031(a)(3) and this section are satisfied with respect to real property K.

Example 2. (i) In the agreement, B identifies real property P as replacement property. Real property P consists of two acres of unimproved land. On October 15, 1991, the owner of real property P erects a fence on the property. On November 1, 1991, C purchases real property P and transfers it to B.

(ii) The erection of the fence on real property P subsequent to its identification did not alter the basic nature or character of real property P as unimproved land. B is considered to have received substantially the same property as identified.

Example 3. (i) In the agreement, B identifies real property Q as replacement property. Real property Q consists of a barn on two acres of land and has a fair market value of $250,000 ($187,500 for the barn and underlying land and $87,500 for the remaining land). As of July 26, 1991, real property Q remains unchanged and has a fair market value of $250,000. On that date, at B's direction, C purchases the barn and underlying land for $187,500 and transfers it to B, and B pays $87,500 to C.

(ii) The barn and underlying land differ in basic nature or character from real property Q as a whole, B is not considered to have received substantially the same property as identified.

Example 4. (i) In the agreement, B identifies real property R as replacement property. Real property R consists of two acres of unimproved land and has a fair market value of $250,000. As of October 3, 1991, real property R remains unimproved and has a fair market value of $250,000. On that date, at B's direction, C purchases 1\1/2\ acres of real property R for $187,500 and transfers it to B, and B pays $87,500 to C.

(ii) The portion of real property R that B received does not differ from the basic nature or character of real property R as a whole. Moreover, the fair market value of the portion of real property R that B received ($187,500) is 75 percent of the fair market value of real property R as of the date of receipt. Accordingly, B is considered to have received substantially the same property as identified.

(e) Special rules for identification and receipt of replacement property to be produced—

(1) In general. A transfer of relinquished property in a deferred exchange will not fail to qualify for nonrecognition of gain or loss under section 1031 merely because the replacement property is not in existence or is being produced at the time the property is identified as replacement property. For purposes of this paragraph (e), the terms "produced" and "production" have the same meanings as provided in section 263A(g)(1) and the regulations thereunder.

(2) Identification of replacement property to be produced.

(i) In the case of replacement property that is to be produced, the replacement property must be identified as provided in paragraph (c) of this section (relating to identification of replacement property). For example, if the identified replacement property consists of improved real property where the improvements are to be constructed, the description of the replacement property satisfies the requirements of paragraph (c)(3) of this section (relating to description of replacement property) if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time the identification is made.

(ii) For purposes of paragraphs (c)(4)(i)(B) and (c)(5) of this section (relating to the 200-percent rule and incidental property), the fair market value of replacement property that is to be produced is its estimated fair market value as of the date it is expected to be received y the taxpayer.

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(3) Receipt of replacement property to be produced.

(i) For purposes of paragraph (d)(1)(ii) of this section (relating to receipt of the identified replacement property), in determining whether the replacement property received by the taxpayer is substantially the same property as identified where the identified replacement property is property to be produced, variations due to usual or typical production changes are not taken into account. However, if substantial changes are made in the property to be produced, the replacement property received will not be considered to be substantially the same property as identified.

(ii) If the identified replacement property is personal property to be produced, the replacement property received will not be considered to be substantially the same property as identified unless production of the replacement property received is completed on or before the date the property is received by the taxpayer.

(iii) If the identified replacement property is real property to be produced and the production of the property is not completed on or before the date the taxpayer receives the property, the property received will be considered to be substantially the same property as identified only if, had production been completed on or before the date the taxpayer receives the replacement property, the property received would have been considered to be substantially the same property as identified. Even so, the property received is considered to be substantially the same property as identified only to the extent the property received constitutes real property under local law.

(4) Additional rules. The transfer of relinquished property is not within the provisions of section 1031(a) if the relinquished property is transferred in exchange for services (including production services). Thus, any additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of a like kind.

(5) Example. This paragraph (e) may be illustrated by the following example.

Example: (i) B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers improved real property X and personal property Y to C on May 17, 1991. On or before November 13, 1991 (the end of the exchange period), C is required to transfer to B real property M, on which C is constructing improvements, and personal property N, which C is producing. C is obligated to complete the improvements and production regardless of when properties M and N are transferred to B. Properties M and N are identified in a manner that satisfies paragraphs (c) (relating to identification of replacement property) and (e)(2) of this section. In addition, properties M and N are of a like kind, respectively, to real property X and personal property Y (determined without regard to section 1031(a)(3) and this section). On November 13, 1991, when construction of the improvements to property M is 20 percent completed and the production of property N is 90 percent completed, C transfers to B property M and property N. If construction of the improvements had been completed, property M would have been considered to be substantially the same property as identified. Under local law, property M constitutes real property to the extent of the underlying land and the 20 percent of the construction that is completed.

(ii) Because property N is personal property to be produced and production of property N is not completed before the date the property is received by B, property N is not considered to be substantially the same property as identified and is treated as property which is not of a like kind to property Y.

(iii) Property M is considered to be substantially the same property as identified to the extent of the underlying land and the 20 percent of the construction that is completed when property M is received by B. However, any additional construction performed by C with respect to property M after November 13, 1991, is not treated as the receipt of property of a like kind.

(f) Receipt of money or other property—

(1) In general. A transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or other property. However, such a transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). See Sec. 1.1031(a)-1(a)(2). In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or 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.

(2) Actual and constructive receipt. Except as provided in paragraph (g) of this section (relating to safe harbors), for purposes of section 1031 and this section, the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. The taxpayer is in actual receipt of money or property at the time the taxpayer actually receives the money or property or receives the economic benefit of the money or property. The taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given. Although the taxpayer is not in constructive receipt of money or property if the taxpayer's control of its receipt is subject to substantial limitations or restrictions, the taxpayer is in constructive receipt of the money or property at the time the limitations or restrictions lapse, expire, or are waived. In addition, actual or constructive receipt of money or property by an agent of the taxpayer (determined without regard to paragraph (k) of this section) is actual or constructive receipt by the taxpayer.

(3) Example. This paragraph (f) may be illustrated by the following example.

Example: (i) B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to the agreement, on May 17, 1991, B transfers real property X to C. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. At any time after May 17, 1991, and before C has purchased the

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replacement property, B has the right, upon notice, to demand that C pay $100,000 in lieu of acquiring and transferring the replacement property. Pursuant to the agreement, B identifies replacement property, and C purchases the replacement property and transfers it to B.

(ii) Under the agreement, B has the unrestricted right to demand the payment of $100,000 as of May 17, 1991. B is therefore in constructive receipt of $100,000 on that date. Because B is in constructive receipt of money in the full amount of the consideration for the relinquished property before B actually receives the like-kind replacement property, the transaction constitutes a sale, and the transfer of real property X does not qualify for nonrecognition of gain or loss under section 1031. B is treated as if B received the $100,000 in consideration for the sale of real property X and then purchased the like-kind replacement property.

(iii) If B's right to demand payment of the $100,000 were subject to a substantial limitation or restriction (*e.g.,* the agreement provided that B had no right to demand payment before November 14, 1991 (the end of the exchange period)), then, for purposes of this section, B would not be in actual or constructive receipt of the money unless (or until) the limitation or restriction lapsed, expired, or was waived.

(g) Safe harbors—

(1) In general. Paragraphs (g)(2) through (g)(5) of this section set forth four safe harbors the use of which will result in a determination that the taxpayer is not in actual or constructive receipt of money or other property for purposes of section 1031 and this section. More than one safe harbor can be used in the same deferred exchange, but the terms and conditions of each must be separately satisfied. For purposes of the safe harbor rules, the term "taxpayer" does not include a person or entity utilized in a safe harbor (*e.g.,* a qualified intermediary). See paragraph (g)(8), Example 3(v), of this section.

(2) Security or guarantee arrangements.

(i) In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured or guaranteed by one or more of the following—

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

(B) A standby letter of credit which satisfies all of the requirements of Sec. 15A.453-1 (b)(3)(iii) and which may not be drawn upon in the absence of a default of the transferee's obligation to transfer like-kind replacement property to the taxpayer, or

(C) A guarantee of a third party.

(ii) Paragraph (g)(2)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive money or other property pursuant to the security or guarantee arrangement.

(3) Qualified escrow accounts and qualified trusts.

(i) In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured by cash or a cash equivalent if the cash or cash equivalent is held in a qualified escrow account or in a qualified trust.

(ii) A qualified escrow account is an escrow account wherein—

(A) The escrow holder is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and

(B) The escrow agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account as provided in paragraph (g)(6) of this section.

(iii) A qualified trust is a trust wherein—

(A) The trustee is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section, except that for this purpose the relationship between the taxpayer and the trustee created by the qualified trust will not be considered a relationship under section 267(b)), and

(B) The trust agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held by the trustee as provided in paragraph (g)(6) of this section.

(iv) Paragraph (g)(3)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the qualified escrow account or qualified trust. Rights conferred upon the taxpayer under state law to terminate or dismiss the escrow holder of a qualified escrow account or the trustee of a qualified trust are disregarded for this purpose.

(v) A taxpayer may receive money or other property directly from a party to the exchange, but not from a qualified escrow account or a qualified trust, without affecting the application of paragraph (g)(3)(i) of this section.

(4) Qualified intermediaries.

(i) In the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer.

(ii) Paragraph (g)(4)(i) of this section applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in paragraph (g)(6) of this section.

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(iii) A qualified intermediary is a person who—

(A) Is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and

(B) Enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

(iv) Regardless of whether an intermediary acquires and transfers property under general tax principals, solely for purposes of paragraph (g)(4)(iii)(B) of this section—

(A) An intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property,

(B) An intermediary is treated as acquiring and transferring the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person, and

(C) An intermediary is treated as acquiring and transferring replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer.

(v) Solely for purposes of paragraphs (g)(4)(iii) and (g)(4)(iv) of this section, an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. For example, if a taxpayer enters into an agreement for the transfer of relinquished property and thereafter assigns its rights in that agreement to an intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as entering into that agreement. If the relinquished property is transferred pursuant to that agreement, the intermediary is treated as having acquired and transferred the relinquished property.

(vi) Paragraph (g)(4)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. Rights conferred upon the taxpayer under state law to terminate or dismiss the qualified intermediary are disregarded for this purpose.

(vii) A taxpayer may receive money or other property directly from a party to the transaction other than the qualified intermediary without affecting the application of paragraph (g)(4)(i) of this section.

(5) Interest and growth factors. In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives the like-kind replacement property will be made without regard to the fact that the taxpayer is or may be entitled to receive any interest or growth factor with respect to the deferred exchange. The preceding sentence applies only if the agreement pursuant to which the taxpayer is or may be entitled to the interest or growth factor expressly limits the taxpayer's rights to receive the interest or growth factor as provided in paragraph (g)(6) of this section. For additional rules concerning interest or growth factors, see paragraph (h) of this section.

(6) Additional restrictions on safe harbors under paragraphs (g)(3) through (g)(5).

(i) An agreement limits a taxpayer's rights as provided in this paragraph (g)(6) only if the agreement provides that the taxpayer has no rights, except as provided in paragraph (g)(6)(ii) and (g)(6)(iii) of this section, to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period.

(ii) The agreement may provide that if the taxpayer has not identified replacement property by the end of the identification period, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property at any time after the end of the identification period.

(iii) The agreement may provide that if the taxpayer has identified replacement property, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property upon or after—

(A) The receipt by the taxpayer of all of the replacement property to which the taxpayer is entitled under the exchange agreement, or

(B) The occurrence after the end of the identification period of a material and substantial contingency that—

(1) Relates to the deferred exchange,

(2) Is provided for in writing, and

(3) Is beyond the control of the taxpayer and of any disqualified person (as defined in paragraph (k) of this section), other than the person obligated to transfer the replacement property to the taxpayer.

(7) Items disregarded in applying safe harbors under paragraphs (g)(3) through (g)(5). In determining whether a safe harbor under paragraphs (g)(3) through (g)(5) of this section ceases to apply and whether the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property are expressly limited as provided in paragraph (g)(6) of this section, the taxpayer's receipt of or right to receive any of the following items will be disregarded—

(i) Items that a seller may receive as a consequence of the disposition of property and that are not included in the amount realized from the disposition of property (*e.g.,* prorated rents), and

(ii) Transactional items that relate to the disposition of the relinquished property or to the acquisition of the replacement property and appear under local standards in the typical closing statements as the responsibility of a buyer or seller (*e.g.,*

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commissions, prorated taxes, recording or transfer taxes, and title company fees).

(8) Examples. This paragraph (g) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B is to transfer real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. The replacement property is identified as provided in paragraph (c) of this section (relating to identification of replacement property) and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

Example 1. (i) On May 17, 1991, B transfers real property X to C. On the same day, C pays $10,000 to B and deposits $90,000 in escrow as security for C's obligation to perform under the agreement. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow before November 14, 1991, except that:

(A) if B fails to identify replacement property on or before July 1, 1991, B may demand the funds in escrow at any time after July 1, 1991; and

(B) if B identifies and receives replacement property, then B may demand the balance of the remaining funds in escrow at any time after B has received the replacement property.

The funds in escrow may be used to purchase the replacement property. The escrow holder is not a disqualified person as defined in paragraph (k) of this section. Pursuant to the terms of the agreement, B identifies replacement property, and C purchases the replacement property using the funds in escrow and transfers the replacement property to B.

(ii) C's obligation to transfer the replacement property to B was secured by cash held in a qualified escrow account because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow as provided in paragraph (g)(6) of this section. In addition, B did not have the immediate ability or unrestricted right to receive money or other property in escrow before B actually received the like-kind replacement property. Therefore, for purposes of section 1031 and this section, B is determined not to be in actual or constructive receipt of the $90,000 held in escrow before B received the like-kind replacement property. The transfer of real property X by B and B's acquisition of the replacement property qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

Example 2. (i) On May 17, 1991, B transfers real property X to C, and C deposits $100,000 in escrow as security for C's obligation to perform under the agreement. Also on May 17, B identifies real property J as replacement property. The escrow agreement provides that no funds may be paid out without prior written approval of both B and C. The escrow agreement also provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow before November 14, 1991, except that:

(A) B may demand the funds in escrow at any time after the later of July 1, 1991, and the occurrence of any of the following events—

(1) real property J is destroyed, seized, requisitioned, or condemned, or

(2) a determination is made that the regulatory approval necessary for the transfer of real property J cannot be obtained in time for real property J to be transferred to B before the end of the exchange period;

(B) B may demand the funds in escrow at any time after August 14, 1991, if real property J has not been rezoned from residential to commercial use by that date; and

(C) B may demand the funds in escrow at the time B receives real property J or any time thereafter.

Otherwise, B is entitled to all funds in escrow after November 13, 1991. The funds in escrow may be used to purchase the replacement property. The escrow holder is not a disqualified person as described in paragraph (k) of this section. Real property J is not rezoned from residential to commercial use on or before August 14, 1991.

(ii) C's obligation to transfer the replacement property to B was secured by cash held in a qualified escrow account because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow as provided in paragraph (g)(6) of this section. From May 17, 1991, until August 15, 1991, B did not have the immediate ability or unrestricted right to receive money or other property before B actually received the like-kind replacement property. Therefore, for purposes of section 1031 and this section, B is determined not to be in actual or constructive receipt of the $100,000 in escrow from May 17, 1991, until August 15, 1991. However, on August 15, 1991, B had the unrestricted right, upon notice, to draw upon the $100,000 held in escrow. Thus, the safe harbor ceased to apply and B was in constructive receipt of the funds held in escrow. Because B constructively received the full amount of the consideration ($100,000) before B actually received the like-kind replacement property, the transaction is treated as a sale and not as a deferred exchange. The result does not change even if B chose not to demand the funds in escrow and continued to attempt to have real property J rezoned and to receive the property on or before November 13, 1991.

(iii) If real property J had been rezoned on or before August 14, 1991, and C had purchased real property J and transferred it to B on or before November 13, 1991, the transaction would have qualified for nonrecognition of gain or loss under section 1031(a).

Example 3. (i) On May 1, 1991, D offers to purchase real property X for $100,000. However, D is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is not a disqualified person as described in paragraph (k) of this section. The exchange agreement between B and C provides that B is to execute and deliver a

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deed conveying real property X to C who, in turn, is to execute and deliver a deed conveying real property X to D. The exchange agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g)(6) of this section. On May 3, 1991, C enters into an agreement with D to transfer real property X to D for $100,000. On May 17, 1991, B executes and delivers to C a deed conveying real property X to C. On the same date, C executes and delivers to D a deed conveying real property X to D, and D deposits $100,000 in escrow. The escrow holder is not a disqualified person as defined in paragraph (k) of this section and the escrow agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section. However, the escrow agreement provides that the money in escrow may be used to purchase replacement property. On June 3, 1991, B identifies real property K as replacement property. On August 9, 1991, E executes and delivers to C a deed conveying real property K to C and $80,000 is released from the escrow and paid to E. On the same date, C executes and delivers to B a deed conveying real property K to B, and the escrow holder pays B $20,000, the balance of the $100,000 sale price of real property X remaining after the purchase of real property K for $80,000.

(ii) B and C entered into an exchange agreement that satisfied the requirements of paragraph (g)(4)(iii)(B) of this section. Regardless of whether C may have acquired and transferred real property X under general tax principles, C is treated as having acquired and transferred real property X because C acquired and transferred legal title to real property X. Similarly, C is treated as having acquired and transferred real property K because C acquired and transferred legal title to real property K. Thus, C was a qualified intermediary. This result is reached for purposes of this section regardless of whether C was B's agent under state law.

(iii) Because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section, the escrow account was a qualified escrow account. For purposes of section 1031 and this section, therefore, B is determined not to be in actual or constructive receipt of the funds in escrow before B received real property K.

(iv) The exchange agreement between B and C expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of any money held by C as provided in paragraph (g)(6) of this section. Because C was a qualified intermediary, for purposes of section 1031 and this section B is determined not to be in actual or constructive receipt of any funds held by C before B received real property K. In addition, B's transfer of real property X and acquisition of real property K qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

(v) If the escrow agreement had expressly limited C's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section, but had not expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of that money or other property, the escrow account would not have been a qualified escrow account. Consequently, paragraph (g)(3)(i) of this section would not have been applicable in determining whether B was in actual or constructive receipt of that money or other property before B received real property K.

Example 4. (i) On May 1, 1991, B enters into an agreement to sell real property X to D for $100,000 on May 17, 1991. However, D is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is not a disqualified person as described in paragraph (k) of this section. In the exchange agreement between B and C, B assigns to C all of B's rights in the agreement with D. The exchange agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g)(6) of this section. On May 17, 1991, B notifies D in writing of the assignment. On the same date, B executes and delivers to D a deed conveying real property X to D. D pays $10,000 to B and $90,000 to C. On June 1, 1991, B identifies real property L as replacement property. On July 5, 1991, B enters into an agreement to purchase real property L from E for $90,000, assigns its rights in that agreement to C, and notifies E in writing of the assignment. On August 9, 1991, C pays $90,000 to E, and E executes and delivers to B a deed conveying real property L to B.

(ii) The exchange agreement entered into by B and C satisfied the requirements of paragraph (g)(4)(iii)(B) of this section. Because B's rights in its agreements with D and E were assigned to C, and D and E were notified in writing of the assignment on or before the transfer of real properties X and L, respectively, C is treated as entering into those agreements. Because C is treated as entering into an agreement with D for the transfer of real property X and, pursuant to that agreement, real property X was transferred to D, C is treated as acquiring and transferring real property X. Similarly, because C is treated as entering into an agreement with E for the transfer of real property K and, pursuant to that agreement, real property K was transferred to B, C is treated as acquiring and transferring real property K. This result is reached for purposes of this section regardless of whether C was B's agent under state law and regardless of whether C is considered, under general tax principles, to have acquired title or beneficial ownership of the properties. Thus, C was a qualified intermediary.

(iii) The exchange agreement between B and C expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by C as provided in paragraph (g)(6) of this section. Thus, B did not have the immediate ability or unrestricted right to receive money or other property held by C before B received real property L. For purposes of section 1031 and this section, therefore, B is determined not to be in actual or constructive receipt of the $90,000 held by C before B received real property L. In addition, the transfer of real property X by B and B's acquisition of real property L qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

Example 5. (i) On May 1, 1991, B enters into an agreement to sell real property X to D for $100,000. However, D is unwilling to participate in a like-kind exchange. B thus enters into an agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is not a disqualified person as described in paragraph (k) of this section. The agreement between B and C expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g)(6) of this section. C neither enters into an agreement with D to transfer real property X to D nor is assigned B's rights in B's

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agreement to sell real property X to D. On May 17, 1991, B transfers real property X to D and instructs D to transfer the $100,000 to C. On June 1, 1991, B identifies real property M as replacement property. On August 9, 1991, C purchases real property L from E for $100,000, and E executes and delivers to C a deed conveying real property M to C. On the same date, C executes and delivers to B a deed conveying real property M to B.

(ii) Because B transferred real property X directly to D under B's agreement with D, C did not acquire real property X from B and transfer real property X to D. Moreover, because C did not acquire legal title to real property X, did not enter into an agreement with D to transfer real property X to D, and was not assigned B's rights in B's agreement to sell real property X to D, C is not treated as acquiring and transferring real property X. Thus, C was not a qualified intermediary and paragraph (g)(4))(i) of this section does not apply.

(iii) B did not exchange real property X for real property M. Rather, B sold real property X to D and purchased, through C, real property M. Therefore, the transfer of real property X does not qualify for nonrecognition of gain or loss under section 1031.

(h) Interest and growth factors—

(1) In general. For purposes of this section, the taxpayer is treated as being entitled to receive interest or a growth factor with respect to a deferred exchange if the amount of money or property the taxpayer is entitled to receive depends upon the length of time elapsed between transfer of the relinquished property and receipt of the replacement property.

(2) Treatment as interest. If, as part of a deferred exchange, the taxpayer receives interest or a growth factor, the interest or growth factor will be treated as interest, regardless of whether it is paid to the taxpayer in cash or in property (including property of a like kind). The taxpayer must include the interest or growth factor in income according to the taxpayer's method of accounting.

(i) [Reserved]

(j) Determination of gain or loss recognized and the basis of property received in a deferred exchange—

(1) In general. Except as otherwise provided, the amount of gain or loss recognized and the basis of property received in a deferred exchange is determined by applying the rules of section 1031 and the regulations thereunder. See Secs. 1.1031(b)-1, 1.1031(c)-1, 1.1031(d)-1, 1.1031(d)-1T, 1.1031(d)-2, and 1.1031(j)-1.

(2) Coordination with section 453—

(i) Qualified escrow accounts and qualified trusts. Subject to the limitations of paragraphs (j)(2) (iv) and (v) of this section, in the case of a taxpayer's transfer of relinquished property in which the obligation of the taxpayer's transferee to transfer replacement property to the taxpayer is or may be secured by cash or a cash equivalent, the determination of whether the taxpayer has received a payment for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter will be made without regard to the fact that the obligation is or may be so secured if the cash or cash equivalent is held in a qualified escrow account or a qualified trust. This paragraph (j)(2)(i) ceases to apply at the earlier of—

(A) The time described in paragraph (g)(3)(iv) of this section; or

(B) The end of the exchange period.

(ii) Qualified intermediaries. Subject to the limitations of paragraphs (j)(2) (iv) and (v) of this section, in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the determination of whether the taxpayer has received a payment for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter is made as if the qualified intermediary is not the agent of the taxpayer. For purposes of this paragraph (j)(2)(ii), a person who otherwise satisfies the definition of a qualified intermediary is treated as a qualified intermediary even though that person ultimately fails to acquire identified replacement property and transfer it to the taxpayer. This paragraph (j)(2)(ii) ceases to apply at the earlier of—

(A) The time described in paragraph (g)(4)(vi) of this section; or

(B) The end of the exchange period.

(iii) Transferee indebtedness. In the case of a transaction described in paragraph (j)(2)(ii) of this section, the receipt by the taxpayer of an evidence of indebtedness of the transferee of the qualified intermediary is treated as the receipt of an evidence of indebtedness of the person acquiring property from the taxpayer for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter.

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

(v) Disqualified property. The provisions of paragraphs (j)(2) (i) and (ii) of this section do not apply if the relinquished property is disqualified property. For purposes of this paragraph (j)(2), disqualified property means property that is not held for productive use in a trade or business or for investment or is property described in section 1031(a)(2).

(vi) Examples. This paragraph (j)(2) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B is a calendar year taxpayer who agrees to enter into a deferred exchange. Pursuant to the agreement, B is to transfer real property X. Real property X, which has been held by B for investment, is unencumbered and has a fair market value of $100,000 at the time of transfer. B's adjusted basis in real property X at that time is $60,000. B identifies a single like-kind replacement property before the end of the identification period, and B receives the replacement property before the end of the exchange period. The transaction qualifies as a like-kind exchange under section 1031.

Example 1. (i) On September 22, 1994, B transfers real property X to C and C agrees to acquire like-kind property and deliver it to B. On that date B has a bona fide intent to enter into a deferred exchange. C's obligation, which is not payable on demand or readily tradable, is secured by $100,000

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in cash. The $100,000 is deposited by C in an escrow account that is a qualified escrow account under paragraph (g)(3) of this section. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash deposited in the escrow account until the earlier of the date the replacement property is delivered to B or the end of the exchange period. On March 11, 1995, C acquires replacement property having a fair market value of $80,000 and delivers the replacement property to B. The $20,000 in cash remaining in the qualified escrow account is distributed to B at that time.

(ii) Under section 1031(b), B recognizes gain to the extent of the $20,000 in cash that B receives in the exchange. Under paragraph (j)(2)(i) of this section, the qualified escrow account is disregarded for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B's receipt of C's obligation on September 22, 1994, does not constitute a payment. Instead, B is treated as receiving payment on March 11, 1995, on receipt of the $20,000 in cash from the qualified escrow account. Subject to the other requirements of sections 453 and 453A, B may report the $20,000 gain in 1995 under the installment method. See section 453(f)(6) for special rules for determining total contract price and gross profit in the case of an exchange described in section 1031(b).

Example 2. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. On September 22, 1994, pursuant to the agreement, B transfers real property X to C who transfers it to D for $100,000 in cash. On that date B has a bona fide intent to enter into a deferred exchange. C is a qualified intermediary under paragraph (g)(4) of this section. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by C until the earlier of the date the replacement property is delivered to B or the end of the exchange period. On March 11, 1995, C acquires replacement property having a fair market value of $80,000 and delivers it, along with the remaining $20,000 from the transfer of real property X to B.

(ii) Under section 1031(b), B recognizes gain to the extent of the $20,000 cash B receives in the exchange. Under paragraph (j)(2)(ii) of this section, any agency relationship between B and C is disregarded for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on September 22, 1994, on C's receipt of payment from D for the relinquished property. Instead, B is treated as receiving payment on March 11, 1995, on receipt of the $20,000 in cash from C. Subject to the other requirements of sections 453 and 453A, B may report the $20,000 gain in 1995 under the installment method.

Example 3. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B enters into an exchange agreement with C whereby B retains C as a qualified intermediary to facilitate an exchange with respect to real property X. On December 1, 1994, pursuant to the agreement, B transfers real property X to C who transfers it to D for $100,000 in cash. On that date B has a bona fide intent to enter into a deferred exchange. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash held by C until the earliest of the end of the identification period if B has not identified replacement property, the date the replacement property is delivered to B, or the end of the exchange period. Although B has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period, B does not identify or acquire any replacement property. In 1995, at the end of the identification period, C delivers the entire $100,000 from the sale of real property X to B.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis in real property X ($60,000), or $40,000. Because B has a bona fide intent at the beginning of the exchange period to enter into a deferred exchange, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(ii) of this section inapplicable even though B fails to acquire replacement property. Further, under paragraph (j)(2)(ii) of this section, C is a qualified intermediary even though C does not acquire and transfer replacement property to B. Thus, any agency relationship between B and C is disregarded for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on December 1, 1994, on C's receipt of payment from D for the relinquished property. Instead, B is treated as receiving payment at the end of the identification period in 1995 on receipt of the $100,000 in cash from C. Subject to the other requirements of sections 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

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

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

Example 5. (i) B is a corporation that has held real property X to expand its manufacturing operations. However, at a meeting in November 1994, B's directors decide that real property X is not suitable for the planned expansion, and authorize a like-kind exchange of this property for property that would be suitable for the planned expansion. B enters into an exchange agreement with C whereby B retains C as a qualified intermediary to facilitate an exchange with respect to real property X. On November 28, 1994, pursuant to the agreement,

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B transfers real property X to C, who then transfers it to D for $100,000 in cash. The exchange agreement does not include any limitations or conditions that make it unreasonable to believe that like-kind replacement property will be acquired before the end of the exchange period. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash held by C until the earliest of the end of the identification period, if B has not identified replacement property, the date the replacement property is delivered to B, or the end of the exchange period. In early January 1995, B's directors meet and decide that it is not feasible to proceed with the planned expansion due to a business downturn reflected in B's preliminary financial reports for the last quarter of 1994. Thus, B's directors instruct C to stop seeking replacement property. C delivers the $100,000 cash to B on January 12, 1995, at the end of the identification period. Both the decision to exchange real property X for other property and the decision to cease seeking replacement property because of B's business downturn are recorded in the minutes of the directors' meetings. There are no other facts or circumstances that would indicate whether, on November 28, 1994, B had a bona fide intent to enter into a deferred like-kind exchange.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis of real property X ($60,000), or $40,000. The directors' authorization of a like-kind exchange, the terms of the exchange agreement with C, and the absence of other relevant facts, indicate that B had a bona fide intent at the beginning of the exchange period to enter into a deferred like-kind exchange. Thus, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(ii) of this section inapplicable, even though B fails to acquire replacement property. Further, under paragraph (j)(2)(ii) of this section, C is a qualified intermediary, even though C does not transfer replacement property to B. Thus, any agency relationship between B and C is disregarded for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment until January 12, 1995, on receipt of the $100,000 cash from C. Subject to the other requirements of sections 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

Example 6. (i) B has held real property X for use in its trade or business, but decides to transfer that property because it is no longer suitable for B's planned expansion of its commercial enterprise. B and D agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to D on September 22, 1994, and D deposits $100,000 cash in a qualified escrow account as security for D's obligation under the agreement to transfer replacement property to B before the end of the exchange period. D's obligation is not payable on demand or readily tradable. The agreement provides that B is not required to accept any property that is not zoned for commercial use. Before the end of the identification period, B identifies real properties J, K, and L, all zoned for residential use, as replacement properties. Any one of these properties, rezoned for commercial use, would be suitable for B's planned expansion. In recent years, the zoning board with jurisdiction over properties J, K, and L has rezoned similar properties for commercial use. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in the escrow account until the earlier of the time that the zoning board determines, after the end of the identification period, that it will not rezone the properties for commercial use or the end of the exchange period. On January 5, 1995, the zoning board decides that none of the properties will be rezoned for commercial use. Pursuant to the exchange agreement, B receives the $100,000 cash from the escrow on January 5, 1995. There are no other facts or circumstances that would indicate whether, on September 22, 1994, B had a bona fide intent to enter into a deferred like-kind exchange.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis of real property X ($60,000), or $40,000. The terms of the exchange agreement with D, the identification of properties J, K, and L, the efforts to have those properties rezoned for commercial purposes, and the absence of other relevant facts, indicate that B had a bona fide intent at the beginning of the exchange period to enter into a deferred exchange. Moreover, the limitations imposed in the exchange agreement on acceptable replacement property do not make it unreasonable to believe that like-kind replacement property would be acquired before the end of the exchange period. Therefore, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(i) of this section inapplicable even though B fails to acquire replacement property. Thus, for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter, the qualified escrow account is disregarded in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on September 22, 1994, on D's deposit of the $100,000 cash into the qualified escrow account. Instead, B is treated as receiving payment on January 5, 1995. Subject to the other requirements of sections 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

(vii) Effective date. This paragraph (j)(2) is effective for transfers of property occurring on or after April 20, 1994. Taxpayers may apply this paragraph (j)(2) to transfers of property occurring before April 20, 1994, but on or after June 10, 1991, if those transfers otherwise meet the requirements of Sec. 1.1031(k)-1. In addition, taxpayers may apply this paragraph (j)(2) to transfers of property occurring before June 10, 1991, but on or after May 16, 1990, if those transfers otherwise meet the requirements of Sec. 1.1031(k)-1 or follow the guidance of IA-237-84 published in 1990-1, C.B. See Sec. 601.601(d)(2)(ii)(b) of this chapter.

(3) Examples. This paragraph (j) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B is to transfer real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. B's adjusted basis in real property X is $40,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received. The replacement property is identified as provided in paragraph (c) of this section and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

Example 1. (i) On May 17, 1991, B transfers real property X to C and identifies real property R as replacement property. On June 3, 1991, C transfers $10,000 to B. On September 4, 1991, C purchases real property R for $90,000 and transfers real property R to B.

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(ii) The $10,000 received by B is "money or other property" for purposes of section 1031 and the regulations thereunder. Under section 1031(b), B recognizes gain in the amount of $10,000. Under section 1031(d), B's basis in real property R is $40,000 (*i.e.,* B's basis in real property X ($40,000), decreased in the amount of money received ($10,000), and increased in the amount of gain recognized ($10,000) in the deferred exchange).

Example 2. (i) On May 17, 1991, B transfers real property X to C and identifies real property S as replacement property, and C transfers $10,000 to B. On September 4, 1991, C purchases real property S for $100,000 and transfers real property S to B. On the same day, B transfers $10,000 to C.

(ii) The $10,000 received by B is "money or other property" for purposes of section 1031 and the regulations thereunder. Under section 1031(b), B recognizes gain in the amount of $10,000. Under section 1031(d), B's basis in real property S is $50,000 (*i.e.,* B's basis in real property X ($40,000), decreased in the amount of money received ($10,000), increased in the amount of gain recognized ($10,000), and increased in the amount of the additional consideration paid by B ($10,000) in the deferred exchange).

Example 3. (i) Under the exchange agreement, B has the right at all times to demand $100,000 in cash in lieu of replacement property. On May 17, 1991, B transfers real property X to C and identifies real property T as replacement property. On September 4, 1991, C purchases real property T for $100,000 and transfers real property T to B.

(ii) Because B has the right on May 17, 1991, to demand $100,000 in cash in lieu of replacement property, B is in constructive receipt of the $100,000 on that date. Thus, the transaction is a sale and not an exchange, and the $60,000 gain realized by B in the transaction (*i.e.,* $100,000 amount realized less $40,000 adjusted basis) is recognized. Under section 1031(d), B's basis in real property T is $100,000.

Example 4. (i) Under the exchange agreement, B has the right at all times to demand up to $30,000 in cash and the balance in replacement property instead of receiving replacement property in the amount of $100,000. On May 17, 1991, B transfers real property X to C and identifies real property U as replacement property. On September 4, 1991, C purchases real property U for $100,000 and transfers real property U to B.

(ii) The transaction qualifies as a deferred exchange under section 1031 and this section. However, because B had the right on May 17, 1991, to demand up to $30,000 in cash, B is in constructive receipt of $30,000 on that date. Under section 1031(b), B recognizes gain in the amount of $30,000. Under section 1031(d), B's basis in real property U is $70,000 (*i.e.,* B's basis in real property X ($40,000), decreased in the amount of money that B received ($30,000), increased in the amount of gain recognized ($30,000), and increased in the amount of additional consideration paid by B ($30,000) in the deferred exchange).

Example 5. (i) Assume real property X is encumbered by a mortgage of $30,000. On May 17, 1991, B transfers real property X to C and identifies real property V as replacement property, and C assumes the $30,000 mortgage on real property X. Real property V is encumbered by a $20,000 mortgage. On July 5, 1991, C purchases real property V for $90,000 by paying $70,000 and assuming the mortgage and transfers real property V to B with B assuming the mortgage.

(ii) The consideration received by B in the form of the liability assumed by C ($30,000) is offset by the consideration given by B in the form of the liability assumed by B ($20,000). The excess of the liability assumed by C over the liability assumed by B, $10,000, is treated as "money or other property." See Sec. 1.1031(b)-1(c). Thus, B recognizes gain under section 1031(b) in the amount of $10,000. Under section 1031(d), B's basis in real property V is $40,000 (*i.e.,* B's basis in real property X ($40,000), decreased in the amount of money that B is treated as receiving in the form of the liability assumed by C ($30,000), increased in the amount of money that B is treated as paying in the form of the liability assumed by B ($20,000), and increased in the amount of the gain recognized ($10,000) in the deferred exchange).

(k) Definition of disqualified person.

(1) For purposes of this section, a disqualified person is a person described in paragraph (k)(2), (k)(3), or (k)(4) of this section.

(2) The person is the agent of the taxpayer at the time of the transaction. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction. Solely for purposes of this paragraph (k)(2), performance of the following services will not be taken into account—

(i) Services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under section 1031; and

(ii) Routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.

(3) The person and the taxpayer bear a relationship described in either section 267(b) or section 707(b) (determined by substituting in each section "10 percent" for "50 percent" each place it appears).

(4) (i) Except as provided in paragraph (k)(4)(ii) of this section, the person and a person described in paragraph (k)(2) of this section bear a relationship described in either section 267(b) or 707(b) (determined by substituting in each section "10 percent" for "50 percent" each place it appears).

(ii) In the case of a transfer of relinquished property made by a taxpayer on or after January 17, 2001, paragraph (k)(4)(i) of this section does not apply to a bank (as defined in section 581) or a bank affiliate if, but for this paragraph (k)(4)(ii), the bank or bank affiliate would be a disqualified person under paragraph (k)(4)(i) of this section solely because it is a member of the same controlled group (as determined under section 267(f)(1), substituting "10 percent" for "50 percent' where it appears) as a person that has provided investment banking or brokerage services to the taxpayer within the 2-year period described in paragraph (k)(2) of this section. For purposes of this paragraph (k)(4)(ii), a bank affiliate is a corporation whose principal activity is rendering services to facilitate exchanges of property intended to qualify for nonrecognition of gain under section 1031 and all of whose stock is owned by either a bank or a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a)).

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(5) This paragraph (k) may be illustrated by the following examples. Unless otherwise provided, the following facts are assumed: On May 1, 1991, B enters into an exchange agreement (as defined in paragraph (g)(4)(iii)(B) of this section) with C whereby B retains C to facilitate an exchange with respect to real property X. On May 17, 1991, pursuant to the agreement, B executes and delivers to C a deed conveying real property X to C. C has no relationship to B described in paragraph (k)(2), (k)(3), or (k)(4) of this section.

Example 1. (i) C is B's accountant and has rendered accounting services to B within the 2-year period ending on May 17, 1991, other than with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under section 1031.

(ii) C is a disqualified person because C has acted as B's accountant within the 2-year period ending on May 17, 1991.

(iii) If C had not acted as B's accountant within the 2-year period ending on May 17, 1991, or if C had acted as B's accountant within that period only with respect to exchanges intended to qualify for nonrecognition of gain or loss under section 1031, C would not have been a disqualified person.

Example 2. (i) C, which is engaged in the trade or business of acting as an intermediary to facilitate deferred exchanges, is a wholly owned subsidiary of an escrow company that has performed routine escrow services for B in the past. C has previously been retained by B to act as an intermediary in prior section 1031 exchanges.

(ii) C is not a disqualified person notwithstanding the intermediary services previously provided by C to B (see paragraph (k)(2)(i) of this section) and notwithstanding the combination of C's relationship to the escrow company and the escrow services previously provided by the escrow company to B (see paragraph (k)(2)(ii) of this section).

Example 3. (i) C is a corporation that is only engaged in the trade or business of acting as an intermediary to facilitate deferred exchanges. Each of 10 law firms owns 10 percent of the outstanding stock of C. One of the 10 law firms that owns 10 percent of C is M. J is the managing partner of M and is the president of C. J, in his capacity as a partner in M, has also rendered legal advice to B within the 2-year period ending on May 17, 1991, on matters other than exchanges intended to qualify for nonrecognition of gain or loss under section 1031.

(ii) J and M are disqualified persons. C, however, is not a disqualified person because neither J nor M own, directly or indirectly, more than 10 percent of the stock of C. Similarly, J's participation in the management of C does not make C a disqualified person.

(l) [Reserved]

(m) Definition of fair market value. For purposes of this section, the fair market value of property means the fair market value of the property without regard to any liabilities secured by the property.

(n) No inference with respect to actual or constructive receipt rules outside of section 1031. The rules provided in this section relating to actual or constructive receipt are intended to be rules for determining whether there is actual or constructive receipt in the case of a deferred exchange. No inference is intended regarding the application of these rules for purposes of determining whether actual or constructive receipt exists for any other purpose.

(o) Effective date. This section applies to transfers of property made by a taxpayer on or after June 10, 1991. However, a transfer of property made by a taxpayer on or after May 16, 1990, but before June 10, 1991, will be treated as complying with section 1031 (a)(3) and this section if the deferred exchange satisfies either the provision of this section or the provisions of the notice of proposed rulemaking published in the Federal Register on May 16, 1990 (55 FR 20278).

[T.D. 8346, 56 FR 19938, May 1, 1991, as amended by T.D. 8535, 59 FR 18749, Apr. 20, 1994; T.D. 8982, 67 FR 4909, Feb. 1, 2002]

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REVENUE PROCEDURE 2000-37

Safe Harbor Parking Transactions (Safe Harbor "Reverse" Exchanges)

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor under which the Internal Revenue Service will not challenge (a) the qualification of property as either "replacement property" or "relinquished property" (as defined in §1.1031(k)–1(a) of the Income Tax Regulations) for purposes of §1031 of the Internal Revenue Code and the regulations thereunder or (b) the treatment of the "exchange accommodation titleholder" as the beneficial owner of such property for federal income tax purposes, if the property is held in a "qualified exchange accommodation arrangement" (QEAA), as defined in section 4.02 of this revenue procedure.

SECTION 2. BACKGROUND

.01 Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.

.02 Section 1031(a)(3) provides that property received by the taxpayer is not treated as like-kind property if it: (a) is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the relinquished property; or (b) is received after the earlier of the date that is 180 days after the date on which the taxpayer transfers the relinquished property, or the due date (determined with regard to extension) for the transferor's federal income tax return for the year in which the transfer of the relinquished property occurs.

.03 Determining the owner of property for federal income tax purposes requires an analysis of all of the facts and circumstances. As a general rule, the party that bears the economic burdens and benefits of ownership will be considered the owner of property for federal income tax purposes. *See* Rev. Rul. 82–144, 1982–2 C.B. 34.

.04 On April 25, 1991, the Treasury Department and the Service promulgated final regulations under §1.1031(k)–1 providing rules for deferred like-kind exchanges under §1031(a)(3). The preamble to the final regulations states that the deferred exchange rules under §1031(a)(3) do not apply to reverse-Starker exchanges (*i.e.,* exchanges where the replacement property is acquired before the relinquished property is transferred) and consequently that the final regulations do not apply to such exchanges. T.D. 8346, 1991–1 C.B. 150, 151; see *Starker v. United States,* 602 F.2d 1341 (9th Cir. 1979). However, the preamble indicates that Treasury and the Service will continue to study the applicability of the general rule of §1031(a)(1) to these transactions. T.D. 8346, 1991–1 C.B. 150, 151.

.05 Since the promulgation of the final regulations under §1.1031(k)–1, taxpayers have engaged in a wide variety of transactions, including so-called "parking" transactions, to facilitate reverse like-kind exchanges. Parking transactions typically are designed to "park" the desired replacement property with an accommodation party until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange. Once such a transfer is arranged, the taxpayer transfers the relinquished property to the accommodation party in exchange for the replacement property, and the accommodation party then transfers the relinquished property to the ultimate transferee. In other situations, an accommodation party may acquire the desired replacement property on behalf of the taxpayer and immediately exchange such property with the taxpayer for the relinquished property, thereafter holding the relinquished property until the taxpayer arranges for a transfer of such property to the ultimate transferee. In the parking arrangements, taxpayers attempt to arrange the transaction so that the accommodation party has enough of the benefits and burdens relating to the property so that the accommodation party will be treated as the owner for federal income tax purposes.

.06 Treasury and the Service have determined that it is in the best interest of sound tax administration to provide taxpayers with a workable means of qualifying their transactions under §1031 in situations where the taxpayer has a genuine intent to accomplish a like-kind exchange at the time that it arranges for the acquisition of the replacement property and actually accomplishes the exchange within a short time thereafter. Accordingly, this revenue procedure provides a safe harbor that allows a taxpayer to treat the accommodation party as the owner of the property for federal income tax purposes, thereby enabling the taxpayer to accomplish a qualifying like-kind exchange.

SECTION 3. SCOPE

.01 *Exclusivity*. This revenue procedure provides a safe harbor for the qualification under §1031 of certain arrangements between taxpayers and exchange accommodation titleholders and provides for the treatment of the exchange accommodation titleholder as the beneficial owner of the property for federal income tax purposes. These provisions apply only in the limited context described in this revenue procedure. The principles set forth in this revenue procedure have no application to any federal income tax determinations other than determinations that involve arrangements qualifying for the safe harbor.

.02 *No inference*. No inference is intended with respect to the federal income tax treatment of arrangements similar to those described in this revenue procedure that were entered into prior to the effective date of this revenue procedure. Further, the Service recognizes that "parking" transactions can be accomplished outside of the safe harbor provided in this revenue procedure. Accordingly, no inference is intended with respect to the federal income tax treatment of "parking" transactions that do not satisfy the terms of the safe harbor provided in this revenue procedure, whether entered into prior to or after the effective date of this revenue procedure.

.03 *Other issues*. Services for the taxpayer in connection with a person's role as the exchange accommodation titleholder in a QEAA shall not be taken into account in determining whether that person or a related person is a disqualified person (as defined in §1.1031(k)–1(k)). Even though property will not fail to be treated as being held in a QEAA as a result of one or more arrangements described in section 4.03 of this revenue procedure, the Service still may recast an amount paid pursuant to such an arrangement as a fee paid to the exchange accommodation titleholder for acting as an exchange accommodation titleholder to the extent necessary to reflect the true economic substance of the arrangement. Other federal income tax issues implicated, but not addressed, in this revenue procedure include the treatment, for federal income tax purposes, of payments described in section 4.03(7) and whether an exchange accommodation titleholder may be precluded from claiming depreciation deductions (*e.g.,* as a dealer) with respect to the relinquished property or the replacement property.

.04 *Effect of Noncompliance*. If the requirements of this revenue procedure are not satisfied (for example, the property subject to a QEAA is not transferred within the time period provided), then this revenue procedure does not apply. Accordingly, the determination of whether the taxpayer or the exchange accommodation titleholder is the owner of the property for federal income tax purposes, and the proper treatment of any transactions entered into by or between the parties, will be made without regard to the provisions of this revenue procedure.

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SECTION 4. QUALIFIED EXCHANGE ACCOMMODATION ARRANGEMENTS

.01 *Generally*. The Service will not challenge the qualification of property as either "replacement property" or "relinquished property" (as defined in §1.1031(k)–1(a)) for purposes of §1031 and the regulations thereunder, or the treatment of the exchange accommodation titleholder as the beneficial owner of such property for federal income tax purposes, if the property is held in a QEAA.

.02 *Qualified Exchange Accommodation Arrangements.* For purposes of this revenue procedure, property is held in a QEAA if all of the following requirements are met:

(1) Qualified indicia of ownership of the property is held by a person (the "exchange accommodation titleholder") who is not the taxpayer or a disqualified person and either such person is subject to federal income tax or, if such person is treated as a partnership or S corporation for federal income tax purposes, more than 90 percent of its interests or stock are owned by partners or shareholders who are subject to federal income tax. Such qualified indicia of ownership must be held by the exchange accommodation titleholder at all times from the date of acquisition by the exchange accommodation titleholder until the property is transferred as described in section 4.02(5) of this revenue procedure. For this purpose, "qualified indicia of ownership" means legal title to the property, other indicia of ownership of the property that are treated as beneficial ownership of the property under applicable principles of commercial law (e.g., a contract for deed), or interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (e.g., a single member limited liability company) and that holds either legal title to the property or such other indicia of ownership;

(2) At the time the qualified indicia of ownership of the property is transferred to the exchange accommodation titleholder, it is the taxpayer's bona fide intent that the property held by the exchange accommodation titleholder represent either replacement property or relinquished property in an exchange that is intended to qualify for nonrecognition of gain (in whole or in part) or loss under §1031;

(3) No later than five business days after the transfer of qualified indicia of owner-ship of the property to the exchange accommodation titleholder, the taxpayer and the exchange accommodation titleholder enter into a written agreement (the "qualified exchange accommodation agreement") that provides that the exchange accommodation titleholder is holding the property for the benefit of the taxpayer in order to facilitate an exchange under §1031 and this revenue procedure and that the taxpayer and the exchange accommodation titleholder agree to report the acquisition, holding, and disposition of the property as provided in this revenue procedure. The agreement must specify that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with this agreement;

(4) No later than 45 days after the transfer of qualified indicia of ownership of the replacement property to the exchange accommodation titleholder, the relinquished property is properly identified. Identification must be made in a manner consistent with the principles described in §1.1031(k)–1(c). For purposes of this section, the taxpayer may properly identify alternative and multiple properties, as described in §1.1031(k)–1(c)(4);

(5) No later than 180 days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, (a) the property is transferred (either directly or indirectly through a qualified intermediary (as defined in §1.1031(k)–1(g)(4))) to the taxpayer as replacement property; or (b) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property; and

(6) The combined time period that the relinquished property and the replacement property are held in a QEAA does not exceed 180 days.

.03 *Permissible Agreements.* Property will not fail to be treated as being held in a QEAA as a result of any one or more of the following legal or contractual arrangements, regardless of whether such arrangements contain terms that typically would result from arm's length bargaining between unrelated parties with respect to such arrangements:

(1) An exchange accommodation titleholder that satisfies the requirements of the qualified intermediary safe harbor set forth in §1.1031(k)–1(g)(4) may enter into an exchange agreement with the taxpayer to serve as the qualified intermediary in a simultaneous or deferred exchange of the property under §1031;

(2) The taxpayer or a disqualified person guarantees some or all of the obligations of the exchange accommodation titleholder, including secured or unsecured debt incurred to acquire the property, or indemnifies the exchange accommodation titleholder against costs and expenses;

(3) The taxpayer or a disqualified person loans or advances funds to the exchange accommodation titleholder or guarantees a loan or advance to the exchange accommodation titleholder;

(4) The property is leased by the exchange accommodation titleholder to the taxpayer or a disqualified person;

(5) The taxpayer or a disqualified person manages the property, supervises improvement of the property, acts as a contractor, or otherwise provides services to the exchange accommodation titleholder with respect to the property;

(6) The taxpayer and the exchange accommodation titleholder enter into agreements or arrangements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, effective for a period not in excess of 185 days from the date the property is acquired by the exchange accommodation titleholder; and

(7) The taxpayer and the exchange accommodation titleholder enter into agreements or arrangements providing that any variation in the value of a relinquished property from the estimated value on the date of the exchange accommodation titleholder's receipt of the property be taken into account upon the exchange accommodation titleholder's disposition of the relinquished property through the taxpayer's advance of funds to, or receipt of funds from, the exchange accommodation titleholder.

.04 *Permissible Treatment.* Property will not fail to be treated as being held in a QEAA merely because the accounting, regulatory, or state, local, or foreign tax treatment of the arrangement between the taxpayer and the exchange accommodation titleholder is different from the treatment required by section 4.02(3) of this revenue procedure.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for QEAAs entered into with respect to an exchange accommodation titleholder that acquires qualified indicia of ownership of property on or after September 15, 2000.

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SECTION 6. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1701. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collections of information are contained in section 4.02 of this revenue procedure, which requires taxpayers and exchange accommodation titleholders to enter into a written agreement that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. This information is required to en-sure that both parties to a QEAA treat the transaction consistently for federal tax purposes. The likely respondents are businesses and other for-profit institutions, and individuals.

The estimated average annual burden to prepare the agreement and certification is two hours. The estimated number of respondents is 1,600, and the estimated total annual reporting burden is 3,200 hours.

The estimated annual frequency of responses is on occasion.

Books and records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal author of this revenue procedure is J. Peter Baumgarten of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Baumgarten at (202) 622-4950 (not a toll-free call).

REVENUE PROCEDURE 2004-51

Amendments to Rev. Proc. 2000-37 to Exclude Property Previously Owned by Taxpayer

SECTION 1. PURPOSE

This revenue procedure modifies sections 1 and 4 of Rev. Proc. 2000–37, 2000–2 C.B. 308, to provide that Rev. Proc. 2000–37 does not apply if the taxpayer owns the property intended to qualify as replacement property before initiating a qualified exchange accommodation arrangement (QEAA).

SECTION 2. BACKGROUND

.01 Section 1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.

.02 Section 1031(a)(3) allows taxpayers to structure deferred like-kind exchanges. Under §1031(a)(3), property may be treated as like-kind property if it is (A) identified as property to be received in the exchange (replacement property) on or before the day that is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange (relinquished property), and (B) received before the earlier of the date that is 180 days after the date on which the taxpayer transfers the relinquished property, or the due date (determined with regard to extensions) for the transferor's federal income tax return for the taxable year in which the transfer of the relinquished property occurs.

.03 Rev. Proc. 2000–37 addresses "parking" transactions. See sections 2.05 and 2.06 of Rev. Proc. 2000–37. Parking transactions typically are designed to "park" the desired replacement property with an accommodation party until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange. Once such a transfer is arranged, the taxpayer transfers the relinquished property to the accommodation party in exchange for the replacement property, and the accommodation party transfers the relinquished property to the ultimate transferee. In other situations, an accommodation party may acquire the desired replacement property on behalf of the taxpayer and immediately exchange that property with the taxpayer for the relinquished property, thereafter holding the relinquished property until the taxpayer arranges for a transfer of the property to the ultimate transferee. Rev. Proc. 2000–37 provides procedures for qualifying parking transactions as like-kind exchanges in situations in which the taxpayer has a genuine intent to accomplish a like-kind exchange at the time that the taxpayer arranges for the acquisition of the replacement property and actually accomplishes the exchange within a short time thereafter.

.04 Section 4.01 of Rev. Proc. 2000–37 provides that the Internal Revenue Service will not challenge the qualification of property held in a QEAA "as either 'replacement property' or 'relinquished property' (as defined in §1.1031(k)–1(a)) for purposes of §1031 and the regulations thereunder, or the treatment of the exchange accommodation titleholder as the beneficial owner of such property… ." Thus, taxpayers are not required to establish that the exchange accommodation titleholder bears the economic benefits and burdens of ownership and is the "owner" of the property. The Service and Treasury Department are aware that some taxpayers have interpreted this language to permit a taxpayer to treat as a like-kind exchange a transaction in which the taxpayer transfers property to an exchange accommodation titleholder and receives that same property as replacement property in a purported exchange for other property of the taxpayer.

.05 An exchange of real estate owned by a taxpayer for improvements on land owned by the same taxpayer does not meet the requirements of §1031. *See DeCleene v. Commissioner,* 115 T.C. 457 (2000); *Bloomington Coca-Cola Bottling Co. v. Commissioner,* 189 F.2d 14 (7th Cir. 1951). Moreover, Rev. Rul. 67–255, 1967–2 C.B. 270, holds that a building constructed on land owned by a taxpayer is not of a like kind to involuntarily converted land of the same taxpayer. Rev. Proc. 2000–37 does not abrogate the statutory requirement of §1031 that the transaction be an exchange of like-kind properties.

.06 The Service and Treasury Department are continuing to study parking transactions, including transactions in which a person related to the taxpayer transfers a leasehold in land to an accommodation party and the accommodation party makes improvements to the land and transfers the leasehold with the improvements to the taxpayer in exchange for other real estate.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers applying the safe harbor rules set forth in Rev. Proc. 2000–37 in structuring like-kind exchanges.

SECTION 4. APPLICATION

.01 Section 1 of Rev. Proc. 2000–37 is modified to read as follows:

> **SECTION 1. PURPOSE**
>
> This revenue procedure provides a safe harbor under which the Internal Revenue Service will treat an exchange accommodation titleholder as the

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beneficial owner of property for federal income tax purposes if the property is held in a "qualified exchange accommodation arrangement" (QEAA), as defined in section 4.02 of this revenue procedure.

.02 Section 4.01 of Rev. Proc. 2000–37 is modified to read as follows:

SECTION 4. QUALIFIED EXCHANGE ACCOMMODATION ARRANGEMENTS

.01 *In general.* The Service will treat an exchange accommodation titleholder as the beneficial owner of property for federal income tax purposes if the property is held in a QEAA. Property held in a QEAA may, therefore, qualify as either "replacement property" or "relinquished property" (as defined in §1.1031(k)–1(a)) in a tax-deferred like-kind exchange if the exchange otherwise meets the requirements for deferral of gain or loss under §1031 and the regulations thereunder.

.03 Section 4.05 is added to Rev. Proc. 2000–37 to read as follows:

.05 *Limitation*. This revenue procedure does not apply to replacement property held in a QEAA if the property is owned by the taxpayer within the 180-day period ending on the date of transfer of qualified *indicia* of ownership of the property to an exchange accommodation titleholder.

SECTION 5. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2000–37 is modified.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for transfers on or after July 20, 2004, of qualified *indicia* of ownership to exchange accommodation titleholders (as described in section 4.02(1) of Rev. Proc. 2000–37).

SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is J. Peter Baumgarten of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Mr. Baumgarten at (202) 622–4920 (not a toll-free call).

REVENUE PROCEDURE 2002-22

Fractional Interest Ownership Ruling Guidelines (Tenancy in Common Ownership)

SECTION 1. PURPOSE

This revenue procedure specifies the conditions under which the Internal Revenue Service will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property as defined in section 614) is not an interest in a business entity, within the meaning of §301.7701-2(a) of the Procedure and Administration Regulations.

This revenue procedure supersedes Rev. Proc. 2000-46, 2002-2 C.B. 438, which provides that the Service will not issue advance rulings or determination letters on the questions of whether an undivided fractional interest in real property is an interest in an entity that is not eligible for tax-free exchange under §1031(a)(1) of the Internal Revenue Code and whether arrangements where taxpayers acquire undivided fractional interests in real property constitute separate entities for federal tax purposes under §7701. This revenue procedure also modifies Rev. Proc. 2002-3, 2002-1 I.R.B. 117, by removing these issues from the list of subjects on which the Service will not rule. Requests for advance rulings described in Rev. Proc. 2000-46 that are not covered by this revenue procedure, such as rulings concerning mineral property, will be considered under procedures set forth in Rev. Proc. 2002-1, 2002-1 I.R.B. 1 (or its successor).

SECTION 2. BACKGROUND

Section 301.7701-1(a)(1) provides that whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal law and does not depend on whether the entity is recognized as an entity under local law. Section 301.7701-1(a)(2) provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom, but the mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.

Section 301.7701-2(a) provides that a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under §301.7701-3) that is not properly classified as a trust under §301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.

Section 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and that is not a corporation or a trust or estate.

Section 1.761-1(a) of the Income Tax Regulations provides that the term "partnership" means a partnership as determined under §§301.7701-1, 301.7701-2, and 301.7701-3.

The central characteristic of a tenancy in common, one of the traditional concurrent estates in land, is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants the possession of the whole parcel and has the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property. These rights generally provide a tenant in common the benefits of ownership of the property within the constraint that no rights may be exercised to the detriment of the other tenants in common. 7 Richard R. Powell, Powell on Real Property §§50.01-50.07 (Michael Allan Wolf ed., 2000).

Rev. Rul. 75-374, 1975-2 C.B. 261, concludes that a two-person co-ownership of an apartment building that was rented to tenants did not constitute a partnership for federal tax purposes. In the revenue ruling, the co-owners employed an agent to manage the apartments on their behalf; the agent collected rents, paid property taxes, insurance premiums, repair and maintenance expenses, and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The ruling concludes that the agent's activities in providing customary services to the tenants, although imputed to the co-owners, were not sufficiently extensive to cause the co-ownership to be characterized as a partnership. See also Rev. Rul. 79-77, 1979-1 C.B. 448, which did not find a business entity where three individuals transferred ownership of a commercial building subject to a net lease to a trust with the three individuals as beneficiaries.

Where a sponsor packages co-ownership interests for sale by acquiring property, negotiating a master lease on the property, and arranging for financing, the courts have looked at the relationships not only among the co-owners, but also between the sponsor (or persons related to the sponsor) and the co-

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owners in determining whether the co-ownership gives rise to a partnership. For example, in *Bergford v. Commissioner,* 12 F.3d 166 (9 Cir. 1993), seventy-eight investors purchased "co-ownership" interests in computer equipment that was subject to a 7-year net lease. As part of the purchase, the co-owners authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the co-owners to decide by majority vote whether to sell or lease the equipment at the end of the lease. Absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10 percent of the equipment's selling price or lease rental whether or not a co-owner terminated the agreement or the manager performed any remarketing. A co-owner could assign an interest in the co-ownership only after fulfilling numerous conditions and obtaining the manager's consent.

The court held that the co-ownership arrangement constituted a partnership for federal tax purposes. Among the factors that influenced the court's decision were the limitations on the co-owners' ability to sell, lease, or encumber either the co-ownership interest or the underlying property, and the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances). *Bergford,* 12 F.3d at 169-170. *Accord Bussing v. Commissioner,* 88 T.C. 449 (1987), *aff'd on reh'g,* 89 T.C. 1050 (1987); *Alhouse v. Commissioner,* T.C. Memo. 1991-652.

Under §1.761-1(a) and §§301.7701-1 through 301.7701-3, a federal tax partnership does not include mere co-ownership of property where the owners' activities are limited to keeping the property maintained, in repair, rented or leased. However, as the above authorities demonstrate, a partnership for federal tax purposes is broader in scope than the common law meaning of partnership and may include groups not classified by state law as partnerships. *Bergford,* 12 F.3d at 169. Where the parties to a venture join together capital or services with the intent of conducting a business or enterprise and of sharing the profits and losses from the venture, a partnership (or other business entity) is created. *Bussing,* 88 T.C. at 460. Furthermore, where the economic benefits to the individual participants are not derivative of their co-ownership, but rather come from their joint relationship toward a common goal, the co-ownership arrangement will be characterized as a partnership (or other business entity) for federal tax purposes. *Bergford,* 12 F.3d at 169.

SECTION 3. SCOPE

This revenue procedure applies to co-ownership of rental real property (other than mineral interests) (the Property) in an arrangement classified under local law as a tenancy-in-common.

This revenue procedure provides guidelines for requesting advance rulings solely to assist taxpayers in preparing ruling requests and the Service in issuing advance ruling letters as promptly as practicable. The guidelines set forth in this revenue procedure are not intended to be substantive rules and are not to be used for audit purposes.

SECTION 4. GUIDELINES FOR SUBMITTING RULING REQUESTS

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the information described in section 5 of this revenue procedure is included in the ruling request and the conditions described in section 6 of this revenue procedure are satisfied. Even if sections 5 and 6 of this revenue procedure are satisfied, however, the Service may decline to issue a ruling under this revenue procedure whenever warranted by the facts and circumstances of a particular case and whenever appropriate in the interest of sound tax administration.

Where multiple parcels of property owned by the co-owners are leased to a single tenant pursuant to a single lease agreement and any debt of one or more co-owners is secured by all of the parcels, the Service will generally treat all of the parcels as a single "Property." In such a case, the Service will generally not consider a ruling request under this revenue procedure unless: (1) each co-owner's percentage interest in each parcel is identical to that co-owner's percentage interest in every other parcel, (2) each co-owner's percentage interests in the parcels cannot be separated and traded independently, and (3) the parcels of property are properly viewed as a single business unit. The Service will generally treat contiguous parcels as comprising a single business unit. Even if the parcels are not contiguous, however, the Service may treat multiple parcels as comprising a single business unit where there is a close connection between the business use of one parcel and the business use of another parcel. For example, an office building and a garage that services the tenants of the office building may be treated as a single business unit even if the office building and the garage are not contiguous.

For purposes of this revenue procedure, the following definitions apply. The term "co-owner" means any person that owns an interest in the Property as a tenant in common. The term "sponsor" means any person who divides a single interest in the Property into multiple co-ownership interests for the purpose of offering those interests for sale. The term "related person" means a person bearing a relationship described in §267(b) or 707(b)(1), except that in applying §267(b) or 707(b)(1), the co-ownership will be treated as a partnership and each co-owner will be treated as a partner. The term "disregarded entity" means an entity that is disregarded as an entity separate from its owner for federal tax purposes. Examples of disregarded entities include qualified REIT subsidiaries (within the meaning of §856(i)(2)), qualified subchapter S subsidiaries (within the meaning of §1361(b)(3)(B)), and business entities that have only one owner and do not elect to be classified as corporations. The term "blanket lien" means any mortgage or trust deed that is recorded against the Property as a whole.

SECTION 5. INFORMATION TO BE SUBMITTED

.01 Section 8 of Rev. Proc. 2002-1 outlines general requirements concerning the information to be submitted as part of a ruling request, including advance rulings under this revenue procedure. For example, any ruling request must contain a complete statement of all facts relating to the co-ownership, including those relating to promoting, financing, and managing the Property. Among the information to be included are the items of information specified in this revenue procedure; therefore, the ruling request must provide all items of information and conditions specified below and in section 6 of this revenue procedure, or at least account for all of the items. For example, if a co-ownership arrangement has no brokerage agreement permitted in section 6.12 of this revenue procedure, the ruling request should so state. Furthermore, merely submitting documents and supplementary materials required by section 5.02 of this revenue procedure does not satisfy all of the information requirements contained in section 5.02 of this revenue procedure or in section 8 of Rev. Proc. 2002-1; all material facts in the documents submitted must be explained in the ruling request and may not be merely incorporated by reference. All submitted documents and supplementary materials must contain applicable exhibits, attachments, and amendments. The ruling request must identify and explain any information or documents required in section 5 of this revenue procedure that are not included and any conditions in section 6 of this revenue procedure that are or are not satisfied.

.02 *Required General Information and Copies of Documents and Supplementary Materials.* Generally the following information and copies of documents and materials must be submitted with the ruling request:

(1) The name, taxpayer identification number, and percentage fractional interest in Property of each co-owner;

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(2) The name, taxpayer identification number, ownership of, and any relationship among, all persons involved in the acquisition, sale, lease and other use of Property, including the sponsor, lessee, manager, and lender;

(3) A full description of the Property;

(4) A representation that each of the co-owners holds title to the Property (including each of multiple parcels of property treated as a single Property under this revenue procedure) as a tenant in common under local law;

(5) All promotional documents relating to the sale of fractional interests in the Property;

(6) All lending agreements relating to the Property;

(7) All agreements among the co-owners relating to the Property;

(8) Any lease agreement relating to the Property;

(9) Any purchase and sale agreement relating to the Property;

(10) Any property management or brokerage agreement relating to the Property; and

(11) Any other agreement relating to the Property not specified in this section, including agreements relating to any debt secured by the Property (such as guarantees or indemnity agreements) and any call and put options relating to the Property.

SECTION 6. CONDITIONS FOR OBTAINING RULINGS

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the conditions described below are satisfied. Nevertheless, where the conditions described below are not satisfied, the Service may consider a request for a ruling under this revenue procedure where the facts and circumstances clearly establish that such a ruling is appropriate.

.01 *Tenancy in Common Ownership.* Each of the co-owners must hold title to the Property (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the Property as a whole may not be held by an entity recognized under local law.

.02 *Number of Co-Owners.* The number of co-owners must be limited to no more than 35 persons. For this purpose, "person" is defined as in §7701(a)(1), except that a husband and wife are treated as a single person and all persons who acquire interests from a co-owner by inheritance are treated as a single person.

.03 *No Treatment of Co-Ownership as an Entity.* The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity). The Service generally will not issue a ruling under this revenue procedure if the co-owners held interests in the Property through a partnership or corporation immediately prior to the formation of the co-ownership.

.04 *Co-Ownership Agreement.* The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition (see section 6.06 of this revenue procedure for conditions relating to restrictions on alienation); or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the Property (see section 6.05 of this revenue procedure for conditions relating to voting).

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

.06 *Restrictions on Alienation.* In general, each co-owner must have the rights to transfer, partition, and encumber the co-owner's undivided interest in the Property without the agreement or approval of any person. However, restrictions on the right to transfer, partition, or encumber interests in the Property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. See section 6.14 of this revenue procedure for restrictions on who may be a lender. Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any co-owner's exercise of the right to transfer the co-ownership interest in the Property. In addition, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition.

.07 *Sharing Proceeds and Liabilities upon Sale of Property.* If the Property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

.08 *Proportionate Sharing of Profits and Losses.* Each co-owner must share in all revenues generated by the Property and all costs associated with the Property in proportion to the co-owner's undivided interest in the Property. Neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.

.09 *Proportionate Sharing of Debt.* The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

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

.11 *No Business Activities.* The co-owners' activities must be limited to those customarily performed in connection with the maintenance and

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repair of rental real property (customary activities). See Rev. Rul. 75-374, 1975-2 C.B. 261. Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in §511(a)(2) from qualifying as rent under §512(b)(3)(A) and the regulations thereunder. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the Property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the Property will be taken into account in determining whether the co-owners' activities are customary activities. However, activities of a co-owner or a related person with respect to the Property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the Property for less than 6 months.

.12 *Management and Brokerage Agreements.* The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. The management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the Property against any revenues before disbursing each co-owner's share of net revenues. In all events, however, the manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the Property. In addition, the management agreement may authorize the manager to obtain or modify insurance on the Property, and to negotiate modifications of the terms of any lease or any indebtedness encumbering the Property, subject to the approval of the co-owners. (See section 6.05 of this revenue procedure for conditions relating to the approval of lease and debt modifications.) The determination of any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived by any person from the Property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

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

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

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

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2000-46 is superseded. Rev. Proc. 2002-3 is modified by removing sections 5.03 and 5.06.

SECTION 7. DRAFTING INFORMATION

The principal authors of this revenue procedure are Jeanne Sullivan and Deane Burke of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Ms. Sullivan or Mr. Burke at (202) 622-3070 (not a toll-free call).

REVENUE PROCEDURE 2005-14

Guidance on the Correlation between Section 121 and Section 1031

SECTION 1. PURPOSE

This revenue procedure provides guidance on the application of §§121 and 1031 of the Internal Revenue Code to a single exchange of property.

SECTION 2. BACKGROUND

.01 Section 121(a) provides that a taxpayer may exclude gain realized on the sale or exchange of property if the property was owned and used as the taxpayer's principal residence for at least 2 years during the 5-year period ending on the date of the sale or exchange. Section 121(b) provides generally that the amount of the exclusion is limited to $250,000 ($500,000 for certain joint returns). Under §121(d)(6), any gain attributable to depreciation adjustments (as defined in §1250(b)(3)) for periods after May 6, 1997, is not eligible for the exclusion. This limitation applies only to depreciation allocable to the portion of the property to which the §121 exclusion applies. See §121–1(d)(1).

.02 Section 121(d), as amended by §840 of the American Jobs Creation Act of 2004, Pub. L. 108–357, provides that, if a taxpayer acquired property in an exchange to which §1031 applied, the §121 exclusion will not apply if the sale or exchange of the property occurs during the 5-year period beginning on the date of the acquisition of the property. This provision is effective for sales or exchanges after October 22, 2004.

.03 Under §1.121–1(e) of the Income Tax Regulations, a taxpayer who uses a portion of a property for residential purposes and a portion of the property for business purposes is treated as using the entire property as the taxpayer's principal residence for purposes of satisfying the 2-year use requirement if the residential and business portions of the property are within the same dwelling unit. The term "dwelling unit" has the same meaning as in §280A(f)(1), but does not include appurtenant structures or other property. If, however, the business portion of the property is separate from the dwelling unit used for residential purposes, the gain allocable to the business portion of the property is not excludable unless the taxpayer has also met the 2-year use requirement for the business portion of the property.

.04 Section 1.121–1(e)(3) provides that, for purposes of determining the amount of gain allocable to the residential and business portions of the property, the taxpayer must allocate the basis and the amount realized using the same method of allocation the taxpayer used to determine depreciation adjustments (as defined in §1250(b)(3)). Allocation based on the square footage of the residential and business portions of the property is an appropriate method

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of allocating the basis and the amount realized. *Poague v. United States,* 66 A.F.T.R.2d (RIA) 5825 (E.D. Va. 1990), *aff'd,* 947 F.2d 942 (4th Cir. 1991).

.05 Section 1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment (relinquished property) if the property is exchanged solely for property of like kind (replacement property) that is to be held either for productive use in a trade or business or for investment. Under §1031(b), if a taxpayer also receives cash or property that is not like-kind property (boot) in an exchange that otherwise qualifies under §1031(a), the taxpayer must recognize gain to the extent of the boot. Section 1031 does not apply to property that is used solely as a personal residence.

.06 Section 1012 provides that the basis of property is its cost. The basis of property acquired in an exchange is its fair market value, unless otherwise provided in the Code or regulations (for example, §1031(d)). See *Philadelphia Park Amusement Co. v. United States,* 126 F. Supp. 184 (Ct. Cl. 1954).

.07 Under §1031(d), the basis of the replacement property is the same as the basis of the relinquished property, decreased by the amount of cash received and increased by the amount of gain recognized by the taxpayer in the exchange.

.08 Neither §121 nor §1031 addresses the application of both provisions to a single exchange of property. Section 121(d)(5)(B), however, provides rules for applying §121 and another nonrecognition provision, §1033, to a single replacement of property. Under §1033, in general, gain is recognized only to the extent the amount realized from a compulsory or involuntary conversion of property exceeds the cost of qualifying replacement property, and the basis of the replacement property is its cost reduced by the amount of the gain not recognized.

.09 Section 121(d)(5)(B) provides that, in applying §1033, the amount realized from the sale or exchange of property is treated as the amount determined without regard to §121, reduced by the amount of gain excluded under §121. Under §121(d)(5)(B), the amount realized from an exchange of a taxpayer's principal residence for purposes of applying §1033 is the fair market value of the relinquished property reduced by the amount of the gain excluded from gross income under §121. Thus, Congress concluded that for exchanges meeting the requirements of both §121 and §1033, (1) the §121 exclusion should be applied to gain from the exchange before the application of §1033, (2) for purposes of determining gain that may be deferred under §1033, the §121 exclusion should be applied first against amounts received by the taxpayer that are not reinvested in the replacement property (amounts equivalent to boot that would result in gain recognition absent the application of §121), and (3) the gain excluded under §121 should be added in the calculation of the taxpayer's basis in the replacement property. See S. Rep. No. 830, 88th Cong., 2d Sess. 52–53, 1964–1 C.B. (Part 2) 505, 556–7 ("the basis of the taxpayer in the newly acquired residence will be his basis for the old residence increased by any exclusion of gain obtained by him under the provision which is rein-vested in the new residence"); H.R. Rep. No. 749, 88th Cong., 1st Sess. 47, 1964–1 C.B. (Part 2) 125, 171.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers who exchange property that satisfies the requirements for both the exclusion of gain from the exchange of a principal residence under §121 and the nonrecognition of gain on the exchange of like-kind properties under §1031. Thus, this revenue procedure applies only to taxpayers who satisfy the held for productive use in a trade or business or for investment requirement of §1031(a)(1) with respect to the relinquished business property and the replacement business property (as defined below).

SECTION 4. APPLICATION

.01 *In general.* Taxpayers within the scope of this revenue procedure may apply both the exclusion of gain from the exchange of a principal residence under §121 and the nonrecognition of gain from the exchange of like-kind properties under §1031 to an exchange of property by applying the procedures set forth in this section 4.

.02 *Computation of gain.*

(1) *Application of §121 before §1031.* Section 121 must be applied to gain realized before applying §1031.

(2) *Application of §1031 to gain attributable to depreciation.* Under §121(d)(6), the §121 exclusion does not apply to gain attributable to depreciation deductions for periods after May 6, 1997, claimed with respect to the business or investment portion of a residence. However, §1031 may apply to such gain.

(3) *Treatment of boot.* In applying §1031, cash or other non-like kind property (boot) received in exchange for property used in the taxpayer's trade or business or held for investment (the relinquished business property), is taken into account only to the extent the boot exceeds the gain excluded under §121 with respect to the relinquished business property.

.03 *Computation of basis.* In determining the basis of the property received in the exchange to be used in the taxpayer's trade or business or held for investment (the replacement business property), any gain excluded under §121 is treated as gain recognized by the taxpayer. Thus, under §1031(d), the basis of the replacement business property is increased by any gain attributable to the relinquished business property that is excluded under §121.

SECTION 5. EXAMPLES

In each example below, the taxpayer is an unmarried individual and the property or a portion of the property has been used in the taxpayer's trade or business or held for investment within the meaning of §1031(a) as well as used as a principal residence as required under §121.

Example 1. (i) Taxpayer A buys a house for $210,000 that A uses as A's principal residence from 2000 to 2004. From 2004 until 2006, A rents the house to tenants and claims depreciation deductions of $20,000. In 2006, A exchanges the house for $10,000 of cash and a townhouse with a fair market value of $460,000 that A intends to rent to tenants. A realizes gain of $280,000 on the exchange.

(ii) A's exchange of a principal residence that A rents for less than 3 years for a townhouse intended for rental and cash satisfies the requirements of both §§121 and 1031. Section 121 does not require the property to be the taxpayer's principal residence on the sale or exchange date. Because A owns and uses the house as A's principal residence for at least 2 years during the 5-year period prior to the exchange, A may exclude gain under §121. Because the house is investment property at the time of the exchange, A may defer gain under §1031.

(iii) Under section 4.02(1) of this revenue procedure, A applies §121 to exclude $250,000 of the $280,000 gain before applying the nonrecognition rules of §1031. A may defer the remaining gain of $30,000, including the $20,000 gain attributable to depreciation, under §1031. See section 4.02(2) of this revenue procedure. Although A receives $10,000 of cash (boot) in the exchange, A is not required to recognize gain because the boot is taken into account for purposes of

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§1031(b) only to the extent the boot exceeds the amount of excluded gain. See section 4.02(3) of this revenue procedure.

These results are illustrated as follows.

(iv) A's basis in the replacement property is $430,000, which is equal to the basis of the relinquished property at the time of the exchange ($190,000) increased by the gain excluded under §121 ($250,000), and reduced by the cash A receives ($10,000)). See section 4.03 of this revenue procedure.

Example 2. (i) Taxpayer B buys a property for $210,000. The property consists of two separate dwelling units (within the meaning of §1.121–1(e)(2)), a house and a guesthouse. From 2001 until 2006, B uses the house as B's principal residence and uses the guesthouse as an office in B's trade or business. Based on the square footage of the respective parts of the property, B allocates 2/3 of the basis of the property to the house and 1/3 to the guesthouse. In 2006, B exchanges the entire property for a residence and a separate property that B intends to use as an office. The total fair market value of B's replacement properties is $360,000. The fair market value of the replacement residence is $240,000 and the fair market value of the replacement business property is $120,000, which is equal to the fair market value of the relinquished business property. From 2001 to 2006, B claims depreciation deductions of $30,000 for the business use. B realizes gain of $180,000 on the exchange.

(ii) Under §121, B may exclude gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000) because B meets the ownership and use requirements for that portion of the property. Because the guesthouse is business property separate from the dwelling unit and B has not met the use requirements for the guesthouse, B may not exclude the gain allocable to the guest-house under §1.121–1(e). However, because the fair market value of the replacement business property is equal to the fair market value of the relinquished business property and B receives no boot, B may defer the remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis, which is 1/3 of $210,000 basis, or $70,000, adjusted by $30,000 depreciation) under §1031.

These results are illustrated as follows:

(iii) Because no portion of the gain attributable to the relinquished business property is excluded under §121 and B receives no boot and recognizes no gain or loss in the exchange, B's basis in the replacement business property is equal to B's basis in the relinquished business property at the time of the exchange ($40,000). B's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000).

Example 3. (i) Taxpayer C buys a property for $210,000. The property consists of a house that constitutes a single dwelling unit under §1.121–1(e)(2). From 2001 until 2006, C uses 2/3 of the house (by square footage) as C's principal residence and uses 1/3 of the house as an office in C's trade or business. In 2006, C exchanges the entire property for a residence and a separate property that C intends to use as an office in C's trade or business. The total fair market value of C's replacement properties is $360,000. The fair market value of the replacement residence is $240,000 and the fair market value of the replacement business property is $120,000, which is equal to the fair market value of the business portion of the relinquished property. From 2001 to 2006, C claims depreciation deductions of $30,000 for the business use. C realizes gain of $180,000 on the exchange.

(ii) Under §121, C may exclude the gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000) because C meets the ownership and use requirements for that portion of the property.

(iii) The remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis, which is 1/3 of $210,000 basis, or $70,000, adjusted by $30,000 depreciation) is allocable to the business portion of the house (the office). Under section 4.02(1) of this revenue procedure, C applies §121 before applying the nonrecognition rules of §1031. Under §1.121–1(e), C may exclude $50,000 of the gain allocable to the office because the office and residence are part of a single dwelling unit. C may not exclude that portion of the gain ($30,000) attributable to depreciation deductions, but may defer the remaining gain of $30,000 under §1031.

These results are illustrated as follows:

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000). C's basis in the replacement business property is $90,000, which is equal to C's basis in the relinquished business property at the time of the exchange ($40,000), increased by the gain excluded under §121 attributable to the relinquished business property ($50,000). See section 4.03 of this revenue procedure.

Example 4. (i) The facts are the same as in *Example 3* except that C also receives $10,000 of cash in the exchange and the fair market value of the replacement business property is $110,000, which is $10,000 less than the fair market value of the business portion of the relinquished property ($120,000).

(ii) Under §121, C may exclude the gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000).

(iii) The remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. Under section 4.02(1) of this revenue procedure, C applies §121 to exclude gain before applying the nonrecognition rules of §1031. Under §1.121–1(e), C may exclude $50,000 of the gain allocable to the business portion of the house but may not exclude the $30,000 of gain attributable to depreciation deductions. Under section 4.02(2) of this revenue procedure, C may defer the $30,000 of gain under §1031. Although C receives $10,000 of cash (boot) in the exchange, C is not required to recognize gain because the boot is taken into account for purposes of §1031(b) only to the extent the boot exceeds the amount of excluded gain attributable to the relinquished business property. See 4.02(3) of this revenue procedure.

These results are illustrated as follows:

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000). C's basis in the replacement business property is $80,000, which is equal to C's basis in the relinquished business property ($40,000), increased by the gain excluded under §121 ($50,000), and reduced by the cash ($10,000) received. See section 4.03 of this revenue procedure.

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Example 5. (i) The facts are the same as in *Example 3* except that the total fair market value of the replacement properties is $540,000. The fair market value of the replacement residence is $360,000, the fair market value of the replacement business property is $180,000, and C realizes gain of $360,000 on the exchange.

(ii) Under §121, C may exclude the gain of $220,000 allocable to the residential portion of the house (2/3 of $540,000 amount realized, or $360,000, minus 2/3 of $210,000 basis, or $140,000).

(iii) The remaining gain of $140,000 (1/3 of $540,000 amount realized, or $180,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. Under section 4.02(1) of this revenue procedure, C excludes the gain before applying the nonrecognition rules of §1031. Under §1.121–1(e), C may exclude $30,000 of the gain allocable to the business portion, at which point C will have excluded the maximum limitation amount of $250,000. C may defer the remaining gain of $110,000 ($140,000 realized gain minus the $30,000 gain excluded under §121), including the $30,000 gain attributable to depreciation, under §1031.

These results are illustrated as follows:

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($360,000). C's basis in the replacement business property is $70,000, which is equal to C's basis in the relinquished business property ($40,000), increased by the amount of the gain excluded under §121 ($30,000). See section 4.03 of this revenue procedure.

Example 6. (i) The facts are the same as in *Example 3* except that the total fair market value of the replacement properties is $750,000. The fair market value of the replacement residence is $500,000, the fair market value of the replacement business property is $250,000, and C realizes gain of $570,000 on the exchange.

(ii) The gain allocable to the residential portion is $360,000 (2/3 of $750,000 amount realized, or $500,000, minus 2/3 of $210,000 basis, or $140,000). C may exclude gain of $250,000 from gross income under §121. C must include in income the gain of $110,000 allocable to the residential portion that exceeds the §121(b) exclusion limitation amount.

(iii) The remaining gain of $210,000 (1/3 of $750,000 amount realized, or $250,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. C may defer the $210,000 of gain, including the $30,000 gain attributable to depreciation, under §1031.

These results are illustrated as follows:

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($500,000). C's basis in the replacement business property is $40,000, which is equal to C's basis in the relinquished business property at the time of the exchange.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective January 27, 2005. However, taxpayers may apply this revenue procedure in taxable years for which the period of limitation on refund or credit under §6511 has not expired.

DRAFTING INFORMATION

The principal author of this revenue procedure is Sara Paige Shepherd of the Office of Associate Chief Counsel (In-come Tax & Accounting). For further information regarding this revenue procedure, contact Ms. Shepherd at (202) 622–4960 (not a toll-free call).

REVENUE PROCEDURE 2007-56
(Abridged)

Time Sensitive Acts (Extending Exchange Deadlines)

SECTION 1. PURPOSE AND NATURE OF CHANGES

.01 This revenue procedure provides an updated list of time-sensitive acts, the performance of which may be postponed under sections 7508 and 7508A of the Internal Revenue Code (Code). Section 7508 postpones specified acts for individuals serving in the Armed Forces of the United States or serving in support of such Armed Forces, in a combat zone, or serving with respect to a contingency operation (as defined in 10 U.S.C. § 101(a)(13)). Section 7508A permits a postponement of the time to perform specified acts for taxpayers affected by a Presidentially declared disaster or a terroristic or military action. The list of acts in this revenue procedure supplements the list of postponed acts in section 7508(a)(1) and section 301.7508A–1(c)(1)(vii) of the Procedure and Administration Regulations. Rev. Proc. 2005-27 is superseded.

.02 This revenue procedure does not, by itself, provide any postponements under section 7508A. In order for taxpayers to be entitled to a postponement of any act listed in this revenue procedure, the IRS generally will publish a notice or issue other guidance (including an IRS News Release) providing relief with respect to a Presidentially declared disaster, or a terroristic or military action. See section 4.01 of this revenue procedure.

.03 For purposes of section 7508, this revenue procedure sets forth such other acts as contemplated by section 7508(a)(1)(K). Unlike section 7508A, when a taxpayer qualifies under section 7508, all the acts listed in section 7508(a)(1) are postponed. Therefore, when a taxpayer qualifies under section 7508, the acts listed in this revenue procedure are also postponed for that taxpayer, whether or not the IRS publishes a notice or issues other guidance.

.04 This revenue procedure will be updated as needed when the IRS determines that additional acts should be included in the list of postponed acts or that certain acts should be removed from the list. Also, taxpayers may recommend that additional acts be considered for postponement under sections 7508 and 7508A. See section 19 of this revenue procedure.

.05 *Significant Changes.* When a Presidentially declared disaster occurs, the IRS guidance usually postpones the time to perform the acts in section 301.7508A–1(c)(1) as well as this revenue procedure. However, because these acts are only listed in the regulations under the disaster relief provision, when an individual qualifies for relief by virtue of service in a combat zone, the time for performing those acts are not postponed. Thus, to ensure that individuals serving in or serving in support of the Armed Forces in a combat zone or contingency operation receive a postponement of time to perform these acts this revenue procedure now includes these acts.

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Certain acts, such as filing Tax Court petitions in innocent spouse and other nondeficiency cases, and making certain distributions from, contributions to, recharacterizations of, and certain transactions involving qualified retirement plans (as defined in section 4974(c)), have been added to this revenue procedure even though they are also listed as acts postponed under section 301.7508A–1(c)(1).

SECTION 2. BACKGROUND

.01 Section 7508(a)(1) of the Code permits a postponement of certain time-sensitive acts for individuals serving in the Armed Forces of the United States or serving in support of such Armed Forces in an area designated by the President as a combat zone under section 112(c)(2) or serving with respect to a contingency operation (as defined in 10 U.S.C. § 101(a)(13)). Among these acts are the filing of certain returns, the payment of certain taxes, the filing of a Tax Court petition for redetermination of a deficiency, and the filing of a refund claim. In the event of service in a combat zone or service with respect to a contingency operation, the acts specified in section 7508(a)(1) are automatically postponed. This revenue procedure sets forth such other acts as contemplated by section 7508(a)(1)(K). Thus, the acts listed in this revenue procedure are also automatically postponed. In addition, the Service may include acts not listed in this revenue procedure in any other published guidance (including an IRS News Release) related to the combat zone or contingency operation.

.02 Section 7508A provides that certain acts performed by taxpayers and the government may be postponed if the taxpayer is affected by a Presidentially declared disaster or a terroristic or military action. A "Presidentially declared disaster" is defined in section 1033(h)(3). A "terroristic or military action" is defined in section 692(c)(2). Section 301.7508A–1(d)(1) defines seven types of affected taxpayers, including any individual whose principal residence (for purposes of section 1033(h)(4)) is located in a "covered dis-aster area" and any business entity or sole proprietor whose principal place of business is located in a "covered disaster area." Postponements under section 7508A are not available simply because a disaster or a terroristic or military action has occurred. Generally, the IRS will publish a notice or issue other guidance (including an IRS News Release) authorizing the postponement. See section 4.01 of this revenue procedure.

SECTION 3. SCOPE

This revenue procedure applies to individuals serving in the Armed Forces of the United States in a combat zone, or serving in support of such Armed Forces, individuals serving with respect to contingency operations, affected taxpayers by reason of Presidentially declared disasters within the meaning of section 301.7508A–1(d)(1), and taxpayers whom the IRS determines are affected by a terroristic or military action. Section 17 of this revenue procedure also applies to transferors who are not affected taxpayers but who are involved in a section 1031 like-kind exchange transaction and are entitled to relief under section 17.02(2) of this revenue procedure.

SECTION 4. APPLICATION

.01 As provided by section 301.7508A–1(e), in the event of a Presidentially declared disaster or terroristic or military action, the IRS will issue a news release or other guidance authorizing the postponement of acts described in this revenue procedure and that will define which taxpayers are considered to be "affected taxpayers" and will describe the acts postponed, the duration of the postponement, and the location of the covered disaster area. See, for example, Notice 2005–73, 2005–2 C.B. 723 (summarizing the relief provided for Hurricane Katrina in news releases IR–2005–84, IR–2005–91, IR–2005–96, and IR–2005–103). The guidance may provide for postponement of only certain acts listed in this revenue procedure based on the time when the disaster occurred, its severity, and other factors. Unless the notice or other guidance for a particular disaster provides that the relief is limited, the guidance will generally postpone all of the acts listed in the regulations and this revenue procedure.

.02 Provisions of the internal revenue laws requiring the timely performance of specified acts that may be postponed under sections 7508 and 7508A are listed in the tables below. In addition, section 17 of this revenue procedure expands the categories of taxpayers qualifying for relief to include transferors of certain property and provides additional postponements of deadlines solely with respect to section 1031 like-kind exchange transactions that are affected by a Presidentially declared disaster. If an IRS News Release or other guidance is issued with respect to a specific Presidentially declared disaster and authorizes postponement of acts in this revenue procedure, affected taxpayers may use the postponement rules provided in section 17 in lieu of section 6. Transferors who are covered by the like-kind exchange rules of section 17, but who are not "affected taxpayers" as defined by the IRS News Release or other guidance or section 301.7508A–1(d)(1) are not eligible for relief under section 7508A or other sections of this revenue procedure.

.03 The following tables may, but do not necessarily, include acts specified in sections 7508 or 7508A and the regulations thereunder. Thus, for example, no mention is made in the following tables of the filing of tax returns or the payment of taxes (or an installment thereof) because these acts are already covered by sections 7508 and 7508A and the applicable regulations. Also, the following tables generally do not refer to the making of elections required to be made on tax returns or attachments thereto. Reference to these elections is not necessary because postponement of the filing of a tax return automatically postpones the making of any election required to be made on the return or an attachment thereto.

This revenue procedure, however, does include acts that are postponed under section 301.7508A–1(c)(1). The regulation lists acts that may be postponed when there has been a Presidentially declared disaster, but does not apply to postpone acts for individuals serving in, or serving in support of, the Armed Forces of the United States in a combat zone or contingency operation. For example, section 301.7508A–1(c)(1)(iii) provides a postponement for certain contributions to, distributions from qualified retirement plans. This revenue procedure also includes these acts to reflect that they are postponed for individuals serving in, or serving in support of, the Armed Forces of the United States in a combat zone or contingency operation.

.04 The following tables refer only to postponement of acts performed by taxpayers. Additional guidance will be published in the Internal Revenue Bulletin if a decision is made that acts performed by the government may be postponed under section 7508A. See, for example, Notice 2005–82, 2005–2 C.B. 978.

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SECTION 6. BUSINESS AND INDIVIDUAL TAX ISSUES

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21. Sec. 1031(a)(3)	In a deferred exchange, property otherwise qualified as like-kind property under section 1031 is treated as like-kind property if the 45-day identification period and the 180-day exchange period requirements under section 1031(a)(3) and section 1.1031(k)–1(b)(2) are met. See also section 17 of this revenue procedure.
22. Sec. 1031	Property held in a qualified exchange accommodation arrangement may qualify as "replacement property" or "relinquished property" under section 1031 if the requirements of section 4 of Rev. Proc. 2000–37,

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2000–2 C.B. 308, modified by Rev. Proc. 2004–51, 2004–2 C.B. 294, are met, including the 5-business day period to enter into a qualified exchange accommodation agreement (QEAA), the 45-day identification period, the 180-day exchange period, and the 180-day combined time period. See also section 17 of this revenue procedure.

...

SECTION 17. SPECIAL RULES FOR SECTION 1031 LIKE-KIND EXCHANGE TRANSACTIONS

.01 Taxpayers are provided the relief described in this section if an IRS news release or other guidance provides relief for acts listed in this revenue procedure (unless the news release or other guidance specifies otherwise).

.02 (1) The last day of a 45-day identification period set forth in section 1.1031(k)–1(b)(2) of the Income Tax Regulations, the last day of a 180-day exchange period set forth in section 1.1031(k)–1(b)(2), and the last day of a period set forth in section 4.02(3) through (6) of Rev. Proc. 2000–37, modified by Rev. Proc. 2004–51, that fall on or after the date of a Presidentially declared disaster, are postponed by 120 days or to the last day of the general disaster extension period authorized by an IRS News Release or other guidance announcing tax relief for victims of the specific Presidentially declared disaster, whichever is later. However, in no event may a postponement period extend beyond: (a) the due date (including extensions) of the taxpayer's tax return for the year of the transfer (See Treas. Reg. § 1.1031(k)–1(b)(2)); or (b) one year (See IRC § 7508A(a)).

(2) A taxpayer who is a transferor qualifies for a postponement under section 17.01 only if—

(a) The relinquished property was transferred on or before the date of the Presidentially declared disaster, or in a transaction governed by Rev. Proc. 2000–37, modified by Rev. Proc. 2004–51, qualified indicia of ownership were transferred to the exchange accommodation titleholder on or before that date; and

(b) The taxpayer (transferor)—

(i) Is an "affected taxpayer" as defined in the IRS News Release or other guidance announcing tax relief for the victims of the specific Presidentially declared disaster; or

(ii) Has difficulty meeting the 45-day identification or 180-day exchange deadline set forth in section 1.1031(k)–1(b)(2), or a deadline set forth in section 4.02(3) through (6) of Rev. Proc. 2000–37, modified by Rev. Proc. 2004–51, due to the Presidentially declared disaster for the following or similar reasons:

(A) The relinquished property or the replacement property is located in a covered disaster area (as defined in section 301.7508A–1(d)(2)) as provided in the IRS News Release or other guidance (the covered disaster area);

(B) The principal place of business of any party to the transaction (for example, a qualified intermediary, exchange accommodation titleholder, transferee, settlement attorney, lender, financial institution, or a title insurance company) is located in the covered disaster area;

(C) Any party to the transaction (or an employee of such a party who is involved in the section 1031 transaction) is killed, injured, or missing as a result of the Presidentially declared disaster;

(D) A document prepared in connection with the exchange (for example, the agreement between the transferor and the qualified intermediary or the deed to the relinquished property or replacement property) or a relevant land record is destroyed, damaged, or lost as a result of the Presidentially declared disaster;

(E) A lender decides not to fund either permanently or temporarily a real estate closing due to the Presidentially declared disaster or refuses to fund a loan to the taxpayer because flood, disaster, or other hazard insurance is not available due to the Presidentially declared disaster; or

(F) A title insurance company is not able to provide the required title insurance policy necessary to settle or close a real estate transaction due to the Presidentially declared disaster.

.03 The postponement described in this section also applies to the last day of a 45-day identification period described in section 1.1031(k)–1(b)(2) and the last day of a 45-day identification period described in section 4.05(4) of Rev. Proc. 2000–37, modified by Rev. Proc. 2004–51, that falls prior to the date of a Presidentially declared disaster if an identified replacement property (in the case of an exchange described in section 1.1031(k)–1), or an identified relinquished property (in the case of an exchange described in Rev. Proc. 2000–37, modified by Rev. Proc. 2004–51) is substantially damaged by the Presidentially declared disaster.

.04 If the taxpayer (transferor) qualifies for relief under this section for any reason other than section 17.02(2)(b)(i), then such taxpayer is not considered an affected taxpayer for purposes of any other act listed in this revenue procedure or for any acts listed in an IRS News Release or other published guidance related to the specific Presidentially declared disaster.

SECTION 18. INQUIRIES

If you wish to recommend that other acts qualify for postponement, please write to the Office of Associate Chief Counsel, Procedure and Administration CC:PA:B7, 1111 Constitution Avenue, NW, Washington, DC 20224. Please mark "7508A List" on the envelope. In the alternative, e-mail your comments to: *Notice.Comments@irscounsel.treas.gov,* and refer to Rev. Proc. 2005–27 in the Subject heading.

SECTION 19. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 2005–27, 2005–1 C.B. 1050, is superseded.

SECTION 20. EFFECTIVE DATE

This revenue procedure is effective for acts that may be performed or disasters which occur on or after August 20, 2007.

SECTION 21. DRAFTING INFORMATION

The principal author of this revenue procedure is Melissa Quale in Branch 7, of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding section 1031 like-kind exchange postponements under section 17 of this revenue procedure, contact Peter J. Baumgarten or Michael F. Schmit of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622–4920 (not a toll-free call) or (202) 622–4960 (not a toll-free call), respectively. For further information regarding other sections of this revenue procedure, contact Ms. Quale at (202) 622–4570 (not a toll-free call).

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REVENUE RULING 2002-83

Related Party Exchanges

ISSUE

Under the facts described below, is a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party entitled to nonrecognition treatment under §1031(a) of the Internal Revenue Code if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property?

FACTS

Individual A owns real property (Property 1) with a fair market value of $150x and an adjusted basis of $50x. Individual B owns real property (Property 2) with a fair market value of $150x and an adjusted basis of $150x. Both Property 1 and Property 2 are held for investment within the meaning of §1031(a). A and B are related persons within the meaning of §267(b).

C, an individual unrelated to A and B, wishes to acquire Property 1 from A. A enters into an agreement for the transfers of Property 1 and Property 2 with B, C, and a qualified intermediary (QI). QI is unrelated to A and B.

Pursuant to their agreement, on January 6, 2003, A transfers Property 1 to QI and QI transfers Property 1 to C for $150x. On January 13, 2003, QI acquires Property 2 from B, pays B the $150x sale proceeds from QI's sale of Property 1, and transfers Property 2 to A.

LAW AND ANALYSIS

Section 1031(a)(1) 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 the property is exchanged solely for property of a like kind that is to be held either for productive use in a trade or business or for investment. Under §1031(d), the basis of property acquired in a §1031 exchange is the same as the basis of the property exchanged, decreased by any money the taxpayer receives and increased by any gain the taxpayer recognizes.

Section 1031 and the regulations thereunder allow for deferred exchanges of property. Under §1031(a)(3) and §1.1031(k)-1(b) of the Income Tax Regulations, however, the property to be received by a taxpayer in the exchange (replacement property) must be: (i) identified within 45 days of the transfer of the property relinquished in the exchange (relinquished property) and (ii) received by the earlier of 180 days after the transfer of the relinquished property or the due date (including extensions) of the transferor's tax return for the taxable year in which the relinquished property is transferred.

Section 1.1031(k)-1(g)(4) allows taxpayers to use a qualified intermediary to facilitate a like-kind exchange. In the case of a transfer of relinquished property involving a qualified intermediary, the taxpayer's transfer of relinquished property to a qualified intermediary and subsequent receipt of like-kind replacement property from the qualified intermediary is treated as an exchange with the qualified intermediary.

Section 1031(f) provides special rules for property exchanges between related parties. Under §1031(f)(1), a taxpayer exchanging like-kind property with a related person cannot use the nonrecognition provisions of §1031 if, within 2 years of the date of the last transfer, either the related person disposes of the relinquished property or the taxpayer disposes of the replacement property. The taxpayer takes any gain or loss into account in the taxable year in which the disposition occurs. For purposes of §1031(f), the term "related person" means any person bearing a relationship to the taxpayer described in §267(b) or 707(b)(1).

Section 1031(f) is intended to deny nonrecognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. The legislative history underlying §1031(f) states that "if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment, and the original exchange should not be accorded nonrecognition treatment." H.R. Rep. No. 247, 101/ Cong. 1/ Sess. 1340 (1989).

To prevent related parties from circumventing the rules of §1031(f)(1), §1031(f)(4) provides that the nonrecognition provisions of §1031 do not apply to any exchange that is part of a transaction (or a series of transactions) structured to avoid the purposes of §1031(f)(1). The legislative history underlying §1031(f)(4) provides:

> If a taxpayer, pursuant to a pre-arranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031. *Id.* at 1341.

Accordingly, under §1031(f)(4), if an unrelated third party is used to circumvent the purposes of the related party rule in §1031(f), the nonrecognition provisions of §1031 do not apply to the transaction.

In the present case, A is using QI to circumvent the purposes of §1031(f) in the same way that the unrelated party was used to circumvent the purposes of §1031(f) in the legislative history example. Absent §1031(f)(1), A could have engaged in a like-kind exchange of Property 1 for Property 2 with B, and B could have sold Property 1 to C. Under §1031(f)(1), however, the non-recognition provisions of §1031(a) do not apply to that exchange because A and B are related parties and B sells the replacement property within 2 years of the exchange.

Accordingly, to avoid the application of §1031(f)(1), A transfers low-basis Property 1 to QI who sells it to C for cash. QI acquires the high-basis replacement property from B and pays B the cash received from C. Thus, A engages in a like-kind exchange with QI, an unrelated third party, instead of B. However, the end result of the transaction is the same as if A had exchanged property with B followed by a sale from B to C. This series of transactions allows A to effectively cash out of the investment in Property 1 without the recognition of gain.

A's exchange of property with QI, therefore, is part of a transaction structured to avoid the purposes of §1031(f) and, under §1031(f)(4), the nonrecognition provisions of §1031 do not apply to the exchange between A and QI. A's exchange of Property 1 for Property 2 is treated as a taxable transaction. Under §1001(a), A has gain of $100x, the difference between A's amount realized on the exchange ($150x, the fair market value of Property 2) and A's adjusted basis in the property exchanged ($50x).

HOLDING

Under the facts described above, a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under §1031(a) of the Internal Revenue Code if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property.

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DRAFTING INFORMATION

The principal author of this revenue ruling is Martin Scully, Jr., of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Scully at (202) 622-4960 (not a toll-free call).

REVENUE RULING 2004-86

Delaware Statutory Trusts and Fractional Interest Ownership

ISSUE(S)

(1) In the situation described below, how is a Delaware statutory trust, described in Del. Code Ann. title 12, §§3801 - 3824, classified for federal tax purposes?

(2) In the situation described below, may a taxpayer exchange real property for an interest in a Delaware statutory trust without recognition of gain or loss under §1031 of the Internal Revenue Code?

FACTS

On January 1, 2005, *A,* an individual, borrows money from *BK*, a bank, and signs a 10-year note bearing adequate stated interest, within the meaning of §483. On January 1, 2005, *A* uses the proceeds of the loan to purchase Blackacre, rental real property. The note is secured by Blackacre and is nonrecourse to *A*.

Immediately following *A*'s purchase of Blackacre, *A* enters into a net lease with *Z* for a term of 10 years. Under the terms of the lease, *Z* is to pay all taxes, assessments, fees, or other charges imposed on Blackacre by federal, state, or local authorities. In addition, *Z* is to pay all insurance, maintenance, ordinary repairs, and utilities relating to Blackacre. *Z* may sublease Blackacre. *Z*'s rent is a fixed amount that may be adjusted by a formula described in the lease agreement that is based upon a fixed rate or an objective index, such as an escalator clause based upon the Consumer Price Index, but adjustments to the rate or index are not within the control of any of the parties to the lease. *Z*'s rent is not contingent on *Z*'s ability to lease the property or on *Z*'s gross sales or net profits derived from the property.

Also on January 1, 2005, *A* forms *DST,* a Delaware statutory trust described in the Delaware Statutory Trust Act, Del. Code Ann. title 12, §§3801 - 3824, to hold property for investment. *A* contributes Blackacre to *DST*. Upon contribution, *DST* assumes *A*'s rights and obligations under the note with *BK* and the lease with *Z*. In accordance with the terms of the note, neither *DST* nor any of its beneficial owners are personally liable to *BK* on the note, which continues to be secured by Blackacre.

The trust agreement provides that interests in *DST* are freely transferable. However, *DST* interests are not publicly traded on an established securities market. *DST* will terminate on the earlier of 10 years from the date of its creation or the disposition of Blackacre, but will not terminate on the bankruptcy, death, or incapacity of any owner or on the transfer of any right, title, or interest of the owners. The trust agreement further provides that interests in *DST* will be of a single class, representing undivided beneficial interests in the assets of *DST*.

Under the trust agreement, the trustee is authorized to establish a reasonable reserve for expenses associated with holding Blackacre that may be payable out of trust funds. The trustee is required to distribute all available cash less reserves quarterly to each beneficial owner in proportion to their respective interests in *DST*. The trustee is required to invest cash received from Blackacre between each quarterly distribution and all cash held in reserve in short-term obligations of (or guaranteed by) the United States, or any agency or instrumentality thereof, and in certificates of deposit of any bank or trust company having a minimum stated surplus and capital. The trustee is permitted to invest only in obligations maturing prior to the next distribution date and is required to hold such obligations until maturity. In addition to the right to a quarterly distribution of cash, each beneficial owner has the right to an in-kind distribution of its proportionate share of trust property.

The trust agreement provides that the trustee's activities are limited to the collection and distribution of income. The trustee may not exchange Blackacre for other property, purchase assets other than the short-term investments described above, or accept additional contributions of assets (including money) to *DST*. The trustee may not renegotiate the terms of the debt used to acquire Blackacre and may not renegotiate the lease with *Z* or enter into leases with tenants other than *Z,* except in the case of *Z*'s bankruptcy or insolvency. In addition, the trustee may make only minor non-structural modifications to Blackacre, unless otherwise required by law. The trust agreement further provides that the trustee may engage in ministerial activities to the extent required to maintain and operate *DST* under local law.

On January 3, 2005, *B* and *C* exchange Whiteacre and Greenacre, respectively, for all of *A*'s interests in *DST* through a qualified intermediary, within the meaning of §1.1031(k)-1(g). A does not engage in a §1031 exchange. Whiteacre and Greenacre were held for investment and are of like kind to Blackacre, within the meaning of §1031.

Neither *DST* nor its trustee enters into a written agreement with *A, B,* or *C,* creating an agency relationship. In dealings with third parties, neither *DST* nor its trustee is represented as an agent of *A, B,* or *C*.

BK is not related to *A, B, C, DST*'s trustee or *Z* within the meaning of §267(b) or §707(b). *Z* is not related to *B, C,* or *DST*'s trustee within the meaning of §267(b) or §707(b).

LAW

Delaware law provides that a Delaware statutory trust is an unincorporated association recognized as an entity separate from its owners. A Delaware statutory trust is created by executing a governing instrument and filing an executed certificate of trust. Creditors of the beneficial owners of a Delaware statutory trust may not assert claims directly against the property in the trust. A Delaware statutory trust may sue or be sued, and property held in a Delaware statutory trust is subject to attachment or execution as if the trust were a corporation. Beneficial owners of a Delaware statutory trust are entitled to the same limitation on personal liability because of actions of the Delaware statutory trust that is extended to stockholders of Delaware corporations. A Delaware statutory trust may merge or consolidate with or into one or more statutory entities or other business entities.

Section 671 provides that, where the grantor or another person is treated as the owner of any portion of a trust (commonly referred to as a "grantor trust"), there shall be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that the items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 1.671-2(e)(1) of the Income Tax Regulations provides that, for purposes of subchapter J, a grantor includes any person to the extent such person either creates a trust or directly or indirectly makes a gratuitous transfer of property to a trust.

Tax Reference Manual for IRC §1031
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Under §1.671-2(e)(3), the term "grantor" includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in certain investment trusts described in §301.7701-4(c).

Under §677(a), the grantor is treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed, or held or accumulated for future distribution, to the grantor or the grantor's spouse.

A person that is treated as the owner of an undivided fractional interest of a trust under subpart E of part I, subchapter J of the Code (§§671 and following), is considered to own the trust assets attributable to that undivided fractional interest of the trust for federal income tax purposes. See Rev. Rul. 88-103, 1988-2 C.B. 304; Rev. Rul. 85-45, 1985-1 C.B. 183; and Rev. Rul. 85-13, 1985-1 C.B. 184. *See also* §1.1001-2(c), *Example 5.*

Section 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and that is not a corporation or a trust or estate. Under regulations the Secretary may, at the election of all the members of the unincorporated organization, exclude such organization from the application of all or part of subchapter K, if the income of the members of the organization may be adequately determined without the computation of partnership taxable income and the organization is availed of (1) for investment purposes only and not for the active conduct of a business, (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or (3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities.

Section 1.761-2(a)(2) provides the requirements that must be satisfied for participants in the joint purchase, retention, sale, or exchange of investment property to elect to be excluded from the application of the provisions of subchapter K. One of these requirements is that the participants own the property as coowners.

Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.

Section 1031(a)(2) provides that §1031(a) does not apply to any exchange of stocks, bonds or notes, other securities or evidences of indebtedness or interest, interests in a partnership, or certificates of trust or beneficial interests. It further provides that an interest in a partnership that has in effect a valid election under §761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of the partnership and not as an interest in a partnership.

Under Sec. 301.7701-1(a)(1) of the Procedure and Administration Regulations, whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Generally, when participants in a venture form a state law entity and avail themselves of the benefits of that entity for a valid business purpose, such as investment or profit, and not for tax avoidance, the entity will be recognized for federal tax purposes. *See Moline Properties, Inc. v. Comm'r,* 319 U.S. 436 (1943); *Zmuda v. Comm'r,* 731 F.2d 1417 (9th Cir. 1984); *Boca Investerings P'ship v. United States,* 314 F.3d 625 (D.C. Cir. 2003); *Saba P'ship v. Comm'r,* 273 F.3d 1135 (D.C. Cir. 2001); *ASA Investerings P'ship v. Comm'r,* 201 F.3d 505 (D.C. Cir. 2000); *Markosian v. Comm'r,* 73 T.C. 1235 (1980).

Section 301.7701-2(a) defines the term "business entity" as any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under §301.7701-3) that is not properly classified as a trust under §301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more owners is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded.

Section 301.7701-3(a) provides that an eligible entity can elect its classification for federal tax purposes. Under §301.7701-3(b)(1), unless the entity elects otherwise, a domestic eligible entity is a partnership if it has two or more owners or is disregarded as an entity separate from its owner if it has a single owner.

Section 301.7701-4(a) provides that the term "trust" refers to an arrangement created either by will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting and conserving it for the beneficiaries. Usually the beneficiaries of a trust do no more than accept the benefits thereof and are not voluntary planners or creators of the trust arrangement. However, the beneficiaries of a trust may be the persons who create it, and it will be recognized as a trust if it was created for the purpose of protecting and conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them.

Section 301.7701-4(b) provides that there are other arrangements known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but that are not classified as trusts for federal tax purposes because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business that normally would have been carried on through business organizations that are classified as corporations or partnerships.

Section 301.7701-4(c)(1) provides that an "investment" trust will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. *See Comm'r v. North American Bond Trust,* 122 F.2d 545 (2d Cir. 1941), *cert. denied,* 314 U.S. 701 (1942). An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power to vary the investment of the certificate holders.

A power to vary the investment of the certificate holders exists where there is a managerial power, under the trust instrument, that enables a trust to take advantage of variations in the market to improve the investment of the investors. *See Comm'r v. North American Bond Trust,* 122 F.2d at 546.

Rev. Rul. 75-192, 1975-1 C.B. 384, discusses the situation where a provision in the trust agreement requires the trustee to invest cash on hand between the quarterly distribution dates. The trustee is required to invest the money in short-term obligations of (or guaranteed by) the United States, or any agency or instrumentality thereof, and in certificates of deposit of any bank or trust company having a minimum stated surplus and capital. The trustee is permitted to invest only in obligations maturing prior to the next distribution date and is required to hold such obligations until maturity. Rev. Rul. 75- 192 concludes that, because the restrictions on the types of permitted investments limit the trustee to a fixed return similar to that earned on a bank account and eliminate any opportunity to profit from market fluctuations, the power to invest in the specified kinds of short-term investments is not a power to vary the trust's investment.

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Rev. Rul. 78-371, 1978-2 C.B. 344, concludes that a trust established by the heirs of a number of contiguous parcels of real estate is an association taxable as a corporation for federal tax purposes where the trustees have the power to purchase and sell contiguous or adjacent real estate, accept or retain contributions of contiguous or adjacent real estate, raze or erect any building or structure, make any improvements to the land originally contributed, borrow money, and mortgage or lease the property. *Compare* Rev. Rul. 79-77, 1979-1 C.B. 448 (concluding that a trust formed by three parties to hold a single parcel of real estate is classified as a trust for federal income tax purposes when the trustee has limited powers that do not evidence an intent to carry on a profit making business).

Rev. Rul. 92-105, 1992-2 C.B. 204, addresses the transfer of a taxpayer's interest in an Illinois land trust under §1031. Under the facts of the ruling, a single taxpayer created an Illinois land trust and named a domestic corporation as trustee. Under the deed of trust, the taxpayer transferred legal and equitable title to real property to the trust, subject to the provisions of an accompanying land trust agreement. The land trust agreement provided that the taxpayer retained exclusive control of the management, operation, renting, and selling of the real property, together with an exclusive right to the earnings and proceeds from the real property. Under the agreement, the taxpayer was required to file all tax returns, pay all taxes, and satisfy any other liabilities with respect to the real property. Rev. Rul 92-105 concludes that, because the trustee's only responsibility was to hold and transfer title at the direction of the taxpayer, a trust, as defined in §301.7701-4(a), was not established. Moreover, there were no other arrangements between the taxpayer and the trustee (or between the taxpayer and any other person) that would cause the overall arrangement to be classified as a partnership (or any other type of entity). Instead, the trustee was a mere agent for the holding and transfer of title to real property, and the taxpayer retained direct ownership of the real property for federal income tax purposes.

ANALYSIS

Under Delaware law, *DST* is an entity that is recognized as separate from its owners. Creditors of the beneficial owners of *DST* may not assert claims directly against Blackacre. *DST* may sue or be sued, and the property of *DST* is subject to attachment and execution as if it were a corporation. The beneficial owners of *DST* are entitled to the same limitation on personal liability because of actions of *DST* that is extended to stockholders of Delaware corporations. *DST* may merge or consolidate with or into one or more statutory entities or other business entities. *DST* is formed for investment purposes. Thus, *DST* is an entity for federal tax purposes.

Whether *DST* or its trustee is an agent of *DST*'s beneficial owners depends upon the arrangement between the parties. The beneficiaries of *DST* do not enter into an agency agreement with *DST* or its trustee. Further, neither *DST* nor its trustee acts as an agent for *A, B,* or *C* in dealings with third parties. Thus, neither *DST* nor its trustee is the agent of *DST*'s beneficial owners. *Cf. Comm'r v. Bollinger,* 485 U.S. 340 (1988).

This situation is distinguishable from Rev. Rul. 92-105. First, in Rev. Rul. 92-105, the beneficiary retained the direct obligation to pay liabilities and taxes relating to the property. *DST,* in contrast, assumed *A*'s obligations on the lease with *Z* and on the loan with *BK,* and Delaware law provides the beneficial owners of *DST* with the same limitation on personal liability extended to shareholders of Delaware corporations. Second, unlike *A,* the beneficiary in Rev. Rul. 92-105 retained the right to manage and control the trust property.

Issue 1. Classification of Delaware Statutory Trust

Because *DST* is an entity separate from its owner, *DST* is either a trust or a business entity for federal tax purposes. To determine whether *DST* is a trust or a business entity for federal tax purposes, it is necessary, under §301.7701-4(c)(1), to determine whether there is a power under the trust agreement to vary the investment of the certificate holders.

Prior to, but on the same date as, the transfer of Blackacre to *DST, A* entered into a 10-year nonrecourse loan secured by Blackacre. A also entered into the 10-year net lease agreement with *Z. A*'s rights and obligations under the loan and lease were assumed by *DST*. Because the duration of *DST* is 10 years (unless Blackacre is disposed of prior to that time), the financing and leasing arrangements related to Blackacre that were made prior to the inception of *DST* are fixed for the entire life of *DST*. Further, the trustee may only invest in short-term obligations that mature prior to the next distribution date and is required to hold these obligations until maturity. Because the trust agreement requires that any cash from Blackacre, and any cash earned on short-term obligations held by *DST* between distribution dates, be distributed quarterly, and because the disposition of Blackacre results in the termination of *DST*, no reinvestment of such monies is possible.

The trust agreement provides that the trustee's activities are limited to the collection and distribution of income. The trustee may not exchange Blackacre for other property, purchase assets other than the short-term investments described above, or accept additional contributions of assets (including money) to *DST*. The trustee may not renegotiate the terms of the debt used to acquire Blackacre and may not renegotiate the lease with *Z* or enter into leases with tenants other than *Z,* except in the case of *Z*'s bankruptcy or insolvency. In addition, the trustee may make only minor nonstructural modifications to Blackacre, unless otherwise required by law.

This situation is distinguishable from Rev. Rul. 78-371, because *DST*'s trustee has none of the powers described in Rev. Rul. 78-371, which evidence an intent to carry on a profit making business. Because all of the interests in *DST* are of a single class representing undivided beneficial interests in the assets of *DST* and *DST*'s trustee has no power to vary the investment of the certificate holders to benefit from variations in the market, *DST* is an investment trust that will be classified as a trust under §301.7701-4(c)(1).

Issue 2. Exchange of Real Property for Interests under §1031

B and *C* are treated as grantors of the trust under §1.671-2(e)(3) when they acquire their interests in the trust from *A*. Because they have the right to distributions of all trust income attributable to their undivided fractional interests in the trust, *B* and *C* are each treated, by reason of §677, as the owner of an *aliquot* portion of the trust and all income, deductions, and credits attributable to that portion are includible by *B* and *C* under §671 in computing their taxable income. Because the owner of an undivided fractional interest of a trust is considered to own the trust assets attributable to that interest for federal income tax purposes, *B* and *C* are each considered to own an undivided fractional interest in Blackacre for federal income tax purposes. See Rev. Rul. 85-13.

Accordingly, the exchange of real property by *B* and *C* for an interest in *DST* through a qualified intermediary is the exchange of real property for an interest in Blackacre, and not the exchange of real property for a certificate of trust or beneficial interest under §1031(a)(2)(E). Because Whiteacre and Greenacre are of like kind to Blackacre, and provided the other requirements of §1031 are satisfied, the exchange of real property for an interest in *DST* by *B* and *C* will qualify for nonrecognition of gain or loss under §1031. Moreover, because *DST* is a grantor trust, the outcome to the parties will remain the same, even if *A* transfers interests in Blackacre directly to *B* and *C,* and *B* and *C* immediately form *DST* by contributing their interests in Blackacre.

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Under the facts of this case, if *DST*'s trustee has additional powers under the trust agreement such as the power to do one or more of the following: (i) dispose of Blackacre and acquire new property; (ii) renegotiate the lease with *Z* or enter into leases with tenants other than *Z;* (iii) renegotiate or refinance the obligation used to purchase Blackacre; (iv) invest cash received to profit from market fluctuations; or (v) make more than minor non-structural modifications to Blackacre not required by law, *DST* will be a business entity which, if it has two or more owners, will be classified as a partnership for federal tax purposes, unless it is treated as a corporation under §7704 or elects to be classified as a corporation under §301.7701-3. In addition, because the assets of *DST* will not be owned by the beneficiaries as coowners under state law, *DST* will not be able to elect to be excluded from the application of subchapter K. *See* §1.761-2(a)(2)(i).

HOLDINGS

(1) The Delaware statutory trust described above is an investment trust, under §301.7701-4(c), that will be classified as a trust for federal tax purposes.

(2) A taxpayer may exchange real property for an interest in the Delaware statutory trust described above without recognition of gain or loss under §1031, if the other requirements of §1031 are satisfied.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 78-371 and Rev. Rul. 92-105 are distinguished.

DRAFTING INFORMATION

The principal author of this revenue ruling is Christopher L. Trump of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Christopher L. Trump at (202) 622-3070 (not a toll-free call).

Rev. Rul. 2004-86, 2004-33 I.R.B. 191

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