

Safe Harbors

The Treasury Regulations provide clear rules for “typical” deferred exchange transactions and delineate four safe harbor tests. These safe harbors define the edges of the envelope of safety. Transactions structured within the safe harbors will result in a determination that the Taxpayer is not in actual or constructive receipt of money or other property for purposes of the Regulations.

1. Transferee’s exchange obligation secured by a mortgage, a standby letter of credit, or a third party guarantee. Under the first safe harbor, the obligation of the Taxpayer’s purchaser to transfer the Replacement Property to the Taxpayer is permitted to be secured or guaranteed by:

- 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 Code Section 15A.453-1(b)(3)(iii) and which does not allow the Taxpayer to draw on such standby letter of credit except upon a default of the purchaser’s obligation to transfer like-kind Replacement Property; or
- c. A guarantee of a third party.

In practice, this safe harbor is rarely used. This security arrangement can be compared to the unsecured promise that T.J. Starker received from his purchaser, Crown Zellerbach Corporation. Crown agreed to acquire and convey Replacement Property to Starker, that Starker would designate over an agreed upon period of time.

2. Qualified Trust or Qualified Escrow

Under the second safe harbor, the obligation of the Taxpayer’s purchaser to transfer the Replacement Property is permitted to be secured by cash or a cash equivalent if such cash or cash equivalent is held in a qualified trust or a qualified escrow.

A trust or escrow is “qualified” if the trustee or escrowee is not a “disqualified person”, and the Taxpayer’s rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in escrow or trust are limited to certain specified circumstances described in Treas. Reg. § 1.1031(k)-1(g)(6) (also referred to as the “(g)(6)” Restrictions).

3. Qualified Intermediary

Under the third safe harbor, deferred exchanges are permitted to be facilitated by the use of a Qualified Intermediary if the Taxpayer’s rights to receive money or other property are limited to those circumstances described at Treas. Reg. § 1.1031(k)-1(g)(6).

A Qualified Intermediary is a person who is not the Taxpayer or a Disqualified Person and who, for a fee, acts to facilitate a deferred exchange by entering into an agreement with the Taxpayer for the exchange of properties. Pursuant to the agreement, the Qualified Intermediary acquires the Relinquished Property from the Taxpayer, transfers the Relinquished Property to a purchaser, acquires the Replacement Property from a third party seller, and transfers the Replacement Property to the Taxpayer.

The Qualified Intermediary may be deemed to have acquired property even if the Qualified Intermediary never acquires legal title to the property. Consistent with Revenue Ruling 90-34, LR.C. 1990-16 (April 16, 1990), the transfer of property in a deferred exchange that is facilitated by the use of a Qualified Intermediary may occur via a “direct deed” of legal title by the current owner of the property to its ultimate owner.

Acquisition by Qualified Intermediary

A Qualified Intermediary is treated as acquiring and transferring property if the Qualified Intermediary:

- a. Acquires and transfers legal title to that property.
- b. Enters into an agreement with a person other than the Taxpayer for the transfer of the Relinquished Property to that person.
- c. Enters into an agreement with the Owner of Replacement Property for the transfer of that property and, pursuant to that agreement, the Replacement Property is transferred to the Taxpayer.
- d. Accepts the assignment of the rights to an agreement and all parties to the agreement are notified in writing of the assignment on or before the date of the relevant transfer of property.

4. Interest Income

Under the fourth safe harbor, the Taxpayer is permitted to receive interest or a growth factor with respect to the deferred exchange, provided that the Taxpayer’s rights to receive such interest or growth factor are limited to certain specified circumstances. Such interest or growth factor will be treated as interest regardless of whether it is paid in cash or in property (including property of a like-kind).

Restrictions on Safe Harbors—The “(g)(6)” Restrictions

In order for an escrow or trust account to be a “qualified” account for purposes of the Treasury Regulations, and to avoid the issue of constructive receipt of funds by the Taxpayer, the account must contain restrictions on the Taxpayer’s rights to receive the cash. Specifically, the Regulations require that the Taxpayer not have the

right to receive money or other property until:

- a. After the end of the Identification Period, if no Replacement Property is identified, or
- b. After the end of the Identification Period if the Taxpayer has received all of the identified Replacement Property to which the Taxpayer is entitled, or
- c. After the end of the Identification Period if there is an occurrence of a material and substantial contingency that:
 - i. Relates to the exchange,
 - ii. Is provided for in writing, and
 - iii. Is beyond the control of the Taxpayer and of any “Disqualified Person,” other than the person obligated to transfer the Replacement Property to the Taxpayer, or
- d. The end of the 180-day Exchange Period.

Abiding by the (g)(6) restrictions is critical to every properly structured exchange. Advance planning, such as beginning the search for Replacement Property prior to transferring Relinquished Property, can help minimize the likelihood that a Taxpayer’s cash is unavailable for distribution as a result of the (g)(6) restrictions.

Dealing with the Consequences of the “(g)(6)” Restrictions

These restrictions can be frustrating for and seem arbitrary to Taxpayers and their advisors when they find they are unable to acquire an identified property and wish to take the cash out of their exchange account prior to the end of the exchange period. In the spring of 2000, CDEC applied to the IRS for a private ruling [PLR 200027028] in an attempt to clarify the definition of “material and substantial contingency”. In the ruling request, two possible scenarios were set forth:

- a. Taxpayer identifies three replacement properties with the intent of acquiring all three properties. Taxpayer acquires two of the properties but is unable to negotiate the acquisition of the third property, leaving a balance in the exchange account.
- b. Taxpayer identifies one Replacement Property but is unable to reach agreement for the purchase of that property.

Question:

Can the cash be released from the qualified account prior to the end of the Exchange Period?

Question:

Is the Taxpayer’s inability to negotiate the acquisition of Replacement Property a “material and substantial contingency” that relates to the exchange, is provided for in writing, and is beyond the control of the Taxpayer or any Disqualified Person?

The IRS concluded that neither of these scenarios would justify early release of the cash in the exchange account and that the only contingencies that would meet this criteria of the Regulation are:

- a. A government agency’s seizure, requisition, or condemnation of the Replacement Property or a government agency’s failure to approve a request to rezone or approve the transfer of the Replacement Property, or
- a. An act beyond anyone’s control (i.e., destruction of the Replacement Property).

Constructed Property

Real Property or Services?

The transfer of real estate in exchange for “services rendered” in the construction of Replacement Property will not fall within the non-recognition provisions of Code Section 1031.

The Regulations provide special rules for the identification and receipt of Replacement Property where the Replacement Property is not in existence or is being produced or constructed at the time the identification is made.

Constructed property will be treated as identified if a legal description of the land is provided with “as much detail as is practicable” for construction of the improvements.

Any construction that occurs after the Replacement Property is received by the Taxpayer will not be deemed qualifying Replacement Property for purposes of the exchange.

Identification and Receipt Requirements

The Regulations provide that, in the case of a deferred exchange, any Replacement Property received by the Taxpayer will be treated as property which is not of like-kind to the Relinquished Property if:

- a. The Replacement Property is not “identified” before the end of the “Identification Period”, or
- b. The identified Replacement Property is not received before the end of the “exchange period”.

The Identification Period begins on the date the Taxpayer transfers the Relinquished Property and ends 45 days thereafter.

Three Property or 200 Percent Rule

The Taxpayer may identify more than one property as Replacement Property. However, regardless of the number of relinquished properties transferred by the Taxpayer as part of the same deferred exchange, the maximum number of replacement properties that

the Taxpayer may identify is:

- a. Three properties of any fair market value, 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.

With certain exceptions, if, as of the end of the Identification Period, the Taxpayer has identified more properties as replacement properties than is permitted, the Taxpayer is treated as if no Replacement Property had been identified.

Exceptions to Three Property or 200 Percent Rule

Any Replacement Property received by the Taxpayer before the end of the Identification Period does not have to be formally identified as Replacement Property but is included in the three property/200 percent rule calculation.

If the Taxpayer exceeds the three property and 200 percent rule, Replacement Property identified within 45 days and received within the Exchange Period would qualify as like-kind property if the Taxpayer received at least 95 percent of the aggregate FMV of ALL identified properties.

Revocation of Identification

A Replacement Property identification may be revoked at any time prior to the end of the Identification Period. The revocation must be made in a written document that is signed by the Taxpayer and must be hand delivered, sent by certified mail, or faxed before the end of the Identification Period to the person or entity to whom the identification was sent.

Receipt Requirements

The Taxpayer must acquire Replacement Property prior to the end of the Exchange Period. The exchange period begins on the date the Taxpayer transfers the Relinquished Property and ends on the earlier of 180 days thereafter or the due date (including extensions) of the Taxpayer's tax return for the taxable year in which the transfer of the Relinquished Property occurs. Because the timing requirements relating to the identification and exchange periods are statutory, requests for extensions of the identification and exchange periods will not be granted.

Related Party Exchanges

Revenue Ruling 2002-83

As part of the Revenue Reconciliation Act of 1989, Code Section 1031(f)(1) added a required two-year holding period on exchanges between related parties.

The language of the statute at Code Section 1031(f)(2) contains specific exceptions to the two-year holding period, including transfers within the two years as a result of involuntary conversion or death of the Taxpayer or a related party. Additionally, in situations where the Taxpayer can establish that neither the exchange nor the subsequent disposition within the two-year period had, as one of its principal purposes, the avoidance of federal income tax, a disposition before the end of the two-year period will not disqualify the exchange.

There had been much uncertainty on the appropriate application of Code Section 1031(f) to exchanges between related parties where a Taxpayer acquires property from a related party.

In November 2002, the Service published Revenue Ruling 2002-83 in an attempt to clarify its position on the application of Code Section 1031(f)(4) - which provides that the non-recognition rules of Code Section 1031 do not apply to any transaction (or series of transactions) structured to avoid the purposes of the related party rules.

Revenue Ruling 2002-83 addresses the following scenario:

1. Taxpayer sells relinquished property with FMV of \$150 and basis of \$50 to an unrelated third party purchaser.
2. Taxpayer transfers the relinquished property, through a Qualified Intermediary, directly to an unrelated third party purchaser.
3. Taxpayer acquires replacement property with a FMV of \$150 from a related party. The property's basis in the related party's hands is \$150.
4. Related party transfers replacement property, through a Qualified Intermediary, directly to Taxpayer.

The Revenue Ruling concludes that Taxpayer is using the Qualified Intermediary to "circumvent the purposes" of Code Section 1031(f) and that, as provided in Code Section 1031(f)(4), the non-recognition provisions afforded by Code Section 1031 will not apply.

The conclusion of the Revenue Ruling is consistent with TAM 9748006. It appears from the example in the Revenue Ruling, and the facts of the TAM, that Taxpayer never intended to acquire any property other than the related party property.

Excluded Property

Code Section 1031(a)(2) denies non-recognition treatment to the transfer or receipt of any real property held primarily for sale.

General Statutory Requirements

General Statutory Requirements

1. Both the property surrendered, and the property received must be held either for productive use in a trade or business, or for investment.
2. The property surrendered and the property received must be of “like-kind”.
3. The exchange must be a reciprocal transfer of properties, as distinguished from a sale and repurchase.

Business/Investment

Code Section 1031 does not define the terms “productive use in a trade or business” or “for investment.” The Regulations provide that otherwise unproductive property held by a “non-dealer” for future trade or business use or for future appreciation constitutes property held for investment. The relevant qualified use is the use of each property in the Taxpayer’s hands. The use of either property in the hands of the other party to the exchange is irrelevant.

Qualifying property must be used in a trade or business in which the Taxpayer is engaged. The test is applied at the time of the exchange without regard to the Taxpayer’s motive prior to the exchange.

In Private Letter Ruling 8103117, the Service ruled that unimproved real estate qualified for a like-kind exchange where the Taxpayer abandoned its original intention to construct a personal residence on it and thereafter held it only for investment. A minimum amount of incidental personal use by a Taxpayer will not taint otherwise qualifying investment property.

The language of Code Section 1031(a) states that an exchange of like-kind property will qualify, provided the property received is “to be held for” productive use or investment. This language reflects the continuity of ownership concept underlying non-taxable exchanges (Treas. Reg. §1.1002-1 (c)). How long the property received must be held by the Taxpayer is uncertain. Depending on the facts and circumstances, the Service may construe subsequent dispositions, taxable or non-taxable, as evidence that the property was not acquired “to be held” so that the initial sale would be taxable.

Like-Kind Property

Like-kind refers to the nature or character of property, not to its grade or quality. Whether the real estate is improved or unimproved is immaterial. The non-recognition rules of Code Section 1031 concern the dichotomy between real property and personal property, rather than real estate, which has dissimilar locations, characteristics, or profit-producing uses.

Improved real estate may be exchanged for unimproved real estate, and urban real estate may be exchanged for rural real estate. Mineral and non-mineral real property interests are like-kind to each other, provided the mineral interests are considered real property. A leasehold interest with a duration of at least 30 years, including optional renewal periods, is like-kind to a fee interest in property.

The Exchange Requirement

The essence of an exchange is a reciprocal transfer of properties, as distinguished from a sale for cash and re-investment.

The Service initially took the position that the reciprocal transfer of properties must be simultaneous. Under this view, a sale today and receipt of like-kind property in the future would not constitute an exchange.

In **Starker v. U.S., 1975-1 USTC 8443 (D. Oregon 1975)**, the Ninth Circuit Court rejected this position and held that a sale of property today in exchange for a promise to deliver like-kind property in the future was a good exchange. The Tax Reform Act of 1984 attempted to provide more certainty in the area of delayed exchanges.

The Tax Court will likely use the “step transaction doctrine” in its analysis of whether the non-recognition requirements under Code Section 1031 have been satisfied. All the legs of the exchange must constitute an integrated, mutually dependent transaction. The Tax Court will look to interdependence, intent, timing, and commitment of the parties to the exchange.