SECTION 1031(A) OF THE INTERNAL REVENUE CODE PROVIDES for the non-recognition of gain in like-kind exchanges of commercial property. It is one of the provisions of the Internal Revenue Code most commonly used by taxpayers to defer taxation. Although like-kind exchanges occur regularly, important questions remain involving the application of this provision. Tax practitioners have developed common-sense answers to many of these questions.

Some of the most often raised practical questions concerning the application of section 1031 are:

- How are “reverse exchanges” treated?

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• What is the tax effect if a taxpayer encumbers replacement property immediately after an exchange?
• What are the tax consequences if the relinquished property is leveraged immediately before the exchange?
• Do tenancy-in-common interests in real estate qualify for like-kind treatment?
• If the relinquished property is held by a partnership, how can some of the partners receive cash while other partners receive replacement property?
• Can a partnership that engages in an exchange distribute the replacement property to its partners?

STATUTORY AND REGULATORY BACKGROUND • 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 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. See Levine, 567-2nd T.M. (BNA), Taxfree Exchanges Under Section 1031; Terence F. Cuff, Real Estate and the Deferred Exchange Regulations, ALI-ABA Course of Study: Creative Tax Planning for Real Estate Transactions Vol. 2, p. 711 (SC22, 1997); Charles H. Egerton and James B. Sowell, Like Kind-Exchanges of Real Properties, 11 Tax Mgmt. Real Est. J. 189 (1995). Thus, there are four requirements for a tax-free exchange:

An “Exchange” Must Take Place
There must be an “exchange.” The exchange must be of “property” of a type that qualifies under section 1031. Under section 1031(a)(2), the properties involved in a like-kind exchange may not be stock in trade or other property held for sale, stocks, bonds or notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust, or beneficial interests or choses in action.

Property Must Be of Like Kind
The replacement property must be of like kind to the property relinquished. Both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment.

The general rule in section 1031(a) requires that qualifying property must be exchanged solely for other qualifying property. Section 1031(b) provides, however, that if an exchange otherwise would be eligible for tax-free treatment under section 1031(a) but for the receipt of cash or non-qualifying property (boot), then any gain realized on the exchange is recognized to the extent of the boot received. If a loss is realized on a like-kind exchange in which boot is received, the loss is not recognized.

Taxable boot includes relief from liabilities. The Treasury Regulations under section 1031 expressly permit a taxpayer to determine whether liabilities have been relieved using a “netting” concept, under which the taxpayer’s liabilities that are assumed or taken subject to by the other party to the exchange may be offset against liabilities encumbering the replacement property or taken subject to by the taxpayer. Liabilities of the taxpayer encumbering his relinquished property also may be offset by cash given by the taxpayer to the other party. Treas. Reg. §1.1031(d)-2. In contrast, if the taxpayer receives cash or nonqualifying property to compensate for differences in net value as a result of liabilities, the cash or nonqualifying property is taxable boot.

Like-kind exchanges result in tax deferral, not tax elimination. To preserve the deferred gain, section 1031(d) provides that the basis of the replacement property received in a section 1031 exchange is equal to the basis of the property transferred, reduced by any cash received
and any loss recognized and increased by any gain recognized. The basis of property received by a taxpayer in a like-kind exchange also may be increased by any cash paid by the taxpayer. The taxpayer’s holding period for the replacement property will include the period during which the taxpayer held the relinquished property, i.e., the holding periods are tacked together.

Special rules apply if an exchange involves related parties. Under section 1031(f), if a taxpayer obtains non-recognition treatment on an exchange of property with a related person that treatment will be lost if the taxpayer or the related person disposes of either property within two years. For purposes of this rule, sections 267(b) and 707(b) apply to determine if two persons are related.

The two-year period will be suspended under section 1031(g) during any period in which any of the exchanged properties is subject to a put, a call, a short sale, or a transaction with similar effect.

It is fair to say that Congress probably believed initially that like-kind exchanges would apply only to simultaneous transfers between two persons. The law quickly evolved, however, to allow both multiparty exchanges as well as deferred exchanges. In a multiparty exchange, the taxpayer (“X”) holds relinquished property (“P”) that is sold to a buyer (B), and B acquires the property (“R”) desired by X from seller (“S”), who conveys R to X on behalf of B. Although the Internal Revenue Service (“IRS”) initially argued that such three-party exchanges did not satisfy section 1031, after losing in court (Barker v. Comm’r, 74 T.C. 555 (1980)) the IRS eventually capitulated.

A significant outgrowth of the rules permitting multiparty exchanges are the Treasury Regulations allowing deferred exchanges. These exchanges are often referred to as Starker transactions after the Ninth Circuit decision that first blessed such arrangements. In Starker, 602 F.2d 1341 (9th Cir. 1979), the taxpayer transferred property in exchange for a promise by the recipient to convey like-kind property chosen by the taxpayer at a later date.

In response, Congress enacted section 1031(a)(3), which allows the transferor of the relinquished property up to 45 days to identify the replacement property and 180 days to close on the acquisition of the replacement property. The taxpayer may identify any three properties or multiple properties with a fair market value not in excess of 200 percent of the FMV of the relinquished property. Treas. Reg. §1.1031(k)-1(c)(4). Most taxpayers prefer to use the three-property rule because of the certainty it engenders.

Much has been written about the Treasury Regulations that permit taxpayers to engage in deferred like-kind exchanges. Treas. Reg. §1.1031(k)-1. See Adam M. Handler, Final Regs. on Deferred Like-Kind Exchanges Provide Additional Clarification, 75 J. Tax’n 10 (July 1991); Ross Bengal and George A. Dasaro, Deferred Real Estate Exchanges Under Section 1031: New Regulations Create Guidelines for Starker Exchanges, 9 J. Tax’n Inv. 91 (Winter 1992); James A. Fellows and Michael A. Yuhas, Deferred Like-Kind Exchanges: An Analysis of the Final Regulations, 16 Rev. Tax’n Indiv. 124 (Spring 1992). Basically, these Regulations set forth detailed (and generally taxpayer-friendly) guidance concerning how a taxpayer can comply with the deferred-exchange requirements in section 1031(a)(3). Most important, the Treasury Regulations contain safe harbors that taxpayers can use to avoid constructive receipt of the proceeds from the relinquished property. These safe harbors have resulted in the creation of an entire industry—qualified intermediaries and title companies that stand ready, willing, and able to assist taxpayers in completing deferred exchanges that are nontaxable under section 1031.
Although the Treasury Regulations and the courts have resolved many questions under section 1031, several issues still remain.

**REVERSE EXCHANGES** • One of the most common problems encountered by a taxpayer who desires to engage in a section 1031 exchange is the inability to identify and acquire replacement property within the 45-day and 180-day periods provided in section 1031(a)(3). Even more frustrating, however, is when a taxpayer finds the replacement property before the taxpayer has sold the relinquished property. This frequently occurring situation has caused taxpayers to wonder whether they could engage in a “reverse exchange” in which the replacement property is acquired first. There currently is no definitive authority concerning reverse exchanges, although the IRS has issued two private rulings that appear to permit such transactions. Priv. Ltr. Ruls. 98-14-019 (Dec. 23, 1997) and 98-23-045 (Mar. 10, 1998).

The section 1031 Treasury Regulations do not prohibit reverse exchanges, and IRS personnel have stated publicly that, as part of the Treasury Business Plan for 1999, the IRS is currently considering the issuance of guidance that would permit reverse exchanges in limited situations. Comments by Kelly Alton, Special Counsel to the IRS Assistant Chief Counsel (Income Tax and Accounting), at the May Meeting of the ABA Tax Section, to the Committee on Sales, Exchanges and Basis, 5/1/99, in Washington, D.C.

In the absence of guidance, what is a taxpayer to do? In most situations, a taxpayer will want to engage in a “parking” transaction in which the replacement property is acquired by a friendly person (“FP”), who will sell the replacement property to the taxpayer after the taxpayer is able to dispose of the relinquished property. If such a transaction is structured properly, the taxpayer would be able to avail herself of the safe harbor in the section 1031 Regulations in buying the replacement property from the FP when she finally locates a buyer for the relinquished property.

**Appropriate FPs**

The most frequently asked question in parking transactions is who can serve as the FP. The only iron-clad rule in this regard is that the FP cannot be a related person within the meaning of section 1031(f); this bars a family member or a controlled entity from serving. In addition, it generally is recommended that the FP not be a person who easily could be viewed as an agent of the taxpayer, such as the taxpayer’s lawyer or accountant. Instead, the FP should be an unrelated person who has a profit motive in entering into the transaction.

**Financing the FP**

Another frequently asked question is whether the taxpayer can lend the purchase price for the replacement property to the FP. Although there is no guidance on this issue, it does not appear that such a loan will have an adverse effect on the subsequent exchange. A better way to structure such transactions, however, may be to have FP borrow money to acquire the replacement property, with the loan guaranteed by the taxpayer (who also waives any right of subrogation against the FP). If the amount that can be borrowed from an unrelated lender is insufficient to acquire the replacement property, the needed equity could be loaned from the taxpayer to the FP, but given the lack of authority the risks would have to be highlighted to a client.

The question becomes even more difficult if the loan is made on a nonrecourse basis, with the only collateral being the replacement property; needless to say, the FP (no matter how friendly it may be) usually will prefer this approach. Although this transaction probably works as well, a recourse (or limited recourse)