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Nontaxable, Like-Kind Exchanges
Under
Internal Revenue Code Section 1031

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2006

Nontaxable, Like-Kind Exchanges
Under
Internal Revenue Code Section 1031

by

A.J. Cataldo II, Ph.D., CPA, CMA

With More Than 80 Tables
&
Over 300 Questions and Answers to Reinforce Learning

Preface

I recommend that you print out this book and spend 3-5 hours on each of the 3 courses on 3 separate days. Retain this material in a binder. After completing these courses you should be able to update you knowledge with periodic (every few years or so) Internet or library searches, using "1031" as the key word for your search.

I completed this book in April 2006. This is not an area of tax law that changes frequently. IRS or Treasury Department guidance and professional journal articles become available, every few years, but the basics concepts and mechanics for a successful IRC§1031 exchange is not likely to change. Therefore, by retaining this material and adding articles, as they become available via Internet or library searches, you should be able to maintain a high level of expertise in this area of tax law.

This is not to say that you should handle all components of an IRC§1031 exchange on your own. You should not! The cost of using a qualified intermediary and tax attorney or tax accountant is not prohibitive and you should use them. An IRC§1031 exchange is not a "do-it-yourself" transaction. This book will educate you on these matters.

This book takes the form of 3 courses, at **Introductory**, **Intermediate** and **Advanced** levels. Each course or level contains 6 sections and each section contains 17 to 21 questions, with the correct answer in bold type, to reinforce the learning. Questions and answers are in a smaller font and immediately follow each section where the relevant information required to correctly answer the question is covered.

In a shortened format, this course is being offered for 4 hours of continuing education credits in various states as a distance learning course and for continuing education credit for Realtors®.

Lesson 1 of the **Intermediate** course represents a review of the **Introductory** course. Lessons 1 and 2 of the **Advanced** course represent a review of the **Intermediate** course.

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Introductory Level

LESSON 1

Introduction

Real estate brokers and agents need to have some basic knowledge of the Internal Revenue Code Section (IRC§) 1031 tax-free exchanges. This introductory course is designed to do just that.

Note: This introductory course will provide you with sufficient background to extend your knowledge of IRC§1031 exchanges, using information available, for free, on the Internet. However, when using secondary sources (e.g., websites promoting their services and non-refereed professional journal articles), exercise caution and please be sure to verify via primary sources (e.g., the IRS or Treasury Department Regulations and/or refereed academic or professional journal articles). Many web-based sources provide insufficient detail, potentially leading to misunderstandings.

The intermediate extension of this introductory course focuses, heavily, on more complex computations and more fully-developed fact patterns. The advanced extension of this and the intermediate course focuses, heavily, on conceptual matters (e.g., contemporary and more complex planning opportunities, frequently the result of recent Treasury Department guidance).

Anecdotal Evidence – Contemporary Problems with IRC§1031 Exchanges

In an article by Jen DeGregorio (reporter), published on May 30, 2005 (Real Estate Swaps Are on the Rise, *Daily Record*,

Baltimore, MD), an increase in flawed IRC§1031 exchanges was noted. Some highlights follow:

- ✓ Poor advice is originating from some mortgage brokers
- ✓ The problems tend to focus on the lack of appropriate tax advice
- ✓ Some are not using qualified intermediaries, which are not required to register with the IRS
- ✓ Mistakes in property analysis or paperwork preparation are becoming increasingly common, as new investors are entering the real estate market
- ✓ Many are unsophisticated and are relying on brokers, often familiar with the 45-day and 180-day deadlines, but not with other IRS guidelines
- ✓ Failures tend to concentrate on the East Coast, since these exchanges have been more popular on the West Coast
- ✓ Strict rules apply to IRC§1031 exchanges, which became legal in 1921 and governed by strict rules adopted in 1991
- ✓ Replacement property must be purchased under the same conditions as the relinquished property

1. Some anecdotal evidence that was noted in a mid-2005 article published in the *Daily Record*, suggesting that some IRC§1031 exchanges were failing due to

a. poor advice is originating from some mortgage brokers
b. problems that tend to focus on the lack of appropriate tax advice
c. failures to use qualified intermediaries, which are not required to register with the IRS
d. All of the above

2. Some anecdotal evidence that was noted in a mid-2005 article published in the *Daily Record*, suggesting that some IRC§1031 exchanges were failing due to

a. mistakes in property analysis or paperwork preparation
b. unsophisticated investors, relying on brokers, often familiar with the 45-day and 180-day deadlines, but not with other IRS guidelines
c. lack of familiarity with IRC§1031 exchanges, that tend to concentrate on the East Coast, since these exchanges have, historically, been more popular on the West Coast

d. All of the above

An IRC§1031 exchange is named for (1) the IRC Section it refers to, but is also known as a (2) Starker exchange, (3) tax-free exchange, or (4) like-kind exchange.

3. An IRC§1031 exchange is also known as
a. a Starker exchange
b. a taxable exchange
c. a tax-free exchange
d. a. and c. only

4. An IRC§1031 exchange is referred to in this manner due to
a. the IRC Section that it refers to
b. the Starker family, responsible for the drafting of the legislation, while living at 1031 Main Street in Chicago
c. its tax-free nature
d. its like-kind nature

5. An IRC§1031 exchange is known by all of the below, except
a. a Starker exchange
b. a tax-free exchange
c. a like-kind exchange
d. an exchange for like-kind and tax-free property, held in a Starker Trust

Personal and Professional Advantages to the Professional Realtor®

The Realtor® can benefit for both personal and professional rewards by maintaining a modest level of competence in IRC§1031 exchanges. In an early 2005 article written by Elyse Umlauf-Garneau, published on February 1, 2005 (Use 1031 Exchanges to Close More Deals: Practitioners Capitalize on Tax Code to Capture Lifelong Clients, *Realtor Magazine Online*), benefits from the time spent to acquire some level of expertise in these transaction were listed. Some highlights follow:

- ✓ "investors" tend to think "long-term," so good service tends to equal "clients for life"
- ✓ <u>not</u> knowing the basics of IRC§1031 exchanges may result in a loss of business or clients
- ✓ clients educated about the benefits of IRC§1031 exchanges are able to buy higher priced properties (i.e., leverage)
- ✓ investors may exchange one property for two, resulting in three commissions
- ✓ especially applicable in areas where real estate values have soared, so do not limit yourself to "serial" investors
- ✓ once expertise is achieved, use your knowledge of IRC§1031 exchanges to promote yourself
- ✓ taxpayers buying homes for their college-age children near school are also potential clients
- ✓ may result in access to tenants of income-producing properties – these are future home buyers and potential clients
- ✓ important to admit ignorance and establish relationships with qualified tax advisors
- ✓ establish relationships and work with qualified intermediaries

6. Personal and professional advantages with respect to the acquisition of expertise in IRC§1031 exchanges, benefiting the Realtor®, include:

a. "investors" tend to think "long-term," so good service tends to equal "clients for life"

b. <u>not</u> knowing the basics of IRC§1031 exchanges may result in a loss of business or clients educated about the benefits of IRC§1031 exchanges are able to buy higher priced properties (i.e., leverage)

c. investors may exchange one property for two, resulting in three commissions especially applicable in areas where real estate values have soared, so do not limit yourself to "serial" investors

d. All of the above

7. Personal and professional advantages with respect to the acquisition of expertise in IRC§1031 exchanges, benefiting the Realtor®, include:

a. once expertise is achieved, use your knowledge of IRC§1031 exchanges to promote yourself taxpayers buying homes for their college-age children near school are also potential clients

b. may result in access to tenants of income-producing properties – these are future home buyers and potential clients
c. important to admit ignorance and establish relationships with qualified tax advisors establish relationships and work with qualified intermediaries
d. All of the above.

Relevant Tax Forms and Publications

IRC§1031 tax-free exchanges are reported on (1) Form 8824, but may also involve and require the taxpayer to file a (2) Form 6252, (3) Form 4797, and/or (4) Form 1040, Schedule D (as applicable). The basic instructions for reporting like-kind exchanges, as well as other gains and losses, are contained in Internal Revenue Service (IRS) *Publication 544 – Sales and Other Dispositions of Assets*, available at http://www.irs.gov.

An IRC§1031 tax-free exchange may involve the use of several federal income tax forms, as follows:

- ✓ Form 8824 – Like-Kind Exchanges: Applies to and is required for all like-kind exchanges
- ✓ Form 6252 – Installment Sale Income: Generally, this form only applies when the exchange has a taxable component and involves installments or payments and the results flow into Form 4797 and/or Form 1040, Schedule D
- ✓ Form 4797 – Sale of Business Property: Generally, this form only applies when the exchange has a taxable component and facilitates the allocation of gains into varying classifications (e.g., ordinary income or long-term capital gains)
- ✓ Form 1040, Schedule D – Capital Gains and Losses: Generally, this form only applies when the exchange has a taxable component and facilitates the allocation of gains into varying classifications (e.g., ordinary income or long-term capital gains)

8. IRC§1031 exchanges always requires the taxpayer to file
a. Form 8824

b. Form 6252
c. Form 4797
d. Form 1040, Schedule D

9. The IRC§1031 exchange may or may not require the taxpayer to file
a. Form 6252
b. Form 4797
c. Form 1040, Schedule D
d. All of the above

10. In the case of an IRC§1031 exchange, which federal income tax form is required when the exchange involves an installment sale?
a. Form 8824
b. Form 6252
c. Form 4797
d. Form 1040, Schedule D

What is a Like-Kind or IRC§1031 Exchange?

"Like-Kind" IRC§1031 exchanges provides a tax deferral alternative to those taxpayers who might otherwise be interested in (1) selling one property or piece of real estate, resulting in a taxable gain, and (2) using the proceeds to purchase another property or piece of real estate. The IRC§1031 tax deferred exchange is just that, tax deferred. The "exchange," if structured properly, may be nontaxable and result in the legitimate, complete avoidance or deferral of the gain that would otherwise be realized on a "sale."

The IRC§1031 exchange is not the result of a tax loophole (i.e., error in tax legislation). It is the result of the intentional desire, by Congress, to allow any taxpayer meeting the requirements to sell their property and avoid paying taxes on this (otherwise taxable) gain.

11. The IRC§1031 exchange is
a. the result of a tax loophole
b. the result of an error in tax legislation
c. the result of an intentional desire, by Congress

d. the result of an error made by Congress

The IRC§1031 exchange is, perhaps most accurately viewed as an interest-free loan (i.e., tax deferral) from the IRS. It provides a vehicle where the taxpayer may be able to legitimately increase their wealth through subsequent exchanges, never resulting in a payment of tax on capital gains, but only through proper tax planning.

12. The IRC§1031 exchange may be (accurately) viewed as all of the following, except
a. an interest-free loan from the IRS
b. a tax deferred investment
c. an illegitimate means of committing fraud against the IRS
d. a vehicle through which gains may be deferred, forever, with proper tax planning

As applied to real property, the IRS provides for 4 classifications, as follows:

✓ real property held for use in a trade or business (e.g., rental property)
✓ real property held for investment
✓ real property held for personal use (i.e., personal residence)
✓ real property held primarily for sale (i.e., dealer property or inventory)

The first two classifications of real property qualify for IRC§1031 exchanges and tax deferral. The latter two do not.

13. All of the following would qualify for an IRC§1031 exchanges and tax deferral treatment, except
a. purchase of an owner’s personal residence, for your use as a rental property
b. exchanging raw land for a duplex, to be used as a rental property
c. the sale of your personal residence, in exchange for raw land
d. exchanging two rental units for three rental units

Why Pursue a Like-Kind or IRC§1031 Exchange?

	Option 1 Sale & Purchase	Option 2 Exchange
Sales Price/Fair Market Value	$100,000	na
less: Cost or Adjusted Basis	$ 50,000	na
equals: Taxable Gain	$ 50,000	na
Taxed at 25%:		
Fair Market Value	$100,000	$100,000
less: Tax ($50,000 x 25%)	$ 12,500	$ -0-
equals: Remaining Equity (12.5% equity lost)	$ 87,500	$100,000
Taxed at 15%:		
Fair Market Value	$100,000	$100,000
less: Tax ($50,000 x 15%)	$ 7,500	$ -0-
equals: Remaining Equity (7.5% equity lost)	$ 92,500	$100,000
Taxed at 5%:		
Fair Market Value	$100,000	$100,000
less: Tax ($50,000 x 5%)	$ 2,500	$ -0-
equals: Remaining Equity (2.5% equity lost)	$ 97,500	$100,000

Table 1

Table 1 illustrates the impact of a **sale and purchase** sequence of transactions (option 1) versus a **tax-free exchange** (option 2). This case assumes that a piece of real estate, for example, has a fair market value and/or selling price at $100,000. It further assumes that the property has a cost or adjusted basis of $50,000, resulting in a potential gain of $50,000.

14. The motivation for a taxpayer to seek to replace real property through a like-kind, tax deferred or tax-free exchange (e.g., IRC§1031), as opposed to a (1) sale and (2) purchase, might include

a. The preservation of equity or wealth

b. The reduction of tax, a cash outflow

c. The reduction of real estate sales commissions

d. a. and b., only.

Additional Motivating Factors for Pursuing Like-Kind Exchange Treatment

The deferral of tax available through an IRC§1031 or tax-free exchange is a significant factor in the taxpayer's decision-making process, but it is not the only consideration. Consider the following, additional motivating factors:

- ✓ Exchange for a property of greater value, resulting from and partially or fully financed by tax deferral/savings (i.e., leveraging)
- ✓ Exchange non-revenue-generating property (e.g., raw land) for income-producing property (e.g., residential rental property)
- ✓ Exchange non-depreciable property (e.g., raw land) for income-producing property with improvements that generate depreciation (e.g., rental property)
- ✓ Exchange property in an already fully appreciated area for one in an area where you anticipate appreciation
- ✓ Exchange property in an area where property values are declining and gentrification is not anticipated for one in an area in the early stages of its life-cycle
- ✓ Exchange economically or functionally obsolete property, where repairs and costs of maintenance are increasing, for a newer property

15. In addition to tax deferral, the IRC§1031 exchange may allow the taxpayer to

a. exchange non-revenue-generating property (e.g., raw land) for income-producing property

b. exchange non-depreciable property (e.g., raw land) for income-producing property with improvements that generate depreciation (e.g., rental property)

c. exchange property in an already fully appreciated area for one in an area where you anticipate appreciation

d. All of the above represent motivating factors for a taxpayer to pursue an IRC§1031 exchange

Disadvantages of Like-Kind Exchange Treatment

There are only two disadvantages to the IRC§1031 tax-free exchange:

- ✓ Lower tax basis and, therefore, lower depreciation (i.e., depreciable base)
- ✓ Losses from tax deferred or tax-free exchanges cannot be deducted

The first disadvantage is really not a disadvantage. Generally, this "disadvantage" is comparable to suggesting that "because I did not pay tax today, I cannot take a larger tax deduction and reduce tax tomorrow." The whole idea of tax deferral is to preserve wealth. A basic understanding of time value of money considerations is, typically, sufficient to understand how this so-called "disadvantage" really has no merit. The second disadvantage is, however, a relevant one, though easily avoided. Simply stated, if a loss is anticipated or desirable, do a sale and do not do an exchange.

16. The disadvantages to an IRC§1031 tax-free exchange include

a. the inability of the taxpayer to recognize a tax loss, otherwise available, in the case of a sale
b. the tax deferral resulting from the exchange
c. a lower tax basis for depreciation
d. both a. and c., though c. is debatable, as it suggest some misconception with respect to the notion of tax deferral and time value of money considerations

17. If the taxpayer anticipates that a tax loss will result from an exchange, it is preferable to

a. avoid or violate the conditions required under IRC§1031, so that the exchange will not be tax-free and the loss will be deductible
b. retains the property and transfers it to his or her heirs
c. do the IRC§1031 tax-free exchange anyway
d. converts the property to their personal residence

LESSON 2

The IRC§1031 Tax-Free Exchange is not an "Election"

IRC§1031 is not an elective provision. It is mandatory. If the exchange qualifies as like-kind, non-recognition of gain or loss on the exchange is mandatory. Therefore, if a taxpayer prefers to recognize a loss on an exchange transaction, he or she must structure the transaction to avoid having it qualify as a like-kind exchange.

1. IRC§1031 is
a. elective
b. mandatory
c. elective for gains
d. mandatory for losses

2. If a taxpayer prefers to recognize a loss on an exchange transaction qualifying as a like-kind exchange
a. the taxpayer need not elect IRC§1031
b. the taxpayer must file a form with the IRS to avoid the mandatory imposition of IRC§1031
c. the taxpayer must structure the transaction to avoid having it qualify as a like-kind exchange
d. the taxpayer must carry the loss forward

Applicable Long-Term Capital Gains Tax Rates – 2004 and 2005

Though state tax rates are also likely to apply, typically, at ordinary income tax rates, only federal income tax rates are illustrated in Table 1, at 25 percent (for recapture of IRC§1250 gain), 15 percent (for taxpayers in the 25, 28, 33, and 35 percent tax brackets or marginal federal income tax rates) and 5 percent (for taxpayers in the 5 and 10 percent tax brackets or marginal federal income tax rates). These rates, for the 2004 and 2005 tax and calendar years, are illustrated in Table 2.

2004-2005 Marginal Federal Income Tax Rate or Tax Bracket	**Applicable Long-Term Capital Gains Tax Rate**
5%	5%
10%	5%
25%	15%
28%	15%
33%	15%
35%	15%

Table 2

3. The applicable long-term capital gains tax rate(s) for the 2004 and 2005 calendar and tax years is
a. 5 percent.
b. 15 percent.
c. 5 percent or 15 percent, depending on the taxpayer's marginal federal income tax rate or bracket.
d. 25 percent.

4. The applicable long-term capital gains tax rate(s) for the 2004 and 2005 calendar and tax years for recapture of IRC§1250 gain is
a. 5 percent.
b. 15 percent.
c. 5 percent or 15 percent, depending on the taxpayer's marginal federal income tax rate or bracket.
d. 25 percent.

Qualifying Property

Qualifying property must be held for investment or the production of income in your trade or business and, in a like-kind exchange, both the property given up and the property received must meet these criteria. Property used for personal purposes (e.g., your personal residence, covered by IRC§1034, and already providing for certain tax exclusions under IRC§121) does not qualify. However, this does not prevent the buyer in an exchange

transaction for qualifying this property, if it is, for example, to be used as a residential rental property for the production of income.

5. Property qualifying for a like-kind exchange must be
a. held for investment
b. held for the production of income in your trade or business
c. include your personal residence
d. a. and/or b.

6. If your replacement property is the seller's personal residence
a. the seller will not be eligible for an IRC§1031 exchange
b. you (the buyer) will be eligible for an IRC§1031 exchange, but only if the buyer also intends to use the property as their personal residence
c. the seller will be eligible for IRC§1031 exchange treatment, but only if the buyer's intent is to use the property as a residential rental
d. you (the buyer) should avoid the purchase of this property

Excluded Property

Property excluded, for the purposes of IRC§1031 tax deferral treatment, follow:

- ✓ Property used for personal purposes (e.g., personal automobile or residence)
- ✓ Stocks in trade or other "inventory" held for sale or resale, including short-term real estate holdings by "dealers"
- ✓ Short-term or current assets, including accounts receivable and debt and equity securities
- ✓ Partnership interests, certificates of trust or beneficial interest, and choses in action

The above may, however, qualify for other forms of nontaxable exchanges, outside of IRC§1031.

7. Which of the below qualifies for IRC§1031 tax deferral treatment?
a. Property used for personal purposes (e.g., personal automobile or residence)
b. Stocks in trade or other "inventory" held for sale or resale, including short-term real estate holdings by "dealers"

c. Short-term or current assets, including accounts receivable and debt and equity securities
d. Property used for investment and/or trade or business purposes

8. Which of the below is specifically excluded for IRC§1031 tax deferral treatment?
a. farm property
b. raw land
c. personal use property (e.g., personal residence)
d. residential rental property

Like-Kind Property

Like-Kind properties are those that are the same in *nature* or *character*. They may differ in *grade* or *quality*. Therefore, as applied to real property, the exchange of a city property for a farm property would represent a like-kind exchange. Similarly, the exchange of an improved property for an unimproved property would qualify for and represent a like-kind exchange. Furthermore, the exchange of real estate for a real estate lease than has a life of 30 years or longer is a like-kind exchange. However, some interests in real property do not qualify. For example, the exchange of a life estate of less than 30 years for a remainder interest does not qualify as a like-kind exchange. Alternatively, the exchange of a remainder interest in real estate for a remainder interest in other real estate would qualify as a like-kind exchange if the *nature* or *character* of the two real property interests is the same. Finally, foreign real property (e.g., not located in the United States or the District of Columbia) and real property located within the United States is not considered like-kind property.

9. The following would not be considered like-kind property:
a. city real property for farm real property
b. improved real property for unimproved real property
c. real estate for a 35-year real estate lease
d. foreign real property for real property located within the United States

An exchange does not qualify as like-kind unless belonging to the same class. For example, an exchange of real property for personal property (or visa versa) would not qualify under IRC§1031 and would not be tax-free.

10. The following would <u>not</u> be considered like-kind property:
a. a personal use automobile for a income-producing real property
b. improved real property for unimproved real property
c. real estate for a 35-year real estate lease
d. farm real property for single family residential real property to be used as a rental

Like-Kind Exchanges through Qualified Intermediaries

A *qualified intermediary* (*QI*) is one engaged, with a written agreement, to broker or arrange for the exchange and transfer of the properties. The QI must (1) acquire the relinquished property from the seller, (2) transfer the relinquished property to the buyer, (3) acquire the replacement property for the buyer, and (4) transfer this replacement property to the buyer. Any agreements with qualified intermediaries must expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise benefit from money or other property. It should also be noted that the use of a QI does not, in and of itself, provide a legitimate vehicle for the avoidance of rules concerning "related parties" and related party transactions.

11. A *qualified intermediary* must do all of the following, <u>except</u>
a. acquire the relinquished property from the seller
b. transfer the relinquished property to the buyer
c. acquire the replacement property for the buyer
d. select up to three replacement properties

12. The use of a *qualified intermediary* will <u>not</u>
a. permit the taxpayer to avoid related party rules and restrictions
b. transfer the relinquished property to the buyer
c. acquire the replacement property for the buyer
d. transfer this replacement property to the buyer

Cautionary Note: A simple key word search on the Internet, using "1031," will provide an introduction to a variety of qualified intermediaries (QIs) (e.g., Asset Preservation, Inc. at http://apiexchange.com). Fees for assistance with exchanges are noted at one site (i.e., 1031 Corporation at http://www.1031cpas.com) at $500 for simultaneous exchanges and $300 to $500 for each property (per $1 million of sales price) for delayed exchanges (see below). (Similarly, many articles have been written on this topic and can be accessed using search engines, e.g., Dogpile at http://www.dogpile.com or Google at http://www.google.com). The information contained in these and other "secondary" sources may be incorrect or outdated and, so, should be verified and/or discussed with your tax accountant and/or tax attorney.)

Four Basic Types or Classifications of Exchanges

The four basic types or classifications of exchanges, along with brief definitions, follow:

- ✓ Simultaneous – closing of relinquished and replacement properties occur on the same day
- ✓ Delayed – closing is not simultaneous, but sequential; also known as a "Starker Exchange" (so named after the well known Supreme Court case, ruling in the taxpayer's favor). A delayed exchange results in (1) the sale of the relinquished property, (2) the identification of the appropriate or desired replacement property (within 45 days from closing on the relinquished property), and (3) the purchase of the replacement property, all occurring within the maximum allowable time period of 180 days.
- ✓ Reverse – closing sequence is reversed; the replacement property is identified, purchased and closed before the relinquished property is sold. A form of "Title-Holding" exchange and usually involving an intermediary.

✓ Improvement – closing occurs after improvements are made to the replacement property. A form of "Title-Holding" exchange that may be performed as "Delayed" or "Reverse" exchange.

13. An IRC§1031 tax deferred exchange, where the sale and/or closing takes place only after improvements are made to the replacement property is known as
a. a simultaneous exchange
b. a delayed exchange
c. a reverse exchange
d. an improvement exchange

14. An IRC§1031 tax deferred exchange, where the sales and/or closing on the replacement property occurs prior to the closing of the relinquished property is known as
a. a simultaneous exchange
b. a delayed exchange
c. a reverse exchange
d. an improvement exchange

15. An IRC§1031 tax deferred exchange, where the sale and/or closing on the relinquished property occurs prior to the sale and/or closing of the replacement property is known as
a. a simultaneous exchange
b. a delayed exchange
c. a reverse exchange
d. an improvement exchange

16. An IRC§1031 tax deferred exchange, known as a "Starker Exchange," is also known as
a. a simultaneous exchange
b. a delayed exchange
c. a reverse exchange
d. an improvement exchange

17. An IRC§1031 tax deferred exchange, where sale and/or closing of the relinquished and replacement properties occur on the <u>same</u> <u>day</u> is referred to as
a. a simultaneous exchange
b. a delayed exchange

c. a reverse exchange
d. an improvement exchange

LESSON 3

The 45-Day Rule (Identification) and the 180-Day Rule (Purchase)

Taxpayers have 45 days after the sale of the relinquished property to identify up to three replacement properties. The 45-day period includes weekends and holidays and, if the 45th day falls on a Saturday, Sunday or holiday, paperwork must be completed by the prior business day or the transaction will be disqualified. This is referred to as the "identification period."

Taxpayers have 180 days after the sale of the relinquished property to close on the purchase of the replacement property. This is referred to as the "exchange period." These rules are very strict, but extensions have occurred in the case of September 11, 2001 and natural disasters (e.g., Hurricane Katrina in New Orleans).

Generally, the taxpayer notifies their intermediary, in writing, of the properties desired. A contract is not necessary at this time, but the property that you (eventually) buy must come from this list.

1. After the sale of a property, taxpayers have
a. 45 days, including weekends and holidays, to identify a single replacement property
b. 45 days, excluding weekends and holidays, to identify a single replacement property
c. 45 days, including weekends and holidays, to identify up to three replacement properties
d. 45 days, excluding weekends and holidays, to identify up to three replacement properties

2. After the sale of a property, taxpayers have
a. 45 days, including weekends and holidays, to purchase the replacement property
b. 45 days, excluding weekends and holidays, to purchase the replacement property

c. **180 days, including weekends and holidays, to purchase the replacement property**
d. 180 days, excluding weekends and holidays, to purchase the replacement property

Dobrich vs. Commissioner – The Importance of the 45-Day Identification Rule

In *David Dobrich and Naomi Dobrich, Petitioners v. Commissioner of the Internal Revenue, Repondent; USTC Tax Court Memorandum 1997-477* (October 20, 1997), the taxpayers were found by the IRS to be deficient for their 1989 and 1990 federal income tax in amounts of $1,111,292 and $1,111,320, respectively. IRC§6663(a) civil fraud penalties of $833,469 (1989) and $833,490 (1990) were also imposed. (Note that state income tax counterparts, if applicable, are not available, but would contribute to and have to be added to these amounts relating only to the federal level).

The fraud penalties were imposed and associated with their efforts to manufacture documentation to backdate and support the identification of the replacement properties they purchased within the timeframe permitted by the 45-day identification rule. Selected relevant dates follow:

- ✓ September 19, 1989 - List of 10 potential replacement properties fail to include Skyland or Pleasant Hill as replacement properties
- ✓ October 6, 1989 - 45-day identification period expiration date
- ✓ January 26, 1990 - Offer to purchase Pleasant Hill property for $3.1 million
- ✓ January 26, 1990 - Offer to purchase Skyland property for $1.2 million
- ✓ February 15, 1990 - Pleasant Hill replacement property purchased
- ✓ February 15, 1990 - Skyland replacement property purchased
- ✓ February 1990 - 180-day replacement period expires

David and Naomi Dobrich were successful in achieving a nominal reduction of tax and civil fraud-related penalties for the 1989 tax year (a $6,236 reduction of the combined tax and penalty amounts of $1,944,761). However, combined 1989 and 1990 capital gains taxes of $2.2 million for failure to comply with the 45-day replacement property identification rule and the fraud penalties of $1.7 million, associated with their efforts to backdate documents, in their failed and fraudulent attempt to provide evidence of compliance with the 45-day replacement property identification rule, illustrate both the importance of strict compliance with this rule and the consequences of failure to comply with it, as well as the consequences of fraud.

3. Dobrich vs. Commissioner illustrates the importance of
a. strict adherence to the 45-day replacement property identification rule
b. strict adherence to the 180-day replacement property purchase rule
c. strict adherence to the IRS guidelines for backdating documents
d. strict adherence to the 3-property rule

4. In the case of Dobrich vs. Commissioner
a. taxpayer's failed to identify purchased replacement properties in accordance with the requirements established in what is known as the 45-day rule
b. taxpayer's attempted to backdate documents to support their timely identification of purchased replacement properties
c. taxpayer's had to pay capital gains taxes, as their failure to follow the requirements of IRC§1031 resulted in disallowance of tax deferral
d. All of the above

More on the 180-Day Rule or Purchase Deadline

The 180-day requirement is quite strict and is more precisely defined as 'within 180 days <u>OR</u> the tax filing date, <u>whichever is earlier,</u>' as the following case illustrates:

> In *Orville Christensen v. Commissioner*, 98-1. USTC ¶50,352 (Ninth Circuit Court of Appeals), the

> Christensen's transferred business property to a facilitator on December 22, 1998, identified the replacement properties on February 3, 1989 (easily within the 45 day window permitted for "identification"), and received the properties between April 25 and June 20, 1989 (easily within the 180 day window permitted for "purchase"). However, the Christensen's filed their tax return on April 15, 1989, prior to the expiration of the 180 days. The purchase of replacement properties occurred AFTER their tax return was filed.

The IRS prevailed in the above case and the tax-free or tax deferred nature of this "would be" IRC§1031 exchange transaction was disallowed. The Christensen's should have filed an extension on April 15, 1989, to benefit from the full 180 days otherwise available to complete the purchase.

5. The 180-day rule is qualified, in that the taxpayer must complete the exchange prior to
a. the lesser of 180 days or the tax return filing date
b. the earlier of the 180 days or the taxpayer's tax return filing date
c. the tax return filing date, if earlier than the conclusion of 180 days
d. All of the above are correct

6. The 180-day purchase date rule or requirement may fall on a date following the April 15th tax return filing date. To take full advantage of the 180-day rule, taxpayers should
a. complete the purchase of the replacement property prior to April 15th
b. file an extension
c. telephone their local IRS agent and ask him or her if it is okay to file your tax return on April 15th and complete the purchase of the replacement property AFTER April 15th, but before the expiration of the 180-day period.
d. attach a note to your tax return, filed in a timely manner on April 15th

Knight vs. Commissioner – The Importance of the 180-Day Purchase Rule

In *David A. and Marilyn P. Knight, Petitioners v. Commissioner of the Internal Revenue, Respondent; USTC Tax Court Memorandum 1998-107 (March 16, 1998)*, the taxpayers were found to have failed in their efforts to comply with the 180-day purchase rule. The fact that circumstances, quite possibly beyond their control, prevented them from complying with this deadline was not relevant. The taxpayers had to pay an additional $27,412 in (1993) federal income tax (additional ordinary income of $16,266 and additional capital gains of $82,288). (Note that state income tax counterparts, if applicable, are not available, but would contribute to and have to be added to these amounts relating only to the federal level). Selected relevant dates follow:

- ✓ February 17, 1993 - Sale of 99th Street rental property (relinquished)
- ✓ February 19, 1993 - Sale of West Center Street rental property (relinquished)
- ✓ April 2, 1993 - Identification of 3 potential replacement properties
- ✓ August 16, 1993 - Negotiations failed; sellers cancelled sale the day prior to expiration of the 180-day deadline of August 17, 1993
- ✓ December 23, 1993 - One of the 3 potential replacement properties, properly identified within the 45-day replacement property identification deadline, was purchased, but <u>after</u> the 180-day deadline

7. Knight vs. Commissioner illustrates the importance of

a. strict adherence to the 45-day replacement property identification rule

b. strict adherence to the 180-day replacement property purchase rule

c. strict adherence to the IRS guidelines for backdating documents

d. strict adherence to the 3-property rule

8. In the case of Knight vs. Commissioner

a. taxpayer's failed to identify purchased replacement properties in accordance with the requirements established in what is known as the 45-day rule

b. taxpayer's attempted to backdate documents to support their timely identification of purchased replacement properties

c. taxpayer's had to pay fraud penalties

d. taxpayer's failed to meet the requirements of the 180-day rule, resulting in disallowance of the deferral of capital gains

Christensen vs. Commissioner – The 180-Day Purchase Rule, as Affected by Tax Return Filing Dates and Extensions

In *Orville E. Christensen and Helen V. Christensen, Petitioners v. Commissioner of the Internal Revenue, Respondent; USTC Tax Court Memorandum 1996-254 (June 3, 1996)*, the taxpayers were found to have, effectively, reduced the 180-day purchase rule by filing their tax return on the due date, April 17, 1989. Had they filed an application for an automatic extension (Form 4868) and delayed the filing of their federal income tax return through the date extended, they would have succeeded in complying with the requirements for the IRC§1031 exchange. They did not do this, however, and had to pay federal income taxes in excess of $200,000. Selected relevant dates follow:

- ✓ April 17, 1989 - Tax return filed by Orville and Helen Christensen
- ✓ April 25, 1989 - Purchase of 1st replacement property
- ✓ April 26, 1989 - Purchase of 2nd replacement property
- ✓ May 1, 1989 - Purchase of 3rd replacement property
- ✓ June 12, 1989 - Purchase of 4th replacement property
- ✓ June 16, 1989 - Purchase of 5th replacement property
- ✓ June 20, 1989 - Purchase of 6th replacement property

The Court noted that "Congress amended, in the Deficit Reduction Act of 1984, Pub. L. 98-369 (DEFRA), sec. 77(a), 98 Stat. 494, 595, the provisions of section 1031 by adding a new paragraph (3) to section 1031(a)," as follows:

(3) …For purposes of this subsection…shall be treated as property which is **not** (emphasis added) like-kind property if--

(B) …received after the **earlier** **of** (emphasis added)--

(i) …the day which is 180 days…, **or** (emphasis added)

(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.

Therefore, the transfer of replacement property must occur before the earlier of (1) the 180 days or (2) the tax return due date. Had the Christensen's simply filed a Form 4868 for automatic extension, they would have avoided the tax imposed by the IRS and upheld by the Tax Court.

9. Christensen vs. Commissioner illustrates the importance of
a. strict adherence to the 45-day replacement property identification rule
b. strict adherence to the 180-day replacement property purchase rule
c. strict adherence to the 180-day replacement property purchase rule and how it might be affected by tax return filing dates and extensions
d. strict adherence to the 3-property rule

10. In the case of Christensen vs. Commissioner
a. taxpayer's failed to identify purchased replacement properties in accordance with the requirements established in what is known as the 45-day rule
b. taxpayer's attempted to backdate documents to support their timely identification of purchased replacement properties
c. taxpayer's failed to meet the requirements of the 180-day rule, effectively reducing the time period otherwise available to them to close on or purchase replacement properties when they failed to

file an extension and, instead, filed their tax return on the April due date

d. taxpayer's failed to meet the requirements of the 180-day rule, resulting in disallowance of the deferral of capital gains

11. Which is true of <u>both</u> Knight vs. Commissioner and Christensen vs. Commissioner?

a. In both cases, the 180-day replacement property rule was not met

b. In both cases, the 45-day replacement property identification rule was not met

c. In both cases, both the 180-day replacement property and the 45-day replacement property identification rules were not met

d. In both cases, the taxpayers were found guilty of fraud

Replacement Property Identification

There are rules and exemptions associated with replacement property identification, as follows:

- ✓ 3-property rule – the taxpayer may select any <u>three</u> qualifying replacement properties as possible replacements for the relinquished property

For those wishing to exceed the 3-property rule or ceiling (above):

- ✓ 200% rule – the taxpayer may identify <u>any number</u> of qualifying properties as possible replacements for the relinquished property as long as their aggregate fair market value does not exceed 200 percent of the value of the relinquished property

For those wishing to avoid application of the fair market value rule or ceiling (above):

- ✓ 95% exemption – the taxpayer may identify <u>any number</u> of qualifying properties as possible replacements for the relinquished property as long as the result in the purchase of at least 95 percent of the aggregate value of all properties identified

In summary, you only have to satisfy 1 of the 3 rules (above) – not all 3 of them!

12. Under the 3-property rule
a. the taxpayer must select at least three qualifying replacement properties as possible replacements for the relinquished property
b. the taxpayer may select any three qualifying replacement properties as possible replacements for the relinquished property
c. the taxpayer must select more than three qualifying replacement properties as possible replacements for the relinquished property
d. the taxpayer must select qualifying replacement properties as possible replacements for the relinquished property, but this must be done in multiples of three

13. Under the 200% rule
a. the taxpayer may identify their three qualifying properties (see 3-property rule) as possible replacements for the relinquished property, but only as long as their aggregate value does not exceed 200 percent of the value of the relinquished property
b. the taxpayer may identify any number of qualifying properties as possible replacements for the relinquished property as long as their aggregate value does not exceed 200 percent of the value of the relinquished property
c. the taxpayer may identify their three qualifying properties (see 3-property rule) as possible replacements for the relinquished property, but only as long as their aggregate value exceeds 200 percent of the value of the relinquished property
b. the taxpayer may identify any their three qualifying properties (3-property rule) as possible replacements for the relinquished property, but only in those cases where the aggregate value of the replacements exceeds 200 percent of the value of the relinquished property

14. Under the 95% exemption
a. the taxpayer may identify any number of qualifying properties as possible replacements for the relinquished property as long as the result in the purchase of at least 95 percent of the aggregate value of all properties identified
b. the taxpayer may identify more than three qualifying properties as possible replacements for the relinquished property as long as the result in the purchase of less than 95 percent of the aggregate value of all properties identified

c. the taxpayer may identify less than three qualifying properties as possible replacements for the relinquished property as long as the result in the purchase of less than 95 percent of the aggregate value of all properties identified
d. the taxpayer may identify any number of qualifying properties as possible replacements for the relinquished property as long as the result in the purchase of less than 95 percent of the aggregate value of all properties identified

15. Which is the <u>best</u> answer? Replacement property rules that must be complied with include
a. The 3-property rule
b. the 200 percent rule
c. the 95 percent rule
d. any 1 of the 3 rules – either (1) the 3-property rule, (2) the 200 percent rule, <u>OR</u> (3) the 95 percent rule

Nontaxable Exchanges

To "completely" defer/avoid tax in a properly executed IRC§1031 exchange, the following steps are essential:

1. The taxpayer must buy replacement property with a fair market value equal to or greater than that of the property relinquished;
2. The taxpayer must use all of the original equity realized from the sale of the relinquished property to purchase the replacement property; and
3. The taxpayer must secure financing of an equal or greater amount on the replacement property, when compared to the amount financed on the relinquished property at the time of its sale.

16. To completely defer/avoid tax in a properly executed IRC§1031 exchange, the taxpayer must
a. buy replacement property with a fair market value equal to or greater than that of the property relinquished
b. use all of the original equity realized from the sale of the relinquished property to purchase the replacement property

c. secure financing of an equal or greater amount on the replacement property, when compared to the amount financed on the relinquished property at the time of its sale

d. All of the above

Partially Nontaxable/Taxable Exchanges

Some “exchanges” include (1) money or (2) unlike property. If a gain is realized, you may be taxed on this gain, but only to the extent of the combined total of the money and the fair market value of the unlike property received. (Note that any “loss” on a nontaxable or tax deferred exchange is never deductible).

The maximum amount of your taxable gain is (1) the fair market value of any unlike property received *plus* (2) any money received *less* (3) any closing costs you paid. Your taxable gain is the lesser of this amount or that amount you might pay on a taxable exchange.

Note: Partially taxable exchanges represent a relatively complex area of taxation and are a topic covered at the intermediate and advanced levels.

LESSON 4

Taxable Exchanges – Gain or Loss Computation

To calculate the gain or loss from a taxable exchange, you must first become acquainted with the terminology. Terms such as fair market value, basis, adjusted basis, gain, loss and realized gain or loss are defined below.

The fair market value (FMV) is the price at which a property will change hands between a willing buyer and a willing seller, with neither party compelled or pressured to buy or sell. When an exchange transaction takes place between parties with adverse or self-interests in an arms-length transaction (e.g., unrelated parties), the sale or exchange value is presumed to have taken place at FMV.

1. *Fair market value* is
a. the price at which an exchange takes place, when neither party is compelled to buy or sell.
b. the price at which an exchange takes place, when neither party is pressured to buy or sell.
c. the price at which an exchange takes place between parties with adverse or self-interests in an arms-length transaction.
d. All of the above.

The *basis* of a property is usually its cost. Exceptions include property acquired by gift, inheritance, or some other means of transfer. (Coverage of these alternative means of transfer, used to determine the basis of a property, is beyond the scope of this introductory course).

2. The *basis* of a property is usually its
a. fair market value.
b. cost.
c. cost less depreciation.
d. cost plus improvements.

The *adjusted basis* of a property is the original cost or other basis (see above) *plus* certain additions or improvements *less* certain deductions (e.g., depreciation and/or casualty losses). When determining gain or loss, costs of transferring the property, including selling expenses, are added to the adjusted basis of the property.

3. The *adjusted basis* of a property is usually its
a. fair market value.
b. cost plus certain additions or improvements less certain deductions (e.g., depreciation).
c. cost less depreciation.
d. cost plus improvements.

The amount you *realize* from a sale or exchange is the (1) money *plus* (2) fair market value of property or services received *plus* (3) any of your liabilities assumed by the buyer, which include real estate taxes or a mortgage.

4. The amount you *realize* from a sale or exchange is
a. the money received.
b. the fair market value of property or services received.
c. any liabilities assumed by the buyer, which include real estate taxes or a mortgage.
d. All of the above.

A gain is the amount realized from a sale or exchange of property that is in excess of its adjusted basis. A loss is the excess of the adjusted basis, when this amount exceeds the amount realized from a sale or exchange.

5. A *gain* is realized when
a. the value of the sale or exchange of property exceeds its adjusted basis.
b. the value of the sale or exchange of property is less than its adjusted basis.
c. the value of the sale or exchange of property is equal to its adjusted basis.
d. the value of the sale or exchange of property exceeds its cost or basis.

6. A *loss* is realized when

a. the value of the sale or exchange of property exceeds its adjusted basis.

b. the value of the sale or exchange of property is less than its adjusted basis.

c. the value of the sale or exchange of property is equal to its adjusted basis.

d. the value of the sale or exchange of property exceeds its cost or basis.

Gain results from (1) past depreciation taken (for tax purposes), (2) the property appreciating in value or, most likely, (3) some combination of depreciation, which lowers the adjusted basis of the property, and appreciation.

7. A *gain* in real property is most likely to be realized when

a. past depreciation, taken for tax purposes, which reduces the adjusted basis of the property

b. the property appreciates in value

c. the property is exchanged in an IRC§1031 tax-free exchange

d. some combination of a. and b.

Table 3 contains an example or illustration to reinforce and allow you to apply the terms covered. It assumes that a taxpayer sold a building that cost $55,000 for $90,000 cash plus $10,000 in other property or services. Improvements of $5,000 were made and depreciation expenses of $10,000 were deducted during the period of ownership. The buyer also assumed real estate taxes of $1,000 and a mortgage for $9,000. Selling expenses were $4,000. The amount *realized* was $110,000, the *adjusted basis* of the property was $54,000, and the *gain* on the sale or exchange transaction was $56,000. The objective of the like-kind, tax-free or tax deferred exchange (IRC§1031) is to legitimately avoid *recognition* of the *realized* gain on the sale.

Amount Realized:		
Cash	$90,000	
Plus: FMV of property or services received	$10,000	
Plus: Real estate taxes assumed by buyer	$ 1,000	
Plus: Mortgage assumed by the buyer	$ 9,000	$110,000
Adjusted Basis:		
Cost	$55,000	
Plus: Improvements	$ 5,000	
equals: Cost plus Improvements	$60,000	
Less: Depreciation	$10,000	
equals: Adjusted Basis	$50,000	
Plus: Selling Expenses	$ 4,000	$ 54,000
Realized Gain on Sale		$ 56,000

Table 3

Realized versus Recognized

In Table 3, $56,000 in gain was *realized* by the taxpayer. However, in the case of a nontaxable or IRC§1031 exchange, this deal might have been structured in such a manner that part or all of the gain would have gone *unrecognized*. Therefore, the distinction between *realization* and *recognition* is an important one. A *realized* gain may or may not be subject to tax. A *recognized* gain is always subject to tax. An IRC§1031 exchange reduces or eliminates the amount *recognized* by a taxpayer with a *realized* gain.

8. A *realized gain*
a. is always taxed.
b. is never taxed.
c. is taxed, but only to the extent that the gain is *recognized*.
d. a. and b. are correct.

9. A *recognized gain*
a. is always taxed.
b. is never taxed.

c. is taxed, but only to the extent that the gain is recognized.
d. a. and b. are correct.

Receipt of Boot

Because exchanges between taxpayers do not always occur with properties of equal value, non-like-kind property or money may be included in the exchange transaction. Money and any other non-like-kind property (e.g., goods or services at FMV) constitute and are referred to as "boot."

Gain is recognized to the extent that boot is received, but limited by the taxpayer's realized gain, which serves as a ceiling for recognized gain. The receipt of boot in a nontaxable exchange does not, in and of itself, cause a realized loss to be recognized. In fact, if there is a realized loss in a boot received situation, the loss is not recognized.

10. Boot includes
a. money
b. services, at their FMV
c. goods, at their FMV
d. All of the above

11. The receipt of boot
a. may or may not result in the recognition of a gain
b. will always result in the recognition of a gain
c. may result in the *recognition* of a gain, but only to the extent of the taxpayer's *realized* gain
d. causes a realized loss to be recognized

Note: For those wishing to do some additional research on the receipt of boot on their own, begin with a careful reading of IRC§1031(b) and (c).

Mortgage Boot (Debt Relief)

Mortgage boot or debt relief occurs when the replacement property debt is less than the relinquished property debt. Mortgage boot is taxable unless offset by contributing an equivalent amount of cash to complete the transaction. The cash contributed has, after all, already been taxed.

12. *Mortgage boot* is
a. debt relief
b. debt reduction, between the relinquished property and the replacement property
c. taxable, unless offset by contribution an equivalent amount of cash to complete the transaction
d. All of the above

Note: Boot takes many forms and represents a relatively complex area of taxation. More on boot is covered in the intermediate and advanced courses on IRC§1031 exchanges, where the level of complexity is much higher than covered in this introductory course. For those wishing to research this topic on their own, begin with a careful reading of IRC§1031(d) and Treasury Regulation §1.1031(d)-2.

Related Party Exchanges

Related party transactions result in the imposition of higher standards and greater scrutiny by the Internal Revenue Service (IRS). In the case of IRC§1031, a two-year holding period requirement is imposed on related parties. If either party disposes of any of the properties exchanged within the two-year period, deferred gain or loss ceases to remain deferred, effective on the date of the disqualifying disposition.

13. Related party transactions involving IRC§1031
a. result in the imposition of a 45-day holding period requirement
b. result in the imposition of a 180-day holding period requirement

c. result in the imposition of a two-year holding period requirement
d. are categorically disallowed

Note: Related party transactions represent a relatively complex area, pervasive throughout the IRC. More on related party transactions is covered in the intermediate and advanced courses on IRC§1031 exchanges.

Involuntary Conversions

An involuntary conversion occurs through casualty, theft, or condemnation. Falling outside of the rules of IRC§1031, per se, involuntary conversions fall under the guidelines contained in IRC§1033, but also represents and exchange involving the non-recognition of gain or loss. Given recent disasters (e.g., 911 in New York City and Katrina in New Orleans), coverage and the distinctions between IRC§1031 and IRC§1033 is warranted.

Replacement properties evolving from an involuntary conversion are governed by two <u>mandatory</u> rules for gain or loss recognition, as follows:

1. no gain is recognized if there is a direct conversion into property that is similar or related in service or use instead of into a money award – the basis of the replacement property is the adjusted basis of the old property
2. allowable, realized losses must be recognized – the basis of the replacement property is its acquisition cost
    a. involuntary conversion losses – recognized if from income-producing or business property
    b. casualty and theft losses – recognized (subject to limitations) if personal use assets
    c. condemnation losses – not recognized for personal use assets

14. In the case of an involuntary conversion loss that is associated with income-producing or business property, <u>mandatory</u> rules require that

a. the loss is recognized
b. the loss is not recognized
c. the loss is added to the basis of the replacement property
d. the loss is subtracted from the basis of the replacement property

15. The recognition of a loss arising from the involuntary conversion of income-producing or business property is
a. mandatory
b. voluntary
c. elective
d. deferred

Other Non-Recognition Transactions

Some additional federal income tax provisions that may also result in the non-recognition of gain or loss follow:

- ✓ corporate and partnership exchanges (see IRC§351, 1032, and 721)
- ✓ stock-for-stock exchanges (see IRC§1036(a))
- ✓ insurance contract exchanges (see IRC§1035(a))
- ✓ U.S. obligation exchanges (see IRC§1037(a))
- ✓ reacquisition and/or repossession of real property (see IRC§1038)

16. IRC§1031 is not the only federal income tax provision for the non-recognition of gain or loss. Others include
a. corporate exchanges
b. partnership exchanges
c. insurance contract exchanges
d. All of the above

17. IRC§1031 is not the only federal income tax provision for the non-recognition of gain or loss. Others include the below, with the exception of
a. U.S. obligation exchanges
b. reacquisition and/or repossession of real property
c. income-producing property for personal use residence exchanges
d. both a. and b.

LESSON 5

The Basis of Replacement Property (An Introduction)

Table 4 summarizes components of the basic formula used to determine the taxpayer's basis in the replacement property resulting from an IRC§1031 exchange. The taxpayer's basis is reduced by boot received and loss recognized on the exchange. The taxpayer's basis is increased by any gain recognized in the exchange.

	Adjusted Basis of RELINQUISHED Property	Expanded in Table 4a
-	Fair Market Value of Boot Received	
+	Gain Recognized	
-	Loss Recognized	
=	Basis of REPLACEMENT Property	

Table 4

Cautionary Note: This section will provide some very basic numerical examples to familiarize you with the tax computations, however, this is an introductory course and it is essential that the Realtor® enlist the assistance of a tax accountant, attorney or other tax professional to avoid any errors that might result from complexities not reflected in this introductory course.

1. The taxpayer calculates his or her basis in the new or *replacement* property by <u>increasing</u> the basis in their *relinquished* property by the amount of

a. boot received
b. gain recognized
c. loss recognized
d. basis in the replacement property

2. The taxpayer calculates his or her basis in the new or *replacement* property by <u>decreasing</u> the basis in their *relinquished* property by the amount of

a. boot received
b. gain recognized

c. loss recognized
d. both a. and b.

3. Assume that a taxpayer has a basis of $1,000,000 in their *relinquished* property, no gain or loss was recognized, and no boot was given or received in the exchange. The taxpayer's basis in the new or *replacement* property is
a. zero
b. $1,000,000
c. the amount of the realized loss
d. the amount of the realized gain

4. Assume that a taxpayer has a basis of $1,000,000 in their *relinquished* property, a gain of $100,000 was recognized, and no boot was given or received in the exchange. The taxpayer's basis in the new or *replacement* property is
a. zero
b. $1,000,000
c. $900,000
d. $1,100,000

5. Assume that a taxpayer has a basis of $1,000,000 in their *relinquished* property, a loss of $100,000 was recognized, and no boot was given or received in the exchange. The taxpayer's basis in the new or *replacement* property is
a. zero
b. $1,000,000
c. $900,000
d. $1,100,000

6. Assume that a taxpayer has a basis of $1,000,000 in their *relinquished* property, no gain or loss was recognized, and boot of $100,000 was given in the exchange. The taxpayer's basis in the new or *replacement* property is
a. zero
b. $1,000,000
c. $900,000
d. $1,100,000

7. Assume that a taxpayer has a basis of $1,000,000 in their *relinquished* property, no gain or loss was recognized, and boot of $100,000 was

received in the exchange. The taxpayer's basis in the new or *replacement* property is

a. zero
b. $1,000,000
c. $900,000
d. $1,100,000

Table 4a summarizes the basic formula used to determine the taxpayer's basis in the relinquished property. The taxpayer's original cost, purchase price or basis (comparable terms) is increased by any capital improvements (i.e., long-lived improvements that have not been expensed, e.g., repairs and maintenance) and reduced by depreciation (including amortization and depletion). The result is the taxpayer's basis, adjusted basis or net adjusted basis (comparable terms) in the relinquished property.

	Original Cost, Basis or Purchase Price of RELINQUISHED Property
+	Capital Improvements
-	Depreciation
=	Adjusted Basis of RELINQUISHED Property

Table 4a

8. The taxpayer calculates his or her basis in the old or *relinquished* property by <u>increasing</u> the basis of the property by the amount of

a. capital improvements
b. depreciation
c. repairs and maintenance expensed in prior years
d. amortization

9. The taxpayer calculates his or her basis in the old or *relinquished* property by <u>decreasing</u> the basis of the property by the amount of

a. capital improvements
b. depreciation
c. repairs and maintenance expensed in prior years
d. both a. and c.

10. Assume that a taxpayer had an original cost or basis of $1,000,000 in their *relinquished* property. Over the period held, the taxpayer made

capital improvements (in addition to repairs and maintenance items that were properly expensed) at $200,000. Depreciation deductions taken on the property, over the period held by the taxpayer, amounted to $150,000. The taxpayer's adjusted basis in the *relinquished* property is

a. $1,000,000
b. $1,200,000
c. $850,000
d. $1,050,000

11. Assume that a taxpayer had an original cost or basis of $1,000,000 in their *relinquished* property. Depreciation deductions taken on the property, over the period held by the taxpayer, amounted to $150,000. The taxpayer's adjusted basis in the *relinquished* property is

a. $1,000,000
b. $1,200,000
c. $850,000
d. $1,050,000

The Basis of Replacement Property (A Comprehensive Illustration)

Table 5 summarizes a comprehensive formula used to determine the taxpayer's basis in the replacement property resulting from an IRC§1031 exchange (see IRC§1031(d)). The taxpayer's basis is reduced by boot received, liabilities assumed by the transferee, and loss recognized on the exchange. The taxpayer's basis is increased by boot given, liabilities assumed by the transferor, and gain recognized in the exchange.

	Original Cost, Basis or Purchase Price of RELINQUISHED Property
+	Boot given
+	Gain recognized
+	Liability assumed by the transferor (seller)
-	Boot received
-	Loss recognized
-	Liability assumed by the transferee (buyer)
=	Basis of REPLACEMENT Property

Table 5

12. The calculation for the basis or replacement property begins with the original cost, basis or purchase price of relinquished property, which is <u>increased</u> by
a. boot given
b. gain recognized
c. liability assumed by the transferor (seller)
d. All of the above

13. The calculation for the basis or replacement property begins with the original cost, basis or purchase price of relinquished property, which is <u>decreased</u> by
a. boot received
b. loss recognized
c. liability assumed by the transferee (buyer)
d. All of the above

14. If boot of $5,000 is given in an exchange transaction, the basis of the replacement property will be
a. decreased by $5,000
b. increased by $5,000
c. not affected if an IRC§1031 exchange
d. All of the above

15. If boot of $5,000 is received in an exchange transaction, the basis of the replacement property will be
a. decreased by $5,000
b. increased by $5,000
c. not affected if an IRC§1031 exchange
d. All of the above

16. If a liability of $50,000 is assumed by the transferor (seller) in an exchange transaction, the basis of the replacement property will be
a. decreased by $50,000
b. increased by $50,000
c. not affected if an IRC§1031 exchange
d. All of the above

17. If a liability of $50,000 is assumed by the transferee (buyer) in an exchange transaction, the basis of the replacement property will be
a. decreased by $50,000
b. increased by $50,000
c. not affected if an IRC§1031 exchange

d. All of the above

18. If a gain in the amount of $10,000 is recognized in an exchange transaction, the basis of the replacement property will be

a. decreased by $10,000
b. increased by $10,000
c. not affected if an IRC§1031 exchange
d. All of the above

19. If a loss in the amount of $10,000 is recognized in an exchange transaction, the basis of the replacement property will be

a. decreased by $10,000
b. increased by $10,000
c. not affected if an IRC§1031 exchange
d. All of the above

LESSON 6

Realized Gains and Losses and Cases Where Boot is Given

In the previous lesson, Tables 4 and 4a provided some very simple examples and illustrations in calculating the basis of replacement property and only dealt with those cases where boot was received. Table 5 provided a comprehensive framework for the calculation of basis in the replacement property. In this lesson, Table 6 is even more comprehensive, provides numerical examples, and more clearly illustrates the treatment of realized and recognized gains and losses, particularly in those cases where boot is involved (e.g., both given and received).

Table 6 begins with a case where the fair market value of the replacement property is held constant at $9,000. No boot is given. In one case (**1a**), the taxpayer has a realized gain. In the other case (**1b**), the taxpayer has a realized loss. Note that neither case results in a recognized gain or loss. You should pay particular attention to three measures in Table 6:

- ✓ the realized gain or (loss),
- ✓ the recognized gain or (loss), and
- ✓ the new basis for the replacement property.

		1a	**1b**
Question			
1	Recognized Gain or (Loss)?	No	No
2	Boot Involved?	No	No
3	Realized Gain or (Loss)?	Gain	Loss
Fair Market Value of REPLACEMENT Property		$9,000	$ 9,000
Adjusted Basis of RELINQUISHED Property		$4,000	$10,000
Boot:			
	Adjusted Basis of Boot Given	$ -0-	$ -0-
	Fair Market Value of Boot Received	$ -0-	$ -0-
Realized Gain or (Loss)		$5,000	$ (1,000)
Recognized Gain or (Loss)		$ -0-	$ -0-
New Basis (REPLACEMENT Property):			
	Adjusted Basis RELINQUISHED Property	$4,000	$10,000
+	Adjusted Basis of Boot Given	$ -0-	$ -0-
+	Recognized Gain or (Loss)	$ -0-	$ -0-
-	Fair Market Value of Boot Received	$ -0-	$ -0-
=	New Basis (REPLACEMENT Property):	$4,000	$10,000

Table 6

1. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $4,000, for a *replacement* property, with a fair market value of $9,000. The realized gain or (loss) is

a. $5,000
b. $(1,000)
c. $4,000
d. $-0-

2. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $4,000, for a *replacement* property, with a fair market value of $9,000. The recognized gain or (loss) is

a. $5,000
b. $(1,000)
c. $4,000
d. $-0-

3. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $4,000, for a *replacement* property, with a fair market value of $9,000. The taxpayer's basis in the *replacement* property is

a. $5,000
b. $(1,000)
c. $4,000
d. $-0-

4. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $10,000, for a *replacement* property, with a fair market value of $9,000. The realized gain or (loss) is
a. $10,000
b. $(1,000)
c. $4,000
d. $-0-

5. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $10,000, for a *replacement* property, with a fair market value of $9,000. The recognized gain or (loss) is
a. $10,000
b. $(1,000)
c. $4,000
d. $-0-

6. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $10,000, for a *replacement* property, with a fair market value of $9,000. The taxpayer's basis in the *replacement* property is
a. $10,000
b. $(1,000)
c. $4,000
d. $-0-

Table 6 proceeds with a case where the fair market value of the replacement property remains constant at $9,000. Boot is given. In one case (**2a**), the taxpayer has a realized gain. In the other case (**2b**), the taxpayer has a realized loss. Note that neither case results in a recognized gain or loss. You should pay particular attention to three measures in Table 6:

- ✓ the realized gain or (loss),
- ✓ the recognized gain or (loss), and
- ✓ the new basis for the replacement property.

		2a	**2b**
Question			
1	Recognized Gain or (Loss)?	No	No
2	Boot Involved?	Given	Given
3	Realized Gain or (Loss)?	Gain	Loss
Fair Market Value of REPLACEMENT Property		$9,000	$ 9,000
Adjusted Basis of RELINQUISHED Property		$4,000	$ 4,000
Boot:			
	Adjusted Basis of Boot Given	$2,500	$ 6,000
	Fair Market Value of Boot Received	$ -0-	$ -0-
Realized Gain or (Loss)		$2,500	$ (1,000)
Recognized Gain or (Loss)		$ -0-	$ -0-
New Basis (REPLACEMENT Property):			
	Adjusted Basis RELINQUISHED Property	$4,000	$ 4,000
+	Adjusted Basis of Boot Given	$2,500	$ 6,000
+	Recognized Gain or (Loss)	$ -0-	$ -0-
-	Fair Market Value of Boot Received	$ -0-	$ -0-
=	New Basis (REPLACEMENT Property):	$6,500	$10,000

7. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $4,000, for a *replacement* property, with a fair market value of $9,000. The adjusted basis of boot given is $2,500. The realized gain or (loss) is

a. $2,500
b. $(1,000)
c. $6,500
d. $-0-

8. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $4,000, for a *replacement* property, with a fair market value of $9,000. The adjusted basis of boot given is $2,500. The recognized gain or (loss) is

a. $2,500
b. $(1,000)
c. $6,500
d. $-0-

9. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $4,000, for a *replacement* property, with a fair market

value of $9,000. The adjusted basis of boot given is $2,500. The taxpayer's basis in the *replacement* property is

a. $2,500
b. $(1,000)
c. $6,500
d. $-0-

10. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $10,000, for a *replacement* property, with a fair market value of $9,000. The adjusted basis of boot given is $6,000. The realized gain or (loss) is

a. $10,000
b. $(1,000)
c. $4,000
d. $-0-

11. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $10,000, for a *replacement* property, with a fair market value of $9,000. The adjusted basis of boot given is $6,000. The recognized gain or (loss) is

a. $10,000
b. $(1,000)
c. $4,000
d. $-0-

12. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $10,000, for a *replacement* property, with a fair market value of $9,000. The adjusted basis of boot given is $6,000. The taxpayer's basis in the *replacement* property is

a. $10,000
b. $(1,000)
c. $4,000
d. $-0-

Table 6 proceeds with a case where the fair market value of the replacement property does not remain constant. Boot is received. In one case (**3a**), the taxpayer has a realized gain. In the other case (**3b**), the taxpayer has a realized loss. Note that one case (**3a**) results in a recognized gain. You should pay particular attention to three measures in Table 6:

- ✓ the realized gain or (loss),
- ✓ the recognized gain or (loss), and
- ✓ the new basis for the replacement property.

		3a	**3b**
Question			
1	Recognized Gain or (Loss)?	Gain	No
2	Boot Involved?	Rec'd	Rec'd
3	Realized Gain or (Loss)?	Gain	Loss
Fair Market Value of REPLACEMENT Property		$9,000	$3,500
Adjusted Basis of RELINQUISHED Property		$4,000	$4,000
Boot:			
	Adjusted Basis of Boot Given	$ -0-	$ -0-
	Fair Market Value of Boot Received	$3,000	$ 250
Realized Gain or (Loss)		$8,000	$ (250)
Recognized Gain or (Loss)		$3,000	$ -0-
New Basis (REPLACEMENT Property):			
	Adjusted Basis RELINQUISHED Property	$4,000	$4,000
+	Adjusted Basis of Boot Given	$ -0-	$ -0-
+	Recognized Gain or (Loss)	$3,000	$ -0-
-	Fair Market Value of Boot Received	$3,000	$ 250
=	New Basis (REPLACEMENT Property):	$4,000	$3,750

13. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $4,000, for a *replacement* property, with a fair market value of $9,000. The fair market value of the boot received is $3,000. The realized gain or (loss) is

a. $8,000
b. $(250)
c. $3,000
d. $4,000

14. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $4,000, for a *replacement* property, with a fair market value of $9,000. The fair market value of the boot received is $3,000. The <u>recognized</u> gain or (loss) is

a. $8,000
b. $(250)
c. $3,000
d. $4.000

15. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $4,000, for a *replacement* property, with a fair market value of $9,000. The fair market value of the boot received is $3,000. The taxpayer's <u>basis</u> in the *replacement* property is

a. $8,000
b. $(250)
c. $3,000
d. $4.000

16. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $4,000, for a *replacement* property, with a fair market value of $3,500. The fair market value of the boot received is $250. The <u>realized</u> gain or (loss) is

a. $-0-
b. $(250)
c. $3,750
d. $4,000

17. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $4,000, for a *replacement* property, with a fair market value of $3,500. The fair market value of the boot received is $250. The <u>recognized</u> gain or (loss) is

a. $-0-
b. $(250)
c. $3,750
d. $4,000

18. Assume that a taxpayer exchanges their *relinquished* property, with an adjusted basis of $4,000, for a *replacement* property, with a fair market value of $3,500. The fair market value of the boot received is $250. The taxpayer's <u>basis</u> in the *replacement* property is

a. $-0-
b. $(250)

c. $3,750
d. $4,000

Note: For those wishing to some addition research on this topic on their own, begin with a careful reading of Treasury Regulation §1.1031(d)-1(e).

Intermediate Level

LESSON 1

Introduction

Real estate brokers and agents need to have some basic knowledge of the Internal Revenue Code Section (IRC§) 1031 tax-free exchanges. This intermediate course is designed to build on the understanding you acquired in the introductory course. A course is also available at the advanced level for those real estate brokers, agents, appraisers, and other Realtor® professionals seeking greater depth in their understanding of IRC§1031.

This intermediate course will provide you with additional background and is likely to be sufficient to extend your knowledge of IRC§1031 exchanges, using information available, for free, on the Internet. However, when using secondary sources (e.g., websites promoting their services and non-refereed professional journal articles), exercise caution and please be sure to verify via primary sources (e.g., the IRS or Treasury Department Regulations and/or refereed academic or professional journal articles). Many web-based sources provide insufficient detail, potentially leading to misunderstandings.

This intermediate extension of the introductory course focuses, heavily, on more complex computations and more fully-developed fact patterns. It also seeks to more fully develop your understanding of technical jargon, of greatest value to those interested in reading (and understanding) contemporary tax planning articles addressing IRC§1031 exchanges. After completing this course you should be able to discuss, in technical terms, the specifics of IRC§1031 exchanges with tax accountants and attorneys. However, as a Realtor®, it remains advisable to

continue to rely on these “experts” to advise clients with respect to the tax treatment of IRC§1031 exchanges.

The advanced extension of this course focuses, heavily, on conceptual matters (e.g., contemporary and more complex planning opportunities, frequently the result of recent Treasury Department guidance and/or professional and academic journal articles). The mechanics will also be useful, but the greater emphasis will be placed on very contemporary planning opportunities.

A Review of Introductory Course Materials

- ✓ An Internal Revenue Code Section (IRC§) 1031 exchange is named for (1) the IRC Section it refers to, but is also known as a (2) Starker exchange, (3) tax-free exchange, or (4) like kind exchange
- ✓ The properly executed IRC§1031 exchange provides for a complete tax deferral of the gain that would otherwise be realized and recognized on the (1) sale of one property or piece of real estate, and its replacement, through the (2) purchase of another property or piece of real estate
- ✓ The IRC§1031 exchange is the result of the intentional desire, by Congress
- ✓ IRC§1031 is not an elective provision. If the exchange qualifies as like-kind, non-recognition of gain or loss on the exchange is mandatory. Therefore, if a taxpayer prefers to recognize a loss on an exchange transaction, he or she must structure the transaction to avoid having it qualify as a like-kind exchange.

1. The IRC§1031 exchange
a. is named for the IRC Section is refers to
b. is also known as a Starker exchange
c. is a tax-free or like kind exchange
d. All of the above are correct

2. The IRC§1031 exchange
a. is an elective provision of the Internal Revenue Code
b. is <u>not</u> an elective provision of the Internal Revenue Code
c. is not a tax loophole; it is the result of an intentional desire by Congress
d. both b. and c. are correct

In recent years, public sources have suggested that an increase in flawed IRC§1031 exchanges have been linked to:

- ✓ poor advice from mortgage brokers, focusing, primarily, on the lack of appropriate <u>tax</u> advice
- ✓ failure to use qualified intermediaries (not monitored by the IRS)
- ✓ mistakes in property analysis or paperwork preparation are becoming increasingly common, as new investors are entering the real estate market
- ✓ many are unsophisticated and are relying on brokers, often familiar with the 45-day and 180-day deadlines, but not with other IRS guidelines
- ✓ failures tend to concentrate on the East Coast, since these exchanges have been more popular on the West Coast
- ✓ strict rules apply to IRC§1031 exchanges, which became legal in 1921 and continue to be governed by strict rules adopted in 1991
- ✓ replacement property must be purchased under the same conditions as the relinquished property

3. Increases in contemporary problems with IRC§1031 exchanges have been linked to
a. poor tax advice
b. failure to use qualified intermediaries
c. the East Coast, as these exchanges have, historically, been more popular on the West Coast
d. All of the above are correct

A basic understanding of IRC§1031 exchanges will benefit both the professional Realtor® and their existing and potential clients. These benefits include:

- ✓ "investors" tend to think "long-term," so good service tends to equal "clients for life"
- ✓ not knowing the basics of IRC§1031 exchanges may result in a loss of business or clients
- ✓ clients educated about the benefits of IRC§1031 exchanges are able to buy higher priced properties (i.e., leverage)
- ✓ investors may exchange one property for two, resulting in three commissions
- ✓ especially applicable in areas where real estate values have soared, so do not limit yourself to "serial" investors
- ✓ once expertise is achieved, use your knowledge of IRC§1031 exchanges to promote yourself
- ✓ taxpayers buying homes for their college-age children near school are also potential clients
- ✓ may result in access to tenants of income-producing properties – these are future home buyers and potential clients
- ✓ important to admit ignorance and establish relationships with qualified tax advisors
- ✓ establish relationships and work with qualified intermediaries
- ✓ exchange for a property of greater value, resulting from and partially or fully financed by tax deferral/savings (i.e., leveraging)
- ✓ exchange non-revenue-generating property (e.g., raw land) for income-producing property (e.g., residential rental property)
- ✓ exchange non-depreciable property (e.g., raw land) for income-producing property with improvements that generate depreciation (e.g., rental property)
- ✓ exchange property in an already fully appreciated area for one in an area where you anticipate appreciation
- ✓ exchange property in an area where property values are declining and gentrification is not anticipated for one in an area in the early stages of its life-cycle
- ✓ exchange economically or functionally obsolete property, where repairs and costs of maintenance are increasing, for a newer property

4. A basic understanding of IRC§1031 exchanges will benefit both the professional Realtor® and their existing and potential clients. Considerations include the following:
a. not knowing the basics of IRC§1031 exchanges may result in a loss of business or clients to the Realtor®
b. the property owner may exchange non-revenue-generating property (e.g., raw land) for income-producing property (e.g., residential rental property)
c. the property owner may exchange for a property of greater value, resulting from and partially or fully financed by tax deferral/savings (i.e., leveraging)
d. All of the above are correct

5. A basic understanding of IRC§1031 exchanges will benefit both the professional Realtor® and their existing and potential clients. Considerations include the following:
a. the property owner may exchange property in an already fully appreciated area for one in an area where you anticipate appreciation
b. the property owner exchange property in an area where property values are declining and gentrification is not anticipated for one in an area in the early stages of its life-cycle
c. the property owner exchange economically or functionally obsolete property, where repairs and costs of maintenance are increasing, for a newer property
d. All of the above are correct

There are only two disadvantages to the IRC§1031 tax-free exchange:

- ✓ lower tax basis and, therefore, lower depreciation (ignores time value of money considerations)
- ✓ losses from tax deferred or tax-free exchanges cannot be deducted; therefore, If a loss is anticipated or desirable, do a sale and do not do an exchange

Federal income tax forms likely to be used in an IRC§1031 tax-free exchange include Form 8824 – Like-Kind Exchanges, Form 6252 – Installment Sale Income, Form 4797 – Sale of Business Property, and Form 1040, Schedule D – Capital Gains and Losses.

6. The primary disadvantage to an IRC§1031 exchange is that

a. losses from an IRC§1031 exchange cannot be deducted
b. the failure to recognize the gain in a sale may result in a lower tax basis for the replacement property
c. real estate commissions are higher
d. additional tax forms must be filed with the IRS

Both the property relinquished and the replacement property must meet the specific criteria to be classified as *qualifying* property:

✓ real property held for the production of income and/or used in a trade or business and real property held for investment (IRC§1221) qualify for IRC§1031 exchanges and tax deferral
✓ real property held for personal use (i.e., personal residence, covered by IRC§1034 and already enjoying certain tax exclusions under IRC§121) and real property held primarily for sale (i.e., dealer property or inventory) does not qualify for IRC§1031 exchanges and tax deferral

Like kind properties are those that are the same in *nature* or *character*. They may differ in *grade* or *quality*. Therefore, as applied to real property, the exchange of a city property for a farm property would represent a like kind exchange. Similarly, the exchange of an improved property for an unimproved property would qualify for and represent a like-kind exchange. Furthermore, the exchange of real estate for a real estate lease than has a life of 30 years or longer is a like-kind exchange. However, some interests in real property do not qualify. For example, the exchange of a life estate of less than 30 years for a remainder interest does not qualify as a like-kind exchange. Alternatively, the exchange of a remainder interest in real estate for a remainder interest in other real estate would qualify as a like-kind exchange if the *nature* or *character* of the two real property interests is the same. Finally, foreign real property (e.g., not located in the United States or the District of Columbia) and real property located within the United States is not considered like-kind property.

An exchange does not qualify as “like kind” unless belonging to the same class. For example, an exchange of real property for personal property (or visa versa) would not be qualify under IRC§1031 and would not be tax-free.

Property excluded, for the purposes of IRC§1031 tax deferral treatment, follow:
- ✓ property used for personal purposes (e.g., personal automobile or residence)
- ✓ stocks in trade or other “inventory” held for sale or resale, including short-term real estate holdings by “dealers”
- ✓ short-term or current assets, including accounts receivable and debt and equity securities
- ✓ partnership interests, certificates of trust or beneficial interest, and choses in action

The above may, however, qualify for other forms of nontaxable exchanges, outside of IRC§1031:
- ✓ corporate and partnership exchanges (see IRC§351, 1032, and 721)
- ✓ stock-for-stock exchanges (see IRC§1036(a))
- ✓ insurance contract exchanges (see IRC§1035(a))
- ✓ U.S. obligation exchanges (see IRC§1037(a))
- ✓ reacquisition and/or repossession of real property (see IRC§1038)

A *qualified intermediary* (*QI*) is one engaged, with a written agreement, to broker or arrange for the exchange and transfer of the properties. The QI must (1) acquire the relinquished property from the seller, (2) transfer the relinquished property to the buyer, (3) acquire the replacement property for the buyer, and (4) transfer the replacement property to the buyer. Any agreements with qualified intermediaries must expressly limit the taxpayer’s rights to receive, pledge, borrow, or otherwise benefit from money or other property. It should also be noted that the use of a QI

does not, in and of itself, provide a legitimate vehicle for the avoidance of rules concerning "related parties" and related party transactions. Related party transactions result in the imposition of higher standards and greater scrutiny by the Internal Revenue Service (IRS). In the case of IRC§1031, a two-year holding period requirement is imposed on related parties. If either party disposes of any of the properties exchanged within the two-year period, deferred gain or loss ceases to remain deferred, effective on the date of the disqualifying disposition.

7. The qualified intermediary must
a. acquire the relinquished property from the seller
b. transfer the relinquished property to the buyer
c. acquire the replacement property for the buyer
d. All of the above must be completed by the qualified intermediary

8. The qualified intermediary must complete all of the following, except
a. acquire the relinquished property from the seller
b. transfer the relinquished property to the buyer
c. transfer the replacement property to the buyer
d. select the replacement property

The four basic types or classifications of IRC§1031 exchanges, along with brief definitions, follow:

- ✓ Simultaneous – closing of relinquished and replacement properties occur on the same day
- ✓ Delayed – closing is not simultaneous, but sequential; also known as a "Starker Exchange" (so named after the well known Supreme Court case, ruling in the taxpayer's favor). A delayed exchange results in (1) the sale of the relinquished property, (2) the identification of the appropriate or desired replacement property (within 45 days from closing on the relinquished property), and (3) the purchase of the replacement property, all occurring within the maximum allowable time period of 180 days.
- ✓ Reverse – closing sequence is reversed; the replacement property is identified, purchased and closed before the

relinquished property is sold. A form of "Title-Holding" exchange and usually involving an intermediary.

- ✓ Improvement – closing occurs after improvements are made to the replacement property. A form of "Title-Holding" exchange that may be performed as "Delayed" or "Reverse" exchange.

9. Types or classifications of IRC§1031 exchanges include all of the below, <u>except</u>

a. delayed
b. reverse
c. simultaneous
d. inverted

The 45-Day (Identification) Rule

Taxpayers have 45 days (identification period – including and/or shortened by weekends and holidays) after the sale of the relinquished property to identify up to three replacement properties.

Generally, the taxpayer notifies their intermediary, in writing, of the properties desired. A contract is not necessary at this time, but the property that the taxpayers (eventually) buy must come from this list.

In *Dobrich v. Comm., 84 AFTR 2d 99-6131 (188 F.3d 512) (8/25/1999)*, the Tax Court properly determined that the taxpayers could not defer gain. They failed to comply with the 45-day identification period. Selected relevant dates (1989 tax year) follow:

- ✓ September 19, 1989 - Replacement property list excluded Skyland and Pleasant Hill
- ✓ October 6, 1989 - 45-day identification period expired
- ✓ February 15, 1990 - Skyland and Pleasant Hill replacement properties purchased

There are 3 rules and/or exemptions associated with replacement property identification. Any 1 may be satisfied, as follows:

- ✓ 3-property rule – the taxpayer may select any <u>three</u> qualifying replacement properties as possible replacements for the relinquished property
- ✓ 200% rule – the taxpayer may identify <u>any number</u> of qualifying properties as possible replacements for the relinquished property as long as their aggregate fair market value does not exceed 200 percent of the value of the relinquished property
- ✓ 95% exemption – the taxpayer may identify <u>any number</u> of qualifying properties as possible replacements for the relinquished property as long as the result in the purchase of at least 95 percent of the aggregate value of all properties identified

The 180-Day (Purchase) Rule

Taxpayers have 180 days (exchange period) after the sale of the relinquished property to close on the purchase of the replacement property. Extensions have occurred in the case of September 11, 2001 and natural disasters (e.g., Hurricane Katrina in New Orleans). The 180-day requirement is quite strict and is more precisely defined as 'within 180 days <u>OR</u> the tax filing date, <u>whichever is earlier,</u>' as the following case illustrates:

In *Christensen v. Comm., 81 AFTR 2d 98-1627 (142 F. 3d 442) (4/10/1998)*, the taxpayers transferred business property to a facilitator on December 22, 1998, identified the replacement properties on February 3, 1989 (within the 45 days permitted for "identification"), and received the properties between April 25 and June 20, 1989 (within the 180 days permitted for "purchase"). However, they filed their tax return on April 15, 1989, <u>prior to the expiration of the 180 days</u>. The purchase of replacement properties occurred <u>after their tax return was filed</u>. Tax Court properly disallowed the tax deferral. They should have filed an extension (Form 4868) on April 15, 1989, to benefit from the full 180 days otherwise available to complete the

purchase. Selected relevant dates (1988 & 1999 tax years) follow:

- ✓ April 17, 1989 - Tax return filed by Orville and Helen Christensen
- ✓ April 25, 1989 - Purchase of 1st replacement property; others at later dates

In *Knight, et ux. v. Comm., TC Memo 1998-107 (March 16, 1998)*, the Tax Court found that the taxpayers failed to comply with the 180-day purchase rule. Selected relevant dates (1993 tax year) follow:

- ✓ February 17, 1993 - Sale of 99th Street rental (relinquished) property
- ✓ February 19, 1993 - Sale of West Center Street rental (relinquished) property
- ✓ April 2, 1993 - Identification of 3 potential replacement properties
- ✓ August 16, 1993 - Negotiations failed on sale
- ✓ August 17, 1993 - Expiration of the 180-day deadline
- ✓ December 23, 1993 - Alternate purchased <u>after</u> the 180-day deadline expired

10. IRC§1031 exchange rules require that replacement properties be properly <u>identified</u>

a. within 45 days of the sale of relinquished property
b. within 180 days of the sale of relinquished property
c. within 45 to 180 days of the sale of relinquished property
d. prior to the due date for the taxpayer's federal income tax return (as extended)

11. IRC§1031 exchange rules require that replacement properties be properly <u>purchased</u>

a. within 45 days of the sale of relinquished property
b. within 180 days of the sale of relinquished property
c. prior to the due date for the taxpayer's federal income tax return (as extended)
d. the earlier of b. or c.

Nontaxable Exchanges

To <u>completely</u> defer/avoid tax in a properly executed IRC§1031 exchange, the following steps are essential:

1. The taxpayer must buy replacement property with a fair market value equal to or greater than that of the property relinquished;
2. The taxpayer must use all of the original equity realized from the sale of the relinquished property to purchase the replacement property; and
3. The taxpayer must secure financing of an equal or greater amount on the replacement property, when compared to the amount financed on the relinquished property at the time of its sale.

12. To <u>completely</u> defer/avoid tax in a properly executed IRC§1031 exchange, the taxpayer must

a. buy replacement property with a fair market value equal to or greater than that of the property relinquished

b. use all of the original equity realized from the sale of the relinquished property to purchase the replacement property

c. secure financing of an equal or greater amount on the replacement property, when compared to the amount financed on the relinquished property at the time of its sale

d. All of the above are correct

Partially Nontaxable/Taxable Exchanges

Some "exchanges" include (1) money or (2) unlike property. If a gain is realized, you may be taxed on this gain, but only to the extent of the combined total of the money and the fair market value of the unlike property received. (Note that any "loss" on a nontaxable or tax deferred exchange is <u>never</u> deductible).

The maximum amount of your taxable gain is (1) the fair market value of any unlike property received *plus* (2) any money received *less* (3) any closing costs you paid. Your taxable gain is the

lesser of this amount or that amount you might pay on a taxable exchange.

Taxable Exchanges – Gain or Loss Computation

To calculate the gain or loss from a taxable exchange, you must first become acquainted with the terminology. Terms such as fair market value, basis, adjusted basis, gain, loss and realized gain or loss are defined below.

The fair market value (FMV) is the price at which a property will change hands between a willing buyer and a willing seller, with neither party compelled or pressured to buy or sell. When an exchange transaction takes place between parties with adverse or self-interests in an arms-length transaction (e.g., unrelated parties), the sale or exchange value is presumed to have taken place at FMV.

The *basis* of a property is usually its cost. Exceptions include property acquired by gift, inheritance, or some other means of transfer. (Coverage of these alternative means of transfer, used to determine the basis of a property, is beyond the scope of this introductory course).

The *adjusted basis* of a property is the original cost or other basis (see above) plus certain additions or improvements less certain deductions (e.g., depreciation and/or casualty losses). When determining gain or loss, costs of transferring the property, including selling expenses, are added to the adjusted basis of the property.

The amount you *realize* from a sale or exchange is the (1) money *plus* (2) fair market value of property or services received *plus* (3) any of your liabilities assumed by the buyer, which include real estate taxes or a mortgage.

A *gain* is the amount *realized* from a sale or exchange of property that is in excess of its *adjusted basis*. A *loss* is the excess of the *adjusted basis*, when this amount exceeds the amount *realized* from a sale or exchange.

Gain results from (1) past depreciation taken (for tax purposes), (2) the property appreciating in value or, most likely, (3) some combination of depreciation, which lowers the adjusted basis of the property, and appreciation.

Table 1 will reinforce and allow you to apply the terms covered above. It assumes that a taxpayer sold a building (cost at $55,000) for $90,000 cash plus $10,000 in other property or services. Improvements of $5,000 were made and depreciation expenses of $10,000 were deducted during the period of ownership. The buyer assumed real estate taxes of $1,000 and a mortgage for $9,000. Selling expenses were $4,000. The amount *realized* was $110,000, the *adjusted basis* of the property was $54,000, and the *gain* on the sale or exchange transaction was $56,000. The objective of the IRC§1031 exchange is to legitimately avoid *recognition* of the *realized* gain on the sale.

Amount Realized:		
Cash	$90,000	
plus: FMV of property or services received	$10,000	
plus: Real estate taxes assumed by the buyer	$ 1,000	
plus: Mortgage assumed by the buyer	$ 9,000	$110,000
Adjusted Basis:		
Cost	$55,000	
plus: Improvements	$ 5,000	
equals: Cost plus Improvements	$60,000	
less: Depreciation	$10,000	
equals: Adjusted Basis	$50,000	
plus: Selling Expenses	$ 4,000	$ 54,000
Realized Gain on Sale		$ 56,000

Table 1

Realized versus Recognized

In Table 1, $56,000 in gain was *realized* by the taxpayer. However, in the case of a nontaxable or IRC§1031 exchange, this deal might have been structured in such a manner that part or all of the gain would have gone *unrecognized*. Therefore, the distinction between *realization* and *recognition* is an important one. A *realized* gain may or may not be subject to tax. A *recognized* gain is always subject to tax. An IRC§1031 exchange reduces or eliminates the amount *recognized* by a taxpayer with a *realized* gain.

Receipt of Boot

Because exchanges between taxpayers do not always occur with properties of equal value, non-like-kind property or money may be included in the exchange transaction. Money and any other non-like-kind property (e.g., goods or services at FMV) constitute and are referred to as *boot*.

Gain is recognized to the extent that boot is received, but limited by the taxpayer's realized gain, which serves as a ceiling for recognized gain. The receipt of boot in a nontaxable exchange does not, in and of itself, cause a realized loss to be recognized. In fact, if there is a realized loss in a boot received situation, the loss is not recognized.

Mortgage boot or debt relief occurs when the replacement property debt is less than the relinquished property debt. Mortgage boot is taxable unless offset by contributing an equivalent amount of cash to complete the transaction. The cash contributed has, after all, already been taxed.
Involuntary Conversions

An involuntary conversion occurs through casualty, theft, or condemnation falls outside of the rules of IRC§1031, per se. Involuntary conversions fall under the guidelines contained in IRC§1033, but also represents and exchange involving the non-recognition of gain or loss. Given recent disasters (e.g., 911 in New York City and Katrina in New Orleans), coverage and the distinctions between IRC§1031 and IRC§1033 is warranted.

Replacement properties evolving from an involuntary conversion are governed by two <u>mandatory</u> rules for gain or loss recognition, as follows:

- ✓ no gain is recognized if there is a direct conversion into property that is similar or related in service or use instead of into a money award – the basis of the replacement property is the adjusted basis of the old property
- ✓ allowable, realized losses must be recognized – the basis of the replacement property is its acquisition cost

The Basis of Replacement Property

The taxpayer's original cost, purchase price or basis (comparable terms) is increased by any capital improvements (i.e., long-lived improvements that have not been expensed, e.g., repairs and maintenance) and reduced by depreciation (including amortization and depletion). The result is the taxpayer's basis, adjusted basis or net adjusted basis (comparable terms) in the relinquished property.

The taxpayer's basis is reduced by boot received, liabilities assumed by the transferee, and loss recognized on the exchange. The taxpayer's basis is increased by boot given, liabilities assumed by the transferor, and gain recognized in the exchange.

	Original Cost, Basis or Purchase Price of RELINQUISHED Property
+	Capital Improvements
-	Depreciation
=	**Adjusted Basis of RELINQUISHED Property**
+	Boot given
+	Gain recognized
+	Liability assumed by the transferor (seller)
-	Fair market value of boot received
-	Loss recognized
-	Liability assumed by the transferee (buyer)
=	**Basis of REPLACEMENT Property**

Table 2

Realized Gains and Losses and Cases Where Boot is Given

✓ Table 3 begins with a case where the fair market value of the replacement property is held constant at $9,000. No boot is given. In one case (**1a**), the taxpayer has a realized gain. In the other case (**1b**), the taxpayer has a realized loss. Note that neither case results in a recognized gain or loss.

- ✓ Table 3 proceeds with a case where boot is given. In one case (**2a**), the taxpayer has a realized gain. In the other case (**2b**), the taxpayer has a realized loss. Note that neither case results in a recognized gain or loss.
- ✓ Table 3 continues with a case where the fair market value of the replacement property does not remain constant. Boot is received. In one case (**3a**), the taxpayer has a realized gain. In the other case (**3b**), the taxpayer has a realized loss. Note that one case (**3a**) results in a recognized gain.
- ✓ You should pay particular attention to three measures in Table 6:
  - ✓ the realized gain or (loss),
  - ✓ the recognized gain or (loss), and
  - ✓ the new basis for the replacement property.

Question		1a	1b
1	Recognized Gain or (Loss)?	No	No
2	Boot Involved?	No	No
3	Realized Gain or (Loss)?	Gain	Loss
Fair Market Value of REPLACEMENT Property		$9,000	$ 9,000
Adjusted Basis of RELINQUISHED Property		$4,000	$10,000
Boot:			
	Adjusted Basis of Boot Given	$ -0-	$ -0-
	Fair Market Value of Boot Received	$ -0-	$ -0-
Realized Gain or (Loss)		$5,000	$ (1,000)
Recognized Gain or (Loss)		$ -0-	$ -0-
New Basis (REPLACEMENT Property):			
	Adjusted Basis RELINQUISHED Property	$4,000	$10,000
+	Adjusted Basis of Boot Given	$ -0-	$ -0-
+	Recognized Gain or (Loss)	$ -0-	$ -0-
-	Fair Market Value of Boot Received	$ -0-	$ -0-
=	New Basis (REPLACEMENT Property):	$4,000	$10,000

Table 3

13. Assume that a taxpayer, with an adjusted basis of $4,000 in their relinquished property, has identified a possible replacement property with a fair market value of $9,000. No boot or other factors are

involved in this exchange. The realized gain or (loss), recognized gain or (loss), and new basis in the replacement property is

a. $5,000, $-0-, and $4,000, respectively
b. $(1,000), $-0-, and $10,000, respectively
c. $5,000, $-0-, and $10,000, respectively
d. $(1,000), $-0-, and $4,000, respectively

14. Assume that a taxpayer, with an adjusted basis of $10,000 in their relinquished property, has identified a possible replacement property with a fair market value of $9,000. No boot or other factors are involved in this exchange. The realized gain or (loss), recognized gain or (loss), and new basis in the replacement property is

a. $5,000, $-0-, and $4,000, respectively
b. $(1,000), $-0-, and $10,000, respectively
c. $5,000, $-0-, and $10,000, respectively
d. $(1,000), $-0-, and $4,000, respectively

Question		2a	2b
1	Recognized Gain or (Loss)?	No	No
2	Boot Involved?	Given	Given
3	Realized Gain or (Loss)?	Gain	Loss
Fair Market Value of REPLACEMENT Property		$9,000	$ 9,000
Adjusted Basis of RELINQUISHED Property		$4,000	$ 4,000
Boot:			
	Adjusted Basis of Boot Given	$2,500	$ 6,000
	Fair Market Value of Boot Received	$ -0-	$ -0-
Realized Gain or (Loss)		$2,500	$ (1,000)
Recognized Gain or (Loss)		$ -0-	$ -0-
New Basis (REPLACEMENT Property):			
	Adjusted Basis RELINQUISHED Property	$4,000	$ 4,000
+	Adjusted Basis of Boot Given	$2,500	$ 6,000
+	Recognized Gain or (Loss)	$ -0-	$ -0-
-	Fair Market Value of Boot Received	$ -0-	$ -0-
=	New Basis (REPLACEMENT Property):	$6,500	$10,000

15. Assume that a taxpayer, with an adjusted basis of $4,000 in their relinquished property, has identified a possible replacement property with a fair market value of $9,000. Boot with an adjusted basis of $2,500 will also be given to complete the exchange. The realized gain

or (loss), recognized gain or (loss), and new basis in the replacement property is

a. $2,500, $-0-, and $6,500, respectively
b. $(1,000), $-0-, and $10,000, respectively
c. $2,500, $-0-, and $10,000, respectively
d. $(1,000), $-0-, and $6,500, respectively

Question		3a	3b
1	Recognized Gain or (Loss)?	Gain	No
2	Boot Involved?	Rec'd	Rec'd
3	Realized Gain or (Loss)?	Gain	Loss
Fair Market Value of REPLACEMENT Property		$9,000	$3,500
Adjusted Basis of RELINQUISHED Property		$4,000	$4,000
Boot:			
	Adjusted Basis of Boot Given	$ -0-	$ -0-
	Fair Market Value of Boot Received	$3,000	$ 250
Realized Gain or (Loss)		$8,000	$ (250)
Recognized Gain or (Loss)		$3,000	$ -0-
New Basis (REPLACEMENT Property):			
	Adjusted Basis RELINQUISHED Property	$4,000	$4,000
+	Adjusted Basis of Boot Given	$ -0-	$ -0-
+	Recognized Gain or (Loss)	$3,000	$ -0-
-	Fair Market Value of Boot Received	$3,000	$ 250
=	New Basis (REPLACEMENT Property):	$4,000	$3,750

16. Assume that a taxpayer, with an adjusted basis of $4,000 in their relinquished property, has identified a possible replacement property with a fair market value of $9,000. Boot with an adjusted basis of $6,000 will also be given to complete the exchange. The realized gain or (loss), recognized gain or (loss), and new basis in the replacement property is

a. $2,500, $-0-, and $6,500, respectively
b. $(1,000), $-0-, and $10,000, respectively
c. $2,500, $-0-, and $10,000, respectively
d. $(1,000), $-0-, and $6,500, respectively

17. Assume that a taxpayer, with an adjusted basis of $4,000 in their relinquished property, has identified a possible replacement property with a fair market value of $9,000. Boot with an adjusted basis of

$3,000 will also be received to complete the exchange. The realized gain or (loss), recognized gain or (loss), and new basis in the replacement property is

a. $8,000, $3,000, and $4,000, respectively
b. $(250), $-0-, and $3,750, respectively
c. $8,000, $-0-, and $3,750, respectively
d. $(250), $3,000, and $4,000, respectively

18. Assume that a taxpayer, with an adjusted basis of $4,000 in their relinquished property, has identified a possible replacement property with a fair market value of $3,500. Boot with an adjusted basis of $250 will also be received to complete the exchange. The realized gain or (loss), recognized gain or (loss), and new basis in the replacement property is

a. $8,000, $3,000, and $4,000, respectively
b. $(250), $-0-, and $3,750, respectively
c. $8,000, $-0-, and $3,750, respectively
d. $(250), $3,000, and $4,000, respectively

LESSON 2

Treasury Regulations

Treasury regulations provide detailed guidance, including excellent illustrations and examples, for many federal income tax issues. (Many textbooks and articles actually use Treasury regulation examples or modifications to explain tax law). They serve as interpretations of the IRC (the highest legislative authority for tax research, planning, and compliance) by the Secretary of the Treasury. They may be issued in proposed (Prop Reg), temporary (Temp Reg), and final (Reg) form, and are interpretive or legislative. Legislative regulations are higher, in terms of authority, than interpretive regulations. Proposed regulations are not authoritative.

In all cases, merely add a 1 to the IRC§, moved to the right of a single decimal place, to determine the section in the Treasury Regulation. For example, in the case of IRC§1031, the Treasury regulation counterpart would be §1.1031 (e.g., IRC§1031 and Reg§1.1031).

1. Which of the below is true?

a. To convert an IRC§ to a Reg§, add a 1 to the IRC§, moved to the right of a single decimal place (e.g., IRC§1031 would be Reg§1.1031)

b. Final Treasury regulations (Reg) are authoritative; proposed regulations (Prop Reg) are not.

c. Treasury regulations serve as interpretation of the IRC, in many cases, including illustrations and examples

d. All of the above are true.

The History of Internal Revenue Code of 1954 - Section 1031

For those interested in researching the legislative history of Internal Revenue Code Section (IRC§) 1031, the following are provided:

- ✓ 1958 – Public Law (P.L.) 85-866, effective only for 1954 and later tax years
- ✓ 1959 – P.L. 86-346, effective only for 9/23/1959 and later tax years
- ✓ 1969 – P.L. 91-172
- ✓ 1984 – P.L. 98-369, effective only for 7/19/84 and later tax years (modifications address the 45-day and 180-day rules)
- ✓ 1986 – P.L. 99-514
- ✓ 1989 – P.L. 101-239, effective only for 7/11/1989 and later tax years
- ✓ 1990 – P.L. 101-508, effective only for 8/4/1990 and later tax years
- ✓ 1997 – P.L. 105-34, effective only for 6/9/1997 and later tax years
- ✓ 1999 – P.L. 106-36, effective only for 11/1/1998 and later tax years

2. In the context of tax law, P.L. is the acronym used for
a. Public Law
b. Public Legislation
c. Private Law
d. Private Legislation

In *Starker v. U.S., 44 AFTR 2d 79-5525 (602 F.2d 1341), 8/24/1979*, the IRS was barred from re-litigating the case, dealing with the taxpayer's 1976 tax return. In the original case, it was found that the transfer of property need not be simultaneous.

The tax forms likely to be used in IRC§1031 exchanges follow:

- ✓ Form 8824 – Like-Kind Exchanges: Applies to and is required for all like-kind exchanges
- ✓ Form 6252 – Installment Sale Income: Generally, this form only applies when the exchange has a taxable component and involves installments or payments and the results flow into Form 4797 and/or Form 1040, Schedule D

- ✓ Form 4797 – Sale of Business Property: Generally, this form only applies when the exchange has a taxable component and facilitates the allocation of gains into varying classifications (e.g., ordinary income or long-term capital gains)
- ✓ Form 1040, Schedule D – Capital Gains and Losses: Generally, this form only applies when the exchange has a taxable component and facilitates the allocation of gains into varying classifications (e.g., ordinary income or long-term capital gains)

IRC§1231 Property and IRC§1245 and 1250 Property Recapture

In the introductory course, applicable long-term capital gains tax rates for 2004 and 2005 were summarized and it was noted that recapture of IRC§1250 gain was taxed at 25 percent:

	Option 1 Sale & Purchase	**Option 2 Exchange**
Sales Price/Fair Market Value	$100,000	na
less: Cost or Adjusted Basis	$ 50,000	na
equals: Taxable Gain	$ 50,000	na
Taxed at 25%:		
Fair Market Value	$100,000	$100,000
less: Tax ($50,000 x 25%)	$ 12,500	$ -0-
equals: Remaining Equity (12.5% equity lost)	$ 87,500	$100,000
Taxed at 15%:		
Fair Market Value	$100,000	$100,000
less: Tax ($50,000 x 15%)	$ 7,500	$ -0-
equals: Remaining Equity (7.5% equity lost)	$ 92,500	$100,000
Taxed at 5%:		
Fair Market Value	$100,000	$100,000
less: Tax ($50,000 x 5%)	$ 2,500	$ -0-
equals: Remaining Equity (2.5% equity lost)	$ 97,500	$100,000

Table 4

2004-2005 Marginal Federal Income Tax Rate or Tax Bracket	**Applicable Long-Term Capital Gains Tax Rate**
5% & 10%	5%
25%, 28%, 33% & 35%	15%

Table 5

This intermediate course elaborates on IRC§1250, but in a fully developed description of IRC§1221 (investment) and IRC§1231 (trade or business use) property and IRC§1245 (personal) and 1250 (real) property recapture, as follows:

Generally, the IRC§1031 exchanges most realtors are likely to be involved in will be comprised of and include IRC§1231 property. IRC§1231 property includes:

- ✓ real or depreciable property used in a trade or business and held for more than one-year

- ✓ timber, coal or domestic iron ore
- ✓ livestock
- ✓ unharvested crops

IRC§1245 property includes automobiles, livestock, railroad grading, and single-purpose agricultural or horticultural structures.

Generally, the IRC§1031 exchanges most realtors are likely to be involved in will be comprised of and require some working knowledge of the recapture provisions of IRC§1250. IRC§1250 property is any depreciable property, other than IRC§1245 property, and includes:

- ✓ low-income housing
- ✓ depreciable residential rental property
- ✓ all other depreciable real property except nonresidential, qualifying as recovery property (placed in service after 1980 and before 1987) unless the straight-line method of cost recovery was elected and used

3. Assume that you purchase a residential rental property with a refrigerator, washer and dryer. The refrigerator, washer and dryer would be properly classified as

a. IRC§1031 property
b. IRC§1231 property
c. IRC§1245 property
d. IRC§1250 property

4. Assume that you purchase a residential rental property with a refrigerator, washer and dryer. The real property, excluding the refrigerator, washer and dryer would be properly classified as

a. IRC§1031 property
b. IRC§1231 property
c. IRC§1245 property
d. IRC§1250 property

Generally, in the case of the purchase of a residential rental property, the purchase price is allocated between land, improvements, and personal property. Land is not a wasting

asset, so no depreciation is permitted. Real property improvements are depreciated, as are personal property items included in the sale/purchase (e.g., refrigerator, washer and dryer). The purchaser seeks, within reason, to allocate higher costs to personal property items, real property improvements and land, in that order, since the shortest depreciable life is associated with personal property and land is not depreciable. This maximizes the depreciable base (and depreciation expense) available to the taxpayer. The allocation of purchase price to personal property, real property improvements and land is made using what is often referred to as the *relative sales value* approach (i.e., pro rated).

5. When purchasing a residential rental property, allocations of the purchase price must be made between
a. personal property (e.g., refrigerator, washer and dryer)
b. real property improvements
c. land
d. All of the above

6. When purchasing a residential rental property, the shortest depreciable life is associated with
a. personal property (e.g., refrigerator, washer and dryer)
b. real property improvements
c. land
d. All of the above

7. When purchasing a residential rental property, which item is not depreciable?
a. personal property (e.g., refrigerator, washer and dryer)
b. real property improvements
c. land
d. All of the above

Depreciation

Depreciation allows the taxpayer to match an expense, representing the functional or economic obsolescence of an asset with an estimated useful life exceeding one-year, against the

revenue generated from these long-lived or fixed assets. The modified accelerated cost recovery system (MACRS) system applies for assets placed in service after December 31, 1986. There are six categories for assets classified as tangible personal property, as follows:

- ✓ 3-year - tractor units, race horses over 12 years old, and special tools
- ✓ 5-year - automobiles, light and heavy-duty general purpose trucks, computers, and research and experimental equipment
- ✓ 7-year - office furniture and equipment, horses, single-purpose agricultural or horticultural structures, and property not otherwise classified; most machinery
- ✓ 10-year - barges, vessels, and petroleum and food processing equipment
- ✓ 15-year - billboards, service station buildings, and land improvements
- ✓ 20-year - utilities and sewers

8. A refrigerator, washer and dryer in a residential rental property is depreciated over a useful life of

a. 3 years
b. 5 years
c. 7 years
d. Some other time period

The above are calculated based on a 200 percent or double declining (DDB) balance method, switching to straight-line (SL) at the mid-life point or where the application of SL results in a higher amount of depreciation. Their application is likely to be most relevant when like kind exchanges include farm properties or rental properties, where non-real properties are included in the transaction and must be separately evaluated for tax deferral (covered later). A half-year (HY) convention is applied in the year of acquisition and disposition. (For all practical purposes, the application of the fist year, half-year, modifying convention adds one-year to the lives presented above.)

There are two categories for assets classified as real property, as follows:

- ✓ 27.5 years - residential rental property
- ✓ 39 years - nonresidential rental property

The above are calculated using the SL method and require the application of a mid-month (MM) convention for the year of acquisition and disposition.

9. Real property improvements associated with the purchase of a residential rental property is depreciated over a useful life of

a. 27.5 years
b. 39 years
c. 20 years
d. Some other time period

10. Real property improvements associated with the purchase of a nonresidential rental property is depreciated over a useful life of

a. 27.5 years
b. 39 years
c. 20 years
d. Some other time period

11. Which of the below acronyms is correctly associated with the term it represents?

a. MM – Middle of Market
b. SL – Simple Line item
c. HY – Half-Year
d. DDB – Dewey Decimal Balance

Realized Gains and Losses and Cases Where Boot is Given – An Extension

The introductory course provided several illustrations for the calculation of (1) realized gain or (loss), (2) recognized gain or (loss), and (3) new basis in the replacement property (METHOD 1). This intermediate course provides an alternative method (METHOD 2), focusing, primarily, on the new basis in the replacement property, but using the same examples or fact

patterns. Note that the same “Basis of REPLACEMENT Property” should result from both methods:

	METHOD 1
	Original Cost, Basis or Purchase Price RELINQUISHED Property
+	Boot given (Adjusted Basis)
+	Gain recognized
+	Liability assumed by the transferor (seller)
-	Boot received (Fair Market Value)
-	Loss recognized
-	Liability assumed by the transferee (buyer)
=	Basis of REPLACEMENT Property
	METHOD 2
	Fair Market Value of REPLACEMENT Property
-	Deferred (Realized *less* Recognized) Gain
+	Deferred Loss
=	Basis of REPLACEMENT Property

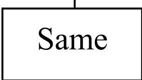

Table 6

Assume the following facts:

Question		1a	1b
1	Recognized Gain or (Loss)?	No	No
2	Boot Involved?	No	No
3	Realized Gain or (Loss)?	Gain	Loss
Fair Market Value of REPLACEMENT Property		$9,000	$ 9,000
Adjusted Basis of RELINQUISHED Property		$4,000	$10,000
Boot:			
	Adjusted Basis of Boot Given	$ -0-	$ -0-
	Fair Market Value of Boot Received	$ -0-	$ -0-
Realized Gain or (Loss)		$5,000	$ (1,000)
Recognized Gain or (Loss)		$ -0-	$ -0-
New Basis (REPLACEMENT Property):			
	Adjusted Basis RELINQUISHED Property	$4,000	$10,000
+	Adjusted Basis of Boot Given	$ -0-	$ -0-
+	Recognized Gain or (Loss)	$ -0-	$ -0-
-	Fair Market Value of Boot Received	$ -0-	$ -0-
=	New Basis (REPLACEMENT Property):	$4,000	$10,000

Table 7

Note that METHOD 1 and METHOD 2 generate the same result:

	1a	**1b**	(000 omitted)
			METHOD 1
			Original Cost,/Basis/Purchase Price
	$4	$10	RELINQUISHED Property
+	-0-	-0-	Boot given (Adjusted Basis)
+	-0-	-0-	Gain recognized
+	-0-	-0-	Liability assumed by the transferor (seller)
-	-0-	-0-	Boot received (Fair Market Value)
-	-0-	-0-	Loss recognized
-	-0-	-0-	Liability assumed by the transferee (buyer)
=	$4	$10	Basis of REPLACEMENT Property ← Same
			METHOD 2
	$9	$ 9	Fair Market Value of REPLACEMENT Property
-	$5	$ (1)	Deferred (Realized *less* Recognized) Gain
+	-0-	-0-	Deferred Loss
=	$4	$10	Basis of REPLACEMENT Property ← Same

Table 7a

12. Assume that a taxpayer, with an adjusted basis of $4,000 in their relinquished property, has identified a possible replacement property with a fair market value of $9,000. No boot or other factors are involved in this exchange. Using METHOD 2 (see below), the basis of the replacement property is

a. $5,000
b. $(1,000)
c. $4,000
d. $10,000

	METHOD 2
	Fair Market Value of REPLACEMENT Property
-	Deferred (Realized *less* Recognized) Gain
+	Deferred Loss
=	Basis of REPLACEMENT Property

13. Assume that a taxpayer, with an adjusted basis of $10,000 in their relinquished property, has identified a possible replacement property with a fair market value of $9,000. No boot or other factors are involved in this exchange. Using METHOD 2 (below), the basis of the replacement property is

a. $5,000
b. $(1,000)
c. $4,000
d. $10,000

METHOD 2
Fair Market Value of REPLACEMENT Property
\- Deferred (Realized *less* Recognized) Gain
\+ Deferred Loss
= Basis of REPLACEMENT Property

Assume the following facts:

Question		2a	2b
1	Recognized Gain or (Loss)?	No	No
2	Boot Involved?	Given	Given
3	Realized Gain or (Loss)?	Gain	Loss
Fair Market Value of REPLACEMENT Property		$9,000	$ 9,000
Adjusted Basis of RELINQUISHED Property		$4,000	$ 4,000
Boot:			
	Adjusted Basis of Boot Given	$2,500	$ 6,000
	Fair Market Value of Boot Received	$ -0-	$ -0-
Realized Gain or (Loss)		$2,500	$ (1,000)
Recognized Gain or (Loss)		$ -0-	$ -0-
New Basis (REPLACEMENT Property):			
	Adjusted Basis RELINQUISHED Property	$4,000	$ 4,000
+	Adjusted Basis of Boot Given	$2,500	$ 6,000
+	Recognized Gain or (Loss)	$ -0-	$ -0-
-	Fair Market Value of Boot Received	$ -0-	$ -0-
=	New Basis (REPLACEMENT Property):	$6,500	$10,000

Table 8

Note that METHOD 1 and METHOD 2 generate the same result:

	2a	2b	
			METHOD 1
			Original Cost/Basis/Purchase Price
	$4,000	$ 4,000	RELINQUISHED Property
+	$2,500	$ 6,000	Boot given (Adjusted Basis)
+	-0-	-0-	Gain recognized
+	-0-	-0-	Liability assumed by the transferor (seller)
-	-0-	-0-	Boot received (Fair Market Value)
-	-0-	-0-	Loss recognized
-	-0-	-0-	Liability assumed by the transferee (buyer)
=	$6,500	$10,000	Basis of REPLACEMENT Property ← Same
			METHOD 2
	$9,000	$ 9,000	Fair Market Value of REPLACEMENT Property
-	$2,500	$ (1,000)	Deferred (Realized *less* Recognized) Gain
+	-0-	-0-	Deferred Loss
=	$6,500	$10,000	Basis of REPLACEMENT Property ← Same

Table 8a

14. Assume that a taxpayer, with an adjusted basis of $4,000 in their relinquished property, has identified a possible replacement property with a fair market value of $9,000. Boot with an adjusted basis of $2,500 will also be given to complete the exchange. Using METHOD 2 (see below), the basis of the replacement property is

a. $2,500
b. $(1,000)
c. $6,500
d. $10,000

15. Assume that a taxpayer, with an adjusted basis of $4,000 in their relinquished property, has identified a possible replacement property with a fair market value of $9,000. Boot with an adjusted basis of $6,000 will also be given to complete the exchange. Using METHOD 2 (see below), the basis of the replacement property is

a. $2,500
b. $(1,000)
c. $6,500
d. $10,000

METHOD 2
Fair Market Value of REPLACEMENT Property
\- Deferred (Realized *less* Recognized) Gain
\+ Deferred Loss
= Basis of REPLACEMENT Property

Assume the following facts:

Question		3a	3b
1	Recognized Gain or (Loss)?	Gain	No
2	Boot Involved?	Rec'd	Rec'd
3	Realized Gain or (Loss)?	Gain	Loss
Fair Market Value of REPLACEMENT Property		$9,000	$3,500
Adjusted Basis of RELINQUISHED Property		$4,000	$4,000
Boot:			
	Adjusted Basis of Boot Given	$ -0-	$ -0-
	Fair Market Value of Boot Received	$3,000	$ 250
Realized Gain or (Loss)		$8,000	$ (250)
Recognized Gain or (Loss)		$3,000	$ -0-
New Basis (REPLACEMENT Property):			
	Adjusted Basis RELINQUISHED Property	$4,000	$4,000
+	Adjusted Basis of Boot Given	$ -0-	$ -0-
+	Recognized Gain or (Loss)	$3,000	$ -0-
-	Fair Market Value of Boot Received	$3,000	$ 250
=	New Basis (REPLACEMENT Property):	$4,000	$3,750

Table 9

Note that METHOD 1 and METHOD 2 generate the same result:

	3a	**3b**	
			METHOD 1
			Original Cost/Basis/Purchase Price
	$4,000	$4,000	RELINQUISHED Property
+	-0-	-0-	Boot given (Adjusted Basis)
+	$3,000	-0-	Gain recognized
+	-0-	-0-	Liability assumed by the transferor (seller)
-	$3,000	$ 250	Boot received (Fair Market Value)
-	-0-	-0-	Loss recognized
-	-0-	-0-	Liability assumed by the transferee (buyer)
=	$4,000	$3,750	Basis of REPLACEMENT Property
			METHOD 2
	$9,000	$3,500	Fair Market Value of REPLACEMENT Property
-	$5,000	$ (250)	Deferred (Realized *less* Recognized) Gain
+	-0-	-0-	Deferred Loss
=	$4,000	$3,750	Basis of REPLACEMENT Property

Same

Table 9a

16. Assume that a taxpayer, with an adjusted basis of $4,000 in their relinquished property, has identified a possible replacement property with a fair market value of $9,000. Boot with an adjusted basis of $3,000 will also be received to complete the exchange. Under METHOD 2 (see below), the basis of the replacement property is

a. $8,000
b. $3,000
c. $4,000
d. $3,750

17. Assume that a taxpayer, with an adjusted basis of $4,000 in their relinquished property, has identified a possible replacement property with a fair market value of $3,500. Boot with an adjusted basis of $250 will also be received to complete the exchange. Under METHOD 2 (see below), the basis of the replacement property is

a. $8,000
b. $3,000
c. $4,000
d. $3,750

METHOD 2
Fair Market Value of REPLACEMENT Property
- Deferred (Realized *less* Recognized) Gain
+ Deferred Loss
= Basis of REPLACEMENT Property

LESSON 3

Terminology, Jargon and Acronyms

The below is a fairly comprehensive list of terms/jargon and acronyms associated with IRC§1031 exchanges that you should familiarize yourself with before proceeding with this course:

Term	Definition
Actual Receipt	See Constructive Receipt and Mortgage Boot; Physical possession
Boot	See Cash Boot; Non like kind property received (or given) and potentially taxable
Cash Boot	See Boot and Mortgage Boot; Amounts actually or constructively received (or given)
Constructive Receipt	See Actual Receipt; Legal entitlement to possession, without regard to actual or physical possession
Debt Relief	See Mortgage Boot
Downleg Property	See Relinquished Property
EAT	Exchange Accommodation Titleholder
Exchange Property	See Relinquished Property
Exchanger	Entity or individual performing an exchange
Identification Period	45-day rule; The maximum number of days from the closing on the relinquished property to properly identify potential replacement property(ies)
QEAA	Qualified Exchange Accommodation Arrangements
Mortgage Boot	See Boot and Cash Boot; Also known as “Debt Relief”; Occurs when taxpayer fails to acquire debt in an

	amount equal to or greater than that on the relinquished property(ies) and potentially taxable
Parked	Also known as “held,” referring to the period during which property is held by EAT during a reverse exchange
Parking	See Parked
Phase I Client	Seller
Phase II Client	Buyer
Phase I Property	See Relinquished Property
Phase II Property	See Replacement Property
Purchase Property	See Replacement Property
Relinquished Property	Property “given up”; Also known as the Sale, Exchange, Downleg, or Phase I property
Replacement Property	Property “received”; Also known as the Purchase, Target, Upleg, or Phase II property
Reverse Exchange	When Replacement Property is closed before Relinquished Property
Sale Property	See Relinquished Property
Target Property	See Replacement Property
Upleg Property	See Replacement Property

1. The property “given up” in an IRC§1031 exchange is also known as
a. phase I property
b. sale property
c. downleg property
d. All of the above

2. The property “received” in an IRC§1031 exchange is also known as
a. phase II property
b. purchase property
c. upleg property
d. All of the above

Relevant Internal Revenue Code (IRC) Sections

Below is a summary of relevant IRC Sections, and the topics they related to, already addressed in the introductory and intermediate courses:

Introduced in the introductory course:

- ✓ IRC§121 - tax exclusions for personal residence
- ✓ IRC§351 - corporate interest exchanges
- ✓ IRC§721 - partnership interest exchanges
- ✓ IRC§1031 - tax-free or tax deferred exchanges
- ✓ IRC§1032 - corporate and partnership interest exchanges
- ✓ IRC§1033 - involuntary conversions
- ✓ IRC§1034 - personal residence
- ✓ IRC§1035 - insurance contract exchanges
- ✓ IRC§1036 - stock for stock exchanges
- ✓ IRC§1037 - U.S. obligation exchanges
- ✓ IRC§1038 - reacquisition and/or repossession of real property introduced in this intermediate course, so far:
- ✓ IRC§1221 - investment property
- ✓ IRC§1231 - trade or business property
- ✓ IRC§1245 - personal property
- ✓ IRC§1250 - real property

3. Which is the best answer? IRC rules governing investment property are contained in

a. IRC§1221
b. IRC§1231
c. IRC§1245
d. IRC§1250

4. Which is the best answer? IRC rules governing trade or business property are contained in

a. IRC§1221
b. IRC§1231
c. IRC§1245
d. IRC§1250

5. Which is the <u>best</u> answer? IRC rules governing <u>personal</u> property are contained in
a. IRC§1221
b. IRC§1231
c. IRC§1245
d. IRC§1250

6. Which is the <u>best</u> answer? IRC rules governing <u>real</u> property are contained in
a. IRC§1221
b. IRC§1231
c. IRC§1245
d. IRC§1250

The purpose of IRC§1245 is to eliminate tax advantages otherwise available via the reduction of ordinary income through depreciation, only to receive IRC§1231 treatment for subsequent gains. To understand this provision of the IRC, you must first understand that ordinary income (e.g., salary, interest and dividend income, and business income) is taxed at a higher rate than long-term capital gain (LTCG). For this reason, Table 5 is, again, provided below:

2004-2005 Marginal Federal Income Tax Rate or Tax Bracket	Applicable Long-Term Capital Gains Tax Rate
5% & 10%	5%
25%, 28%, 33% & 35%	15%

Table 5

IRC§1245 recapture provisions prevent net IRC§1231 gains from being treated as LTCG and receiving preferential tax treatment. So, for example, the depreciation expense on your rental property that you deducted while in a 35 percent marginal federal income tax bracket (e.g., tax savings or deferral of $35 per $100 depreciation deduction), will <u>not</u> be taxed at the lesser rate of 15 percent, when the rental property is sold for a profit (see Table 5). The taxpayer does, however, continue to benefit from time value of money or tax deferral (i.e., a dollar today is worth more than a

dollar tomorrow, so the $35 savings in, for example, the 2000 tax year, still benefited the taxpayer deferring and paying this amount in the 2005 tax year, when the depreciated must be recaptured under IRC§1245 and the property is sold).

IRC§1245

- ✓ affects the character of the gain, not the amount of the gain
- ✓ does not apply to assets sold or exchanged at a loss
- ✓ ordinary income is never greater than the realized gain
- ✓ recapture applies to total depreciation (or amortization) allowed (or allowable), but not to exceed the realized gain
- ✓ property includes depreciable personal property (and amortizable intangible assets)
- ✓ property includes nonresidential real property placed in service after 1980 and before 1987 under the accelerated cost recovery system (ACRS), unless the taxpayer elected straight-line (SL) depreciation
- ✓ does not apply to any buildings placed in service after 1986

7. IRC§1245
a. prevents net IRC§1231 gains from being treated and taxed, preferentially, as LTCG
b. has no impact on taxpayers
c. does not eliminate the benefits associated with tax deferral
d. both a. and c. are correct

8. IRC§1245
a. has no impact on taxpayers
b. does not apply to assets sold or exchanged at a loss
c. applies to building placed in service after 1986
d. specifically excludes depreciable personal property

IRC§1250 converts a portion of IRC§1231 gains into ordinary income when real property is sold or exchanged. IRC§1250 recapture can be avoided by using straight-line (SL) depreciation, as it is the accelerated depreciation component (e.g., DDB or double-declining balance) that IRC§1250 converts into ordinary

income. IRC§1250 recapture can also be avoided by simply keeping the property for its entire useful or depreciable life, since the accumulated depreciation is the same under both SL and DDB at the end of the useful life of an asset.

IRC§1250
- ✓ affects the character of the gain, not the amount of the gain
- ✓ does not apply to assets sold or exchanged at a loss
- ✓ ordinary income is never greater than the realized gain
- ✓ ordinary income is never greater than the additional depreciation allowed (e.g., DDB in excess of SL depreciation)
- ✓ property includes depreciable real property, unless nonresidential and placed in service in 1980 and before 1987 under the accelerated cost recovery system (ACRS) and the taxpayer did not elect straight-line (SL) depreciation
- ✓ does not apply if SL depreciation is used

9. Which statement is true of both IRC§1245 and IRC§1250
a. affects the character of the gain, not the amount of the gain
b. does not apply to assets sold or exchanged at a loss
c. ordinary income is never greater than the realized gain
d. All of the above are true of both IRC§1245 and IRC§1250

10. IRC§1250
a. converts a portion of IRC§1231 gains into ordinary income
b. can be avoided by using SL depreciation
c. can be avoided by keeping a property for its entire useful or depreciable life
d. All of the above are correct

11. Generally, IRC§1245 recapture applies to
a. depreciable personal property (and amortizable intangible assets)
b. nonresidential real property placed in service after 1980 and before 1987 under the accelerated cost recovery system (ACRS), unless the taxpayer elected straight-line (SL) depreciation
c. depreciable real property, unless nonresidential and placed in service in 1980 and before 1987 under the accelerated cost recovery system (ACRS) and the taxpayer did not elect straight-line (SL) depreciation
d. both a. and b.

12. Generally, IRC§1250 recapture applies to
a. depreciable personal property (and amortizable intangible assets)
b. nonresidential real property placed in service after 1980 and before 1987 under the accelerated cost recovery system (ACRS), unless the taxpayer elected straight-line (SL) depreciation
c. depreciable real property, unless nonresidential and placed in service in 1980 and before 1987 under the accelerated cost recovery system (ACRS) and the taxpayer did not elect straight-line (SL) depreciation
d. both a. and b.

Related Party Exchanges

Generally, the IRS views transactions between related parties with greater scrutiny. Related party transactions are governed by IRC§1239. Were it not for IRC§1239, related taxpayers could engage in tax planning to shift the deferred gain to a related party in a lower tax bracket, effectively using IRC§1031 for estate planning purposes. Other tax planning opportunities, not intended by Congress, would also be available. In the case of IRC§1031 exchanges, related party exchanges are not "like kind" and do not qualify for tax deferral if either party disposes of the property within 2 years of the exchange. Dispositions due to death, involuntary conversion, or for purposes (clearly) other than tax avoidance are disregarded. Related parties include brothers, sisters, parents, children, and corporations or partnerships where the taxpayer owns or controls at least 50 percent of the stock or value.

13. Two family members properly execute an IRC§1031 exchange. One dies 1 year later. In this case
a. the IRC§1031 exchange is retroactively disallowed and the deferred gain recognized
b. the IRC§1031 exchange remains intact, as no tax avoidance motivation is presumed
c. the taxpayers must amend their tax returns
d. the error is corrected in the deceased taxpayer's estate tax return

14. Related parties include all of the following, except

a. brothers and sisters
b. parents
c. children
d. third cousins

15. Related party exchanges are governed under
a. IRC§1221
b. IRC§1231
c. IRC§1239
d. IRC§1250

16. Related party exchanges do not qualify as like kind if either party disposes of the property
a. within 45 days of the exchange
b. within 180 days of the exchange
c. within 2 years of the exchange
d. there is no holding period or time restriction with respect to related party transactions

17. Generally, related party exchanges
a. are not viewed as like kind
b. do not qualify for tax deferral
c. are treated like any other exchange
d. both a. and b. are correct

LESSON 4

Depreciable Tangible Personal Property

This course deals, primarily, with IRC§1031 as applied to real property. However, a transaction may also involve depreciable tangible personal property (e.g., furniture and fixtures in a business exchange). Therefore, some familiarity with the treatment of personal property under IRC§1031 is warranted.

IRC§1031 applies to depreciable tangible personal property if the property is exchanged for property of a like kind or class. Revenue Procedure (Rev. Proc.) 87-56, 1987-2 C.M. 674 describes General Asset Classes (in parentheses). Those frequently used in many businesses follow (Reg§1.1031(a)-2(b)(2)):
(i) - Office furniture, fixtures, & equipment (00.11)
(ii) - Information systems (computers & peripheral equipment) (00.12)
(iii) - Data handling equipment, except computers (00.13)
(iv) - Airplanes (airframes & engines), except those used in commercial or contract carrying of passengers or freight, & all helicopters (airframes & engines) (00.21)
(v) - Automobiles, taxis (00.22)
(vi) - Buses (00.23)
(vii) - Light general purpose trucks (00.241)
(viii) - Heavy general purpose trucks (00.242)
(ix) - Railroad cars & locomotives, except those owned by railroad transportation companies (00.25)
(x) - Tractor units for use over-the-road (00.26)
(xi) - Trailers & trailer-mounted containers (00.27)
(xii) - Vessels, barges, tugs, & similar water-transportation equipment, except those used in marine construction (00.28)
(xiii) - Industrial steam & electric generation and/or distribution systems (00.4)

An example of a like kind exchange of depreciable tangible personal property, and qualifying for IRC§1031 tax deferral, follows:

✓ a taxpayer exchanges a personal computer to another taxpayer for a printer (Reg§1.1031(a)-2(b)(7)Example (1)) – see asset class (00.12)

An example of depreciable tangible personal property that is <u>not</u> of a like kind, and does <u>not</u> qualify for IRC§1031 tax deferral, follows:

✓ a taxpayer transfers an airplane to another taxpayer for a heavy general purpose truck (Reg§1.1031(a)-2(b)(7)Example (2)) – see asset class (00.21 & 00.242)

1. Which of the below qualifies as like kind items of depreciable tangible personal property?

a. exchanging a personal computer for a printer
b. exchanging an airplane for a heavy general purpose truck
c. exchanging an automobile for a heavy general purpose truck
d. All of the above qualify as like kind exchanges

Exchange Group Surpluses, Deficiencies and Basis Determination

The example that follows involves multiple personal property components. It is a fairly complex, but not comprehensive example (as adapted from Reg§1.1031(j)-1(c) Example(1)). *Realized* and *recognized* are terms that were developed and defined in the introductory course. You should already feel comfortable with these terms, as well as *replacement* property and *relinquished* property. This example introduces two new terms: exchange group *surplus* and exchange group *deficiency*. These terms are important in understanding the computation of *basis* in the replacement properties. The example follows:

✓ Taxpayer A exchanges his computer (adjusted (adj.) basis at $375 and fair market value (FMV) at $1,000) and automobile

(adj. basis at $1,500 and FMV at $4,000) with taxpayer B for B's printer (FMV at $2,050) and automobile (FMV at $2,950). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The basic facts from this above case are summarized in Table 10, below:

Description	Adjusted Basis	Fair Market Value
Computer A	$ 375	$ 1,000
Automobile A	$ 1,500	$ 4,000
Printer B	$ -0-	$ 2,050
Automobile B	$ -0-	$ 2,950

Table 10

- Step 1 – separate the assets into exchange groups to calculate A's *surplus* or *deficiency*:
  - computer (00.12) & printer (00.12)
    relinquish computer (adj. basis at $375; FMV at $1,000)
    replace with printer (FMV at $2,050)
    exchange group *surplus* ($1,050) = replaced at $2,050 – relinquished at $1,000
  - automobile (00.22) & automobile (00.22)
    relinquish automobile (adj. basis at $1,500; FMV at $4,000)
    replace with automobile (FMV at $2,950)
    exchange group *deficiency* ($1,050) = replaced at $2,950 – relinquished at $4,000

If taxpayer As Replacement Property FMV > Relinquished Property FMV, an Exchange Group *Surplus* is established with respect to taxpayer A. Alternatively, if taxpayer As Replacement Property FMV < Relinquished Property FMV, an Exchange Group *Deficiency* exists with respect to taxpayer A.

2. Generally, an *Exchange Group* *<u>Surplus</u>* exists when the taxpayer's

a. Replacement Property FMV < Relinquished Property FMV
b. Replacement Property FMV > Relinquished Property FMV
c. Replacement Property FMV = Relinquished Property FMV
d. Exchange Group Surplus has nothing to do with the taxpayer's Replacement Property FMV or the taxpayer's Relinquished Property FMV

3. Generally, an *Exchange Group Deficiency* exists when the taxpayer's
a. Replacement Property FMV < Relinquished Property FMV
b. Replacement Property FMV > Relinquished Property FMV
c. Replacement Property FMV = Relinquished Property FMV
d. Exchange Group Surplus has nothing to do with the taxpayer's Replacement Property FMV or the taxpayer's Relinquished Property FMV

- Step 2 – evaluate *realized* and *recognized gain* or *loss* for each exchange group:
  - computer (00.12) & printer (00.12)
    realized gain ($625) = FMV ($1,000) – adj. basis ($375)
    recognized gain (**$-0-**) = lesser of realized gain ($625) or exchange group deficiency ($-0-)
    Note: The was no exchange group *deficiency*; there was an exchange group *surplus*
  - automobile (00.22) & automobile (00.22)
    realized gain ($2,500) = FMV ($4,000) – adj. basis ($1,500)
    recognized gain (**$1,050**) = lesser of realized gain ($2,500) or exchange group deficiency ($1,050)

The Recognized Gain or Loss for each Exchange Group is the lesser of the (1) Realized Gain or the (2) Exchange Group Deficiency. If there is no Exchange Group Deficiency or if there is an Exchange Group Surplus, the Exchange Group Deficiency is equal to zero.

4. Generally, the *Recognized Gain or Loss for each Exchange Group* is
a. the lesser of the (1) Realized Gain or the (2) Exchange Group Deficiency
b. the lesser of the (1) Realized Gain or the (2) Exchange Group Surplus

c. the greater of the (1) Realized Gain or the (2) Exchange Group Deficiency
d. the greater of the (1) Realized Gain or the (2) Exchange Group Surplus

5. If there is *no Exchange Group Deficiency* or if there is *an Exchange Group Surplus*
a. the Exchange Group Deficiency is equal to zero
b. the Exchange Group Surplus is equal to zero
c. the Exchange Group Deficiency is positive
d. the Exchange Group Surplus is used

- Step 3 – combine *recognized gains* from both exchange groups:
    - the sum of gains recognized for both exchange groups (**$1,050**) = ($-0-) + ($1,050)
- Step 4 – determine *basis*:
    - computer (00.12) & printer (00.12)
      basis of replacement printer ($1,425) = adj. basis of relinquished computer ($375) + gain recognized ($-0-) + exchange group *surplus* ($1,050)
    - automobile (00.22) & automobile (00.22)
      basis of replacement automobile ($1,500) = adj. basis of relinquished automobile ($1,500) + gain recognized ($1,050) – exchange group *deficiency* ($1,050)

6. Taxpayer A exchanges his computer (adjusted (adj.) basis at $375 and fair market value (FMV) at $1,000) and automobile (adj. basis at $1,500 and FMV at $4,000) with taxpayer B for B's printer (FMV at $2,050) and automobile (FMV at $2,950). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The <u>basis</u> of the replacement <u>automobile</u> is
a. $1,500
b. $1,050
c. $1,425
d. $-0-

7. Taxpayer A exchanges his computer (adjusted (adj.) basis at $375 and fair market value (FMV) at $1,000) and automobile (adj. basis at $1,500 and FMV at $4,000) with taxpayer B for B's printer (FMV at $2,050) and

automobile (FMV at $2,950). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The basis of the replacement printer is

a. $1,500
b. $1,050
c. $1,425
d. $-0-

8. Taxpayer A exchanges his computer (adjusted (adj.) basis at $375 and fair market value (FMV) at $1,000) and automobile (adj. basis at $1,500 and FMV at $4,000) with taxpayer B for B's printer (FMV at $2,050) and automobile (FMV at $2,950). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The recognized gain on the replacement automobile is

a. $1,500
b. $1,050
c. $1,425
d. $-0-

9. Taxpayer A exchanges his computer (adjusted (adj.) basis at $375 and fair market value (FMV) at $1,000) and automobile (adj. basis at $1,500 and FMV at $4,000) with taxpayer B for B's printer (FMV at $2,050) and automobile (FMV at $2,950). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The recognized gain on the replacement printer is

a. $1,500
b. $1,050
c. $1,425
d. $-0-

The example that follows extends the earlier example. It, too, involves multiple personal property components (as adapted from Reg§1.1031(j)-1(c) Example(2)), including corporate stock and cash. The example follows:

- ✓ Taxpayer A exchanges his computer (adjusted (adj.) basis at $375 and fair market value (FMV) at $1,000) and automobile (adj. basis at $3,500 and FMV at $4,000) with taxpayer B for B's printer (FMV at $800), automobile (FMV at $2,950), corporate stock (FMV at $750) and cash ($500). Assume that

both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The basic facts from this case are summarized in Table 11, below:

Description	Adjusted Basis	Fair Market Value
Computer A	$ 375	$1,000
Automobile A	$3,500	$4,000
Printer B	$ -0-	$ 800
Automobile B	$ -0-	$2,950
Corporate Stock B	$ -0-	$ 750
Cash B	$ -0-	$ 500

Table 11

- Step 1 – separate the assets into exchange groups to calculate A's *surplus* or *deficiency*:
  - computer (00.12) & printer (00.12)
    relinquish computer (adj. basis at $375; FMV at $1,000)
    replace with printer (FMV at $800)
    exchange group *deficiency* ($200) = replaced at $800 – relinquished at $1,000
  - automobile (00.22) & automobile (00.22)
    relinquish automobile (adj. basis at $3,500; FMV at $4,000)
    replace with automobile (FMV at $2,950)
    exchange group *deficiency* ($1,050) = replaced at $2,950 – relinquished at $4,000
  - residual group ($1,250) = corporate stock ($750) + cash ($500)
- Step 2 – evaluate realized and recognized gain or loss for each exchange group:
  - computer (00.12) & printer (00.12)
    realized gain ($625) = FMV ($1,000) – adj. basis ($375)
    recognized gain (**$200**) = lesser of realized gain ($625) or exchange group deficiency ($200)
  - automobile (00.22) & automobile (00.22)

realized gain ($500) = FMV ($4,000) – adj. basis ($3,500)
recognized gain (**$500**) = lesser of realized gain ($500) or exchange group deficiency ($1,050)

- residual group is not applicable

- Step 3 – combine recognized gains from both exchange groups:
    - the sum of gains recognized for both exchange groups (**$700**) = ($200) + ($500)
- Step 4 – determine *basis*:
    - computer (00.12) & printer (00.12)
      basis of replacement printer ($375) = adj. basis of relinquished computer ($375) + gain recognized ($200) - exchange group *deficiency* ($200)
    - automobile (00.22) & automobile (00.22)
      basis of replacement automobile ($2.950) = adj. basis of relinquished automobile ($3,500) + gain recognized ($500) – exchange group *deficiency* ($1,050)
    - residual group basis in stock and cash is $750 and $500, respectively

10. Taxpayer C exchanges his computer (adjusted (adj.) basis at $375 and fair market value (FMV) at $1,000) and automobile (adj. basis at $3,500 and FMV at $4,000) with taxpayer D for D's printer (FMV at $800), automobile (FMV at $2,950), corporate stock (FMV at $750) and cash ($500). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The basis of the replacement automobile is

a. $200
b. $500
c. $375
d. $2,950

11. Taxpayer C exchanges his computer (adjusted (adj.) basis at $375 and fair market value (FMV) at $1,000) and automobile (adj. basis at $3,500 and FMV at $4,000) with taxpayer D for D's printer (FMV at $800), automobile (FMV at $2,950), corporate stock (FMV at $750) and cash ($500). Assume that both taxpayers are using these assets for

productive business purposes and will do so, also, after the exchange. The basis of the replacement printer is

a. $200
b. $500
c. $375
d. $2,950

12. Taxpayer C exchanges his computer (adjusted (adj.) basis at $375 and fair market value (FMV) at $1,000) and automobile (adj. basis at $3,500 and FMV at $4,000) with taxpayer D for D's printer (FMV at $800), automobile (FMV at $2,950), corporate stock (FMV at $750) and cash ($500). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The recognized gain on the replacement automobile is

a. $200
b. $500
c. $375
d. $2,950

13. Taxpayer C exchanges his computer (adjusted (adj.) basis at $375 and fair market value (FMV) at $1,000) and automobile (adj. basis at $3,500 and FMV at $4,000) with taxpayer D for D's printer (FMV at $800), automobile (FMV at $2,950), corporate stock (FMV at $750) and cash ($500). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The recognized gain on the replacement printer is

a. $200
b. $500
c. $375
d. $2,950

14. Taxpayer C exchanges his computer (adjusted (adj.) basis at $375 and fair market value (FMV) at $1,000) and automobile (adj. basis at $3,500 and FMV at $4,000) with taxpayer D for D's printer (FMV at $800), automobile (FMV at $2,950), corporate stock (FMV at $750) and cash ($500). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The basis of the corporate stock is

a. $200
b. $500
c. $375
d. $750

This final example in this lesson further extends the earlier examples. It involves multiple personal property components (as adapted from Reg§1.1031(j)-1(c) Example(3)), but includes real property. The example follows:

- ✓ Taxpayer A exchanges two computers – adjusted (adj.) basis at $1,500 and fair market value (FMV) at $5,000 for computer (A)(1) and adj. basis at $500 and FMV at $3,000 for computer (A)(2), a printer with adj. basis at $2,000 and FMV at $1,500; two pieces of real property – parcel (A)(1) with an adj. basis at $1,200 and FMV at $2,000 and parcel (A)(2) with an adj. basis at $-0- and FMV at $1,800; a scraper with an adj. basis at $3,300 and FMV at $2,500; and inventory with an adj. basis at $1,000 and FMV at $1,700 with taxpayer B for B's computer (FMV at $4,500); printer (FMV at $2,500); two real property parcels – parcel (B)(1) (FMV at $1,000) and parcel (B)(2) (FMV at $4,000); a grader (FMV at $2,000); truck (FMV at $1,700); and cash ($1,800). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The basic facts from this case are summarized in Table 12, below:

Description	Relinquished Adjusted Basis	Relinquished Fair Market Value	Replacement Fair Market Value
Computer A(1)	$1,500	$5,000	na
Computer A(2)	$ 500	$3,000	na
Computer B	na	na	$4,500
Printer A	$2,000	$1,500	na
Printer B	na	na	$2,500
Real Estate A(1)	$1,200	$2,000	na
Real Estate A(2)	$ -0-	$1,800	na
Real Estate B(1)	na	na	$1,000
Real Estate B(2)	na	na	$4,000
Scraper A	$3,300	$2,500	na
Grader B	na	na	$2,000
Truck B	na	na	$1,700
Inventory A	$1,000	$1,700	na
Cash B	na	na	$1,800

Table 12

- Step 1 – separate the assets into exchange groups to calculate A's *surplus* or *deficiency*:
  - computers (00.12) & printers (00.12)
    relinquish computers & printer (adj. basis at $4,000 = $1,500 + $500 + $2,000; FMV at $9,500 = $5,000 + $3,000 + $1,500)
    replace with computer & printer (FMV at $7,000 = $4,500 + $2,500)
    exchange group *deficiency* ($2,500) = replaced at $7,000 – relinquished at $9,500
  - real property
    relinquish real property (adj. basis at $1,200 = $1,200 + $-0-; FMV at $3,800 = $2,000 + $1,800)
    replace with real property (FMV at $5,000 = $1,000 + $4,000)
    exchange group *surplus* ($1,200) = replaced at $5,000 – relinquished at $3,800

- scraper & grader
  relinquish scraper (adj. basis at $3,300; FMV at $2,500)
  replace with grader (FMV at $2,000)
  exchange group *deficiency* ($500) = replaced at $2,500 – relinquished at $2,000
- residual groups ($1,800) = cash ($1,800), where inventory (adj. basis at $1,000; FMV at $1,700) is exchanged for a truck (FMV at $1,700); the inventory is taxable and the truck is not of a like class to any property transferred in the exchange

- Step 2 – evaluate realized and recognized gain or loss for each exchange group:
  - computer (00.12) & printer (00.12)
    realized gain ($5,500) = FMV ($9,500) – adj. basis ($4,000)
    recognized gain (**$2,500**) = lesser of realized gain ($5,500) or exchange group deficiency ($2,500)
  - real property
    realized gain ($2,600) = FMV ($3,800) – adj. basis ($1,200)
    recognized gain (**$-0-**) = lesser of realized gain ($2,600) or exchange group deficiency ($-0-)
  - scraper & grader
    realized loss ($800) = FMV ($2,500) – adj. basis ($3,300)
    recognized loss (**$-0-**) under IRC§1031
  - residual group
    realized gain ($700) = FMV ($1700) – adj. basis ($1,000)
    recognized gain **($700**)
- Step 3 – combine recognized gains from all exchange groups:
  - the sum of gains recognized for all exchange groups (**$2,500**) = ($2,500) + ($-0-) + ($-0-)
  - gain recognized from residual group (**$700**)
- Step 4 – determine *basis*:
  - computer (00.12) & printer (00.12)
    basis of computer and printer ($4,000) = adj. basis of relinquished computer ($4,000) + gain recognized ($2,500)

– exchange group *deficiency* ($2,500) + excess liabilities assumed ($-0-)

- *allocation* to computer ($2,571) = $4,000 x [$4,500/$7,000]
- *allocation* to printer ($1,429) = $4,000 x [$2,500/$7,000]

- real property
  basis of real property ($2,400) = adj. basis of ($1,200) + gain recognized ($-0-) – exchange group surplus ($1,200) + excess liabilities assumed ($-0-)
  - *allocation* to real property parcel (c) ($480) = $2,400 x [$1,000/$5,000]
  - *allocation* to real property parcel (d) ($1,920) = $2,400 x [$4,000/$5,000]
- scraper & grader
  basis of grader ($2,800) = adj. basis of ($3,300) + gain recognized ($-0-) – exchange group deficiency ($500) + excess liabilities assumed ($-0-)
- residual group basis in cash and truck is $1,800 and $1,700, respectively

15. Taxpayer E exchanges two computers (adjusted (adj.) basis at $1,500 and fair market value (FMV) at $5,000 for computer (a) and adj. basis at $500 and FMV at $3,000 for computer (b)), a printer (adj. basis at $2,000 and FMV at $1,500) two pieces of real property (parcel (a) adj. basis at $1,200 and FMV at $2,000 and parcel (b) adj. basis at $-0- and FMV at $1,800), a scraper (adj. basis at $3,300 and FMV at $2,500), and inventory (adj. basis at $1,000 and FMV at $1,700) with taxpayer F for F's computer (FMV at $4,500), printer (FMV at $2,500), two real property parcels – parcel (c) (FMV at $1,000) and parcel (d) (FMV at $4,000), a grader (FMV at $2,000), truck (FMV at $1,700), and cash ($1,800). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The basis of the replacement computer is

a. $4,000
b. $2,571 = $4,000 x [$4,500/$7,000]
c. $1,429= $4,000 x [$2,500/$7,000]
d. $-0-

16. Taxpayer E exchanges two computers (adjusted (adj.) basis at $1,500 and fair market value (FMV) at $5,000 for computer (a) and adj. basis at $500 and FMV at $3,000 for computer (b)), a printer (adj. basis at $2,000 and FMV at $1,500) two pieces of real property (parcel (a) adj. basis at $1,200 and FMV at $2,000 and parcel (b) adj. basis at $-0- and FMV at $1,800), a scraper (adj. basis at $3,300 and FMV at $2,500), and inventory (adj. basis at $1,000 and FMV at $1,700) with taxpayer F for F's computer (FMV at $4,500), printer (FMV at $2,500), two real property parcels – parcel (c) (FMV at $1,000) and parcel (d) (FMV at $4,000), a grader (FMV at $2,000), truck (FMV at $1,700), and cash ($1,800). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The basis of the replacement printer is

a. $4,000
b. $2,571 = $4,000 x [$4,500/$7,000]
c. $1,429= $4,000 x [$2,500/$7,000]
d. $-0-

17. Taxpayer E exchanges two computers (adjusted (adj.) basis at $1,500 and fair market value (FMV) at $5,000 for computer (a) and adj. basis at $500 and FMV at $3,000 for computer (b)), a printer (adj. basis at $2,000 and FMV at $1,500) two pieces of real property (parcel (a) adj. basis at $1,200 and FMV at $2,000 and parcel (b) adj. basis at $-0- and FMV at $1,800), a scraper (adj. basis at $3,300 and FMV at $2,500), and inventory (adj. basis at $1,000 and FMV at $1,700) with taxpayer F for F's computer (FMV at $4,500), printer (FMV at $2,500), two real property parcels – parcel (c) (FMV at $1,000) and parcel (d) (FMV at $4,000), a grader (FMV at $2,000), truck (FMV at $1,700), and cash ($1,800). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The basis of the replacement real property parcel (c) is

a. $480 = $2,400 x [$1,000/$5,000]
b. $1,920 = $2,400 x [$4,000/$5,000]
c. $2,571 = $4,000 x [$4,500/$7,000]
d. $1,429= $4,000 x [$2,500/$7,000]

18. Taxpayer E exchanges two computers (adjusted (adj.) basis at $1,500 and fair market value (FMV) at $5,000 for computer (a) and adj. basis at $500 and FMV at $3,000 for computer (b)), a printer (adj. basis at $2,000 and FMV at $1,500) two pieces of real property (parcel (a) adj. basis at $1,200 and FMV at $2,000 and parcel (b) adj. basis at $-0- and FMV at $1,800), a scraper (adj. basis at $3,300 and FMV at $2,500), and inventory (adj. basis at $1,000 and FMV at $1,700) with taxpayer F for F's computer (FMV at $4,500), printer (FMV at $2,500), two real

property parcels – parcel (c) (FMV at $1,000) and parcel (d) (FMV at $4,000), a grader (FMV at $2,000), truck (FMV at $1,700), and cash ($1,800). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The basis of the replacement real property parcel (d) is

a. $480 = $2,400 x [$1,000/$5,000]
b. $1,920 = $2,400 x [$4,000/$5,000]
c. $2,571 = $4,000 x [$4,500/$7,000]
d. $1,429= $4,000 x [$2,500/$7,000]

19. Taxpayer E exchanges two computers (adjusted (adj.) basis at $1,500 and fair market value (FMV) at $5,000 for computer (a) and adj. basis at $500 and FMV at $3,000 for computer (b)), a printer (adj. basis at $2,000 and FMV at $1,500) two pieces of real property (parcel (a) adj. basis at $1,200 and FMV at $2,000 and parcel (b) adj. basis at $-0- and FMV at $1,800), a scraper (adj. basis at $3,300 and FMV at $2,500), and inventory (adj. basis at $1,000 and FMV at $1,700) with taxpayer F for F's computer (FMV at $4,500), printer (FMV at $2,500), two real property parcels – parcel (c) (FMV at $1,000) and parcel (d) (FMV at $4,000), a grader (FMV at $2,000), truck (FMV at $1,700), and cash ($1,800). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The basis of the replacement grader is

a. $1,800
b. $1,700
c. $2,800
d. $-0-

20. Taxpayer E exchanges two computers (adjusted (adj.) basis at $1,500 and fair market value (FMV) at $5,000 for computer (a) and adj. basis at $500 and FMV at $3,000 for computer (b)), a printer (adj. basis at $2,000 and FMV at $1,500) two pieces of real property (parcel (a) adj. basis at $1,200 and FMV at $2,000 and parcel (b) adj. basis at $-0- and FMV at $1,800), a scraper (adj. basis at $3,300 and FMV at $2,500), and inventory (adj. basis at $1,000 and FMV at $1,700) with taxpayer F for F's computer (FMV at $4,500), printer (FMV at $2,500), two real property parcels – parcel (c) (FMV at $1,000) and parcel (d) (FMV at $4,000), a grader (FMV at $2,000), truck (FMV at $1,700), and cash ($1,800). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The basis of the replacement truck is

a. $1,800

b. $1,700
c. $2,800
d. $-0-

Intangibles and Non-Depreciable Personal Property

Generally, intangibles and non-depreciable personal property qualifies for IRC§1031 non-recognition of gain or loss only if of a like kind. Examples follow:

- ✓ the exchange of goodwill associated with one business is not of a like kind to the goodwill of another business (Reg§1.1031(a)-2(c)(2))
- ✓ the exchange of a copyright on a novel for the copyright on another novel is of a like kind (Reg§1.1031(a)-2(c)(3) Example (1))
- ✓ the exchange of a copyright on a novel for the copyright on a song is not of a like kind (Reg§1.1031(a)-2(c)(3) Example (2))

21. Which of the below qualifies as like kind intangibles?
a. exchanging goodwill from your business for goodwill in another business
b. exchanging a copyright on a novel for the copyright on another novel
c. exchanging a copyright on a novel for the copyright on a song
d. All of the above qualify as like kind exchanges

LESSON 5

Sequence of a Typical IRC§1031 Exchange

Below is a brief framework of the sequence of events likely to occur in an IRC§1031 exchange. Generally, the sequence can be easily recalled as review, contract-contact-close (relinquished) property(s) and contract-contact-close (replacement) property(s), as follows:

1. Review transactions with tax and/or legal advisors
2. Contract for sale via "assignment" to qualified intermediary (QI) for relinquished property
3. Contact QI prior to closing of sale of relinquished property(s) for exchange document preparation
4. Close relinquished property(s) by assignee (QI); QI receives exchange proceeds; relinquished property deeded directly to the buyer; the 45-day (identification) and 180-day (replacement) periods begin – the latter, as affected by the due date of the tax return
5. Contract for purchase via "assignment" to QI for properly identified replacement property(s)
6. Contact QI prior to closing of purchase of replacement property(s) for exchange document preparation
7. Close on replacement property(s)

1. An easy method to recall the sequence of the typical IRC§1031 exchange, where a qualified intermediary is successfully employed, is

a. review, contract-contact-close (relinquished), contract-contact-close (replacement)

b. contract-contact-close (relinquished), contract-contact-close (replacement), review

c. review, contact-contract-close (relinquished), contact-contract-close (replacement)

d. contact-contract-close (relinquished), contact-contract-close (replacement), review

Receipt of Property or Money (Boot)

An example of an exchange involving the receipt of property or money (boot) follows:

- ✓ A taxpayer exchanges real property held for investment (IRC§1221) (adjusted basis of $50,000) for other real property (fair market value of $60,000), to be used in his trade or business, and cash ($20,000). The realized gain is $30,000 ($60,000 + $20,000 = $80,000 - $50,000). This gain, however, is recognized only to the extent of cash or boot, at $20,000. This taxpayer has effectively deferred the gain on the remaining $10,000 ($30,000 - $20,000) (as adapted from Reg§1.1031(b)-1(b) Example(1)).

An Introduction to the Impact of Debt and Equity, Using an Accounting Approach

In financial accounting, the accounting equation follows:

Assets (A) = Liabilities (L) + Owners' Equity (OE)

Generally, A consists of Debits and L and OE consist of Credits, therefore, an extension of the basic accounting equation follows:

Debits (DR) = Credits (CR)

While A = L + OE and DR = CR focus on the Balance Sheet or, in FMV terms, the individual's Net Worth, Gains and Losses may also be viewed in this same framework, where Gains = CR and result in an increase in both net A (A-L) and OE and Losses = DR and result in a decrease in both net A (A-L) and OE.

Be sure to memorize the above equations and acronyms before proceeding to the next set of questions.

2. The basic accounting equation is

a. **A = L + OE**
b. A – L = OE
c. A – OE = L
d. DR = CR

3. The basic accounting equation can be <u>extended</u> to
a. A = L + OE
b. A – L = OE
c. A – OE = L
d. **DR = CR**

4. Gains are
a. **CR**
b. DR
c. A
d. L

5. Losses are
a. CR
b. **DR**
c. A
d. L

Table 13a summarizes 3 cases, where (**1a**) a taxpayer's relinquished property is of a lesser FMV than the replacement property, (**1b**) a taxpayer's relinquished property is of equal FMV when compared to the replacement property, and (**1c**) a taxpayer's relinquished property is of lesser FMV when compared to the replacement property. These are relatively simple examples, intended to focus on developing your understanding of the basic and extended accounting equation. They will prepare you to read contemporary professional journal articles on IRC§1031 exchanges, where authors sometimes employ these equations.

Recalling METHOD 2 (below, from Table 6 of Lesson 2), the <u>basis</u> of replacement properties may be computed, as follows:

METHOD 2
Fair Market Value REPLACEMENT Property
- Deferred (Realized *less* Recognized) Gain
+ Deferred Loss
= Basis REPLACEMENT Property

Table 6

(**1a**) the taxpayer exchanged a $1M property for a $1.1M property. Debt (L) remained constant at $½M, therefore, Equity increased by $100,000 as a direct result of the exchange. In this case, no gain or loss is realized, no gain or loss is recognized, and the basis of the replacement property is equivalent to that of the relinquished property.

(**1b**) the taxpayer exchanged a $1M property for a $1M property. Debt (L) remained constant at $0.5M; therefore, Equity also remained constant at $100,000. In this case, also, no gain or loss is realized, no gain or loss is recognized, and the basis of the replacement property is equivalent to that of the relinquished property.

(**1c**) the taxpayer exchanged a $1M property for a $0.9M property. Debt (L) remained constant at $0.5M, therefore, Equity decreased by $100,000 as a direct result of the exchange. Finally, in this case, the potential for realized and recognized gain is possible (up to $100,000), as the taxpayer failed to "trade up" in terms of FMV, however, this simple illustration has not provided sufficient information (i.e., adj. basis for relinquished property) to determine the amount of the deferred gain, if any. If, however, this taxpayer were to have received cash of $100,000, a realized and recognized gain of $100,000 would have resulted from the exchange. Understanding this is important, and leads to the following *rule of thumb* with respect to IRC§1031 exchanges:

Always trade "across" (**1a**) or "up" (**1b**); never trade "down" (**1c**). Trading "down" (typically) results in boot received. The receipt of boot results in a taxable component to the exchange.

Case		Relinquished	Replaced	Difference
1a	**DEBITS (DR):**			
	Asset (FMV)	$1,000,000	$1,100,000	$ 100,000
	CREDITS (CR):			
	Debt	$ (500,000)	$ (500,000)	$ -0-
	Equity	$ (500,000)	$ (600,000)	$(100,000)
	A=L+OE or **DR=CR**	$ -0-	$ -0-	$ -0-
1b	**DEBITS (DR):**			
	Asset (FMV)	$1,000,000	$1,000,000	$ -0-
	CREDITS (CR):			
	Debt	$ (500,000)	$ (500,000)	$ -0-
	Equity	$ (500,000)	$ (500,000)	$ -0-
	A=L+OE or **DR=CR**	$ -0-	$ -0-	$ -0-
1c	**DEBITS (DR):**			
	Asset (FMV)	$1,000,000	$ 900,000	$(100,000)
	CREDITS (CR):			
	Debt	$ (500,000)	$ (500,000)	$ -0-
	Equity	$ (500,000)	$ (400,000)	$ 100,000
	A=L+OE or **DR=CR**	$ -0-	$ -0-	$ -0-

Table 13a

6. A general rule of thumb, to conclude an IRC§1031 exchange with 100 percent tax deferral, is to
a. trade "up"
b. trade "across"
c. trade "down"
d. both a. and b. are correct

7. Which is most likely to trigger a realized and recognized gain, and the payment of tax, in an IRC§1031 exchange?
a. trading "up"
b. trading "across"
c. trading "down"
d. both a. and b. are correct

Table 13b summarizes 3 cases, where (**2a**) a taxpayer's relinquished property is of a lesser FMV than the replacement property, (**2b**) a taxpayer's relinquished property is of equal FMV when compared to the replacement property, and (**2c**) a taxpayer's relinquished property is of lesser FMV when compared to the replacement property. These, also, are relatively simple examples, intended to focus on developing your understanding of the basic and extended accounting equation.

Again, recalling METHOD 2 (below, from Table 6 of Lesson 2), the basis of replacement properties may be computed, as follows:

	METHOD 2
	Fair Market Value REPLACEMENT Property
-	Deferred (Realized *less* Recognized) Gain
+	Deferred Loss
=	Basis REPLACEMENT Property

Table 6

(**2a**) the taxpayer exchanged a $1M property for a $1.1M property. Equity remained constant and Debt (L) increased by $100,000 as a direct result of the exchange. In this case, no gain or loss is realized, no gain or loss is recognized, and the basis of the replacement property is equivalent to that of the relinquished property.

(**2b**) the taxpayer exchanged a $1M property for a $1M property. Equity remained constant and Debt (L) remained constant, therefore, in this case, also, no gain or loss is realized, no gain or loss is recognized, and the basis of the replacement property is equivalent to that of the relinquished property.

(**2c**) the taxpayer exchanged a $1M property for a $0.9M property. Equity remained constant and Debt (L) decreased by $100,000 as a direct result of the exchange. Finally, in this case, the potential for realized and recognized gain is quite likely (up to $100,000), as the

taxpayer reduced their debt and "traded down" in terms of FMV.

Case		Relinquished	Replaced	Difference
2a	**DEBITS (DR):**			
	Asset (FMV)	$1,000,000	$1,100,000	$ 100,000
	CREDITS (CR):			
	Debt	$ (500,000)	$ (600,000)	$(100,000)
	Equity	$ (500,000)	$ (500,000)	$ -0-
	A=L+OE or **DR=CR**	$ -0-	$ -0-	$ -0-
2b	**DEBITS (DR):**			
	Asset (FMV)	$1,000,000	$1,000,000	$ -0-
	CREDITS (CR):			
	Debt	$ (500,000)	$ (500,000)	$ -0-
	Equity	$ (500,000)	$ (500,000)	$ -0-
	A=L+OE or **DR=CR**	$ -0-	$ -0-	$ -0-
2c	**DEBITS (DR):**			
	Asset (FMV)	$1,000,000	$ 900,000	$(100,000)
	CREDITS (CR):			
	Debt	$ (500,000)	$ (400,000)	$ 100,000
	Equity	$ (500,000)	$ (500,000)	$ -0-
	A=L+OE or **DR=CR**	$ -0-	$ -0-	$ -0-

Table 13b

8. Assume that a taxpayer exchanged a $1M property for a $900,000 property. In the process, the taxpayer also experienced $100,000 in debt relief. In this case, the taxpayer

a. traded "up"
b. traded "across"
c. traded "down"
d. both a. and b. are correct

9. If a taxpayer traded "down" in terms of FMV and debt (i.e., debt relief), the exchange is

a. taxable to the extent of boot received
b. partially taxable
c. not a completely tax deferred exchange
d. All of the above are correct

Examples That Includes Debt and *Excess Liabilities*

Excess liabilities is that amount of net debt assumed by one party in an IRC§1031 exchange. This amount must be allocated to exchange groups, based on the relative FMV of the assets contained within each group.

EXAMPLE 1

Assume that taxpayer A exchanges computer A, automobile A and truck A with taxpayer B for computer B, automobile B, truck B and $400 cash. All assets were and will continue to be used for trade or business purposes. The adjusted basis, FMV, and liability secured by each asset is contained in Table 14 (as adapted from Reg§1.1031(j)-1(c) Example (4)).

Description	FMV	Adjusted Basis	Liability	Equity
Computer A	$1,500	$ 800	$ -0-	$1,500
Computer B	$1,600	$1,100	$ -0-	$1,600
Automobile A	$2,500	$ 900	$ 500	$2,000
Automobile B	$3,100	$2,100	$ 750	$2,350
Truck A	$2,000	$ 700	$ -0-	$2,000
Truck B	$1,400	$ 600	$ 250	$1,150
Cash B	$ 400	$ -0-	$ -0-	$ 400

Table 14

Taxpayer A will assume $1,000 ($750+$250) in liabilities from taxpayer B. Taxpayer B will only assume $500 in liabilities from taxpayer A. Therefore, Taxpayer A is assuming $500 ($1,000-$500) in excess liabilities from taxpayer B, which must be allocated to each of the 3 exchange groups (e.g., computers, automobiles and trucks) based on the relative FMV of each exchange group.

Table 14a illustrates the allocation of *excess liabilities* to assets in each of the exchange groups:

Computer B	$131 = $500 x [$1,600 / $6,100]
Automobile B	$254 = $500 x [$3,100 / $6,100]
Truck B	$115 = $500 x [$1,400 / $6,100]

Description	FMV	Adj Basis	Liability	Liability Allocated
Computer B	$1,600	$1,100	$ -0-	$ 131
Automobile B	$3,100	$2,100	$ 750	$ 254
Truck B	$1,400	$ 600	$ 250	$ 115
Exch to A	$6,100	$3,800	$1,000	$ 500

Table 14a

10. *Excess liabilities* represent

a. liabilities (1) assumed less liabilities (2) relieved of in an exchange

b. liabilities (1) relieved of less liabilities (2) assumed in an exchange

c. liabilities (1) assumed plus liabilities (2) relieved of in an exchange

d. liabilities in excess of your credit card limit

11. The below table represents an exchange between taxpayers A and B (e.g., taxpayer A will exchange Computer A for taxpayer B's Computer B). In this exchange

a. taxpayer A will have *excess liabilities*

b. taxpayer B will have *excess liabilities*

c. taxpayer C will have *excess liabilities*

d. neither taxpayer will have *excess liabilities*

Description	FMV	Adjusted Basis	Liability
Computer A	$1,500	$ 800	$ -0-
Computer B	$1,600	$1,100	$ -0-
Automobile A	$2,500	$ 900	$ 500
Automobile B	$3,100	$2,100	$ 750
Truck A	$2,000	$ 700	$ -0-
Truck B	$1,400	$ 600	$ 250
Cash B	$ 400	$ -0-	$ -0-

12. Any *excess liabilities* in an IRC§1031 exchange must be
a. paid off
b. avoided through Chapter 11 bankruptcy proceedings
c. allocated to assets in each of the exchange groups
d. refinanced by the taxpayer benefiting through the alleviation of debt or *excess liabilities*

13. The below table represents an exchange between taxpayers A and B (e.g., taxpayer A will exchange Computer A for taxpayer B's Computer B). Assume that you are assigned the task of allocating *excess liabilities* of $500 to assets in each of the 3 exchange groups in the below table. How much of the $500 would be allocated to <u>Computer</u> <u>B</u>?
a. $131 = $500 x [$1,600 / $6,100]
b. $254 = $500 x [$3,100 / $6,100]
c. $115 = $500 x [$1,400 / $6,100]
d. $500 = $500 x [$61,00 / $6,100]

Description	FMV	Adj Basis	Liability
Computer B	$1,600	$1,100	$ -0-
Automobile B	$3,100	$2,100	$ 750
Truck B	$1,400	$ 600	$ 250
Exch to A	$6,100	$3,800	$1,000

14. The below table represents an exchange between taxpayers A and B (e.g., taxpayer A will exchange Automobile A for taxpayer B's Automobile B). Assume that you are assigned the task of allocating *excess liabilities* of $500 to assets in each of the 3 exchange groups in the below table. How much of the $500 would be allocated to <u>Automobile</u> <u>B</u>?
a. $131 = $500 x [$1,600 / $6,100]
b. $254 = $500 x [$3,100 / $6,100]
c. $115 = $500 x [$1,400 / $6,100]
d. $500 = $500 x [$61,00 / $6,100]

15. The below table represents an exchange between taxpayers A and B (e.g., taxpayer A will exchange Truck A for taxpayer B's Truck B). Assume that you are assigned the task of allocating *excess liabilities* of $500 to assets in each of the 3 exchange groups in the below table. How much of the $500 would be allocated to <u>Truck</u> <u>B</u>?
a. $131 = $500 x [$1,600 / $6,100]

b. $254 = $500 x [$3,100 / $6,100]
c. $115 = $500 x [$1,400 / $6,100]
d. $500 = $500 x [$6,100 / $6,100]

Description	FMV	Adj Basis	Liability
Computer B	$1,600	$1,100	$ -0-
Automobile B	$3,100	$2,100	$ 750
Truck B	$1,400	$ 600	$ 250
Exch to A	$6,100	$3,800	$1,000

EXAMPLE 2

Assume that taxpayer A exchanges real estate A(1), real estate A(2) and grader A with taxpayer B for real estate B and railroad car B. All assets were and will continue to be used for trade or business purposes. The adjusted basis, FMV, and liability secured by each asset is contained in Table 15 (as adapted from Reg§1.1031(j)-1(c) Example(5)).

Description	FMV	Adjusted Basis	Liability
Real Estate A(1)	$ 5,000	$2,000	$ -0-
Real Estate A(2)	$13,500	$8,000	$ -0-
Real Estate B	$26,500	$2,000	$7,000
Grader A	$ 2,000	$ 500	$ -0-
Railroad Car B	$ 1,000	$1,200	$ -0-

Table 15

Taxpayer A will assume $7,000 in liabilities from taxpayer B. Taxpayer B will not assume any liabilities from taxpayer A. Therefore, all liabilities assumed by taxpayer A are excess liabilities.

Table 15a illustrates the allocation of the entire amount of *excess liability* to real estate B:

Description	FMV	Adj Basis	Liability	Liability Allocated
Real Estate B	$26,500	$20,000	$7,000	$7,000
Railroad Car B	$ 1,000	$ 1,200	$ -0-	$ -0-
Exch to A	$27,500	$21,200	$7,000	$7,000

Table 15a

16. The below table represents an exchange between taxpayers A and B (e.g., taxpayer A will exchange Real Estate A(1) and A(2) for taxpayer B's Real Estate B). In this exchange
a. taxpayer A will have *excess liabilities*
b. taxpayer B will have *excess liabilities*
c. taxpayer C will have *excess liabilities*
d. neither taxpayer will have *excess liabilities*

17. The below table represents an exchange between taxpayers A and B (e.g., taxpayer A will exchange Real Estate A(1) and A(2) for taxpayer B's Real Estate B). In this exchange
a. $7,000 in *excess liabilities* will be paid off by taxpayer B to complete the exchange
b. taxpayer B will have *excess liabilities* in the amount of $7,000
c. the $7,000 in debt relief will result in *boot* to taxpayer B
d. neither taxpayer will have *excess liabilities*

Description	FMV	Adjusted Basis	Liability
Real Estate A(1)	$ 5,000	$2,000	$ -0-
Real Estate A(2)	$13,500	$8,000	$ -0-
Real Estate B	$26,500	$2,000	$7,000

LESSON 6

An Extension of EXAMPLE 1 from Lesson 5

Table 16 extends EXAMPLE 1 from Lesson 5. The liabilities have been allocated based on the relative FMV of the assets contained within each group. The exchange groups have been fully developed and a gain realized column has been added. The facts associated with this example are reproduced below:

Assume that taxpayer A exchanges computer A, automobile A and truck A with taxpayer B for computer B, automobile B, truck B and $400 cash. All assets were and will continue to be used for trade or business purposes. Exchange Group analyses follow:

- ✓ Exchange Group 1. Recall that *gain realized* is the FMV of Computer A at $1,500 less adjusted basis of $800 or $700 (see Table 16) and the *gain recognized* is the lesser of gain realized at $700 and the *exchange group deficiency* at $31 ($131 - $100) or $31.
- ✓ Exchange Group 2. Also recall that *gain realized* is the FMV of Automobile A at $2,500 less adjusted basis of $900 or $1,600 (see Table 16) and *gain recognized* is the lesser of gain realized at $1,600 and the *exchange group deficiency* at $0 or $0.
- ✓ Exchange Group 3. Finally, the *gain realized* is the FMV of Truck A at $2,000 less adjusted basis of $700 or $1,300 (see Table 16) and *gain recognized* is the lesser of gain realized at $1,300 and the *exchange group deficiency* at $715 or $715.

Descr	FMV	Adj Basis	Liability	Liability Allocated	Equity	Gain Realized
ExGr 1						
Comp A	$1,500	$ 800	$ -0-		$1,500	$ 700
Comp B	$1,600	$ 1,100	$ -0-		$1,600	$ 500
Diff	$ (100)	$ (300)	$ -0-	$ 131	$ (100)	$ 200
ExGr 2						
Auto A	$2,500	$ 900	$ 500		$2,000	$1,600
Auto B	$3,100	$ 2,100	$ 750		$2,350	$1,000
Diff	$ (600)	$(1,200)	$ (250)	$ 254	$ (350)	$ 600
ExGr 3						
Truck A	$2,000	$ 700	$ -0-		$2,000	$1,300
Truck B	$1,400	$ 600	$ 250		$1,150	$ 800
Diff	$ 600	$ 100	$ (250)	$ 115	$ 850	$ 500
ResidGr						
Cash B	$ 400	$ -0-	$ -0-		$ 400	$ 400
Diff	$ 300	$(1,400)	$ (500)		$ 800	$1,700
Allocate Excess Liab:						
Comp B	$1,600	$ 1,100	$ -0-	$ 131	$1,600	
Auto B	$3,100	$ 2,100	$ 750	$ 254	$2,350	
Truck B	$1,400	$ 600	$ 250	$ 115	$1,150	
Ex to A	$6,100	$ 3,800	$1,000	$ 500	$5,100	

Table 16

1. Assume that the *gain realized* by a taxpayer is the FMV of Computer A at $1,500 less adjusted basis of $800 or $700 and the *gain recognized* is the lesser of gain realized at $700 and the *exchange group deficiency* at $31 ($131 - $100). In this case, the amount of gain recognized is

a. $1,500
b. $800
c. $700
d. $31

2. Assume that the *gain realized* is the FMV of Automobile A at $2,500 less adjusted basis of $900 or $1,600 and *gain recognized* is the lesser of gain realized at $1,600 and the *exchange group deficiency* at $0. In this case, the amount of gain recognized is
a. $2,500
b. $1,600
c. $900
d. $0

3. Assume that the *gain realized* is the FMV of Truck A at $2,000 less adjusted basis of $700 or $1,300 and *gain recognized* is the lesser of gain realized at $1,300 and the *exchange group deficiency* at $715. In this case, the amount of the gain recognized is
a. $2,000
b. $700
c. $1,300
d. $715

Under IRC§1031, the total amount of the gain recognized by a taxpayer is the sum of the gains recognized with respect to each exchange group.

4. Assume that taxpayer A had the following recognized gains:
Exchange Group 1 at $31
Exchange Group 2 at $0
Exchange Group 3 at $715
The total amount of the gain to be recognized by taxpayer A is
a. $31
b. $0
c. $715
d. $746 [$31 + $0 + $715]

Comparison of METHOD 2 to METHOD 3

Recall that the *basis* of replacement property may be determined by METHOD 2. Apply an extended form of METHOD 2, which will be referred to as METHOD 3, to the Exchange Groups in this extension of EXAMPLE 1 from Lesson 5.

	METHOD 2
	Fair Market Value of REPLACEMENT Property
-	Deferred (Realized *less* Recognized) Gain
+	Deferred Loss
=	Basis of REPLACEMENT Property

	METHOD 3
	Adjusted Basis of Property RELINQUISHED
+	Gain Recognized in Exchange Group
-/(+)	Exchange Group Deficiency/(Surplus)
+	Excess Liabilities Assumed Allocated to Exchange Group
=	Basis of REPLACEMENT Property

Same

Table 17

Therefore, referring to Table 16 for Exchange Group 1, the adjusted basis of the property transferred with respect to that exchange group is $800, increased by the gain recognized with respect to that exchange group at $31, decreased by the exchange group deficiency of $31, and increased by the liabilities assumed, as allocated, to that exchange group at $131, or $931 ($800 + $31 – $31 + 131), where this entire amount represents the basis of Computer B, as follows:

	METHOD 3	Developed from Table 16 – Exchange Group 1
	$ 800	Adjusted Basis of Property RELINQUISHED
+	$ 31	Gain Recognized in Exchange Group
-/(+)	$ (31)	Exchange Group Deficiency/(Surplus)
+	$ 131	Excess Liabilities Assumed Allocated to Exch Gr
=	$ 931	Basis of REPLACEMENT Property

Table 17a

5. Use the Table, below, to assist you in responding to this question. Assume that a taxpayer, for an Exchange Group, has an adjusted basis of the property transferred at $800, a gain recognized at $31, an exchange group deficiency of $31, and an increase in liabilities assumed, as allocated to that exchange group at $131. What is the basis of the single item of personal property in this Exchange Group?

a. $800
b. $931
c. $0, because this is an IRC§1031 tax-free or tax deferred exchange
d. Some other amount

	METHOD 3
	Adjusted Basis of Property RELINQUISHED
+	Gain Recognized in Exchange Group
-/(+)	Exchange Group Deficiency/(Surplus)
+	Excess Liabilities Assumed Allocated to Exchange Group
=	Basis of REPLACEMENT Property

Referring to Table 16 for Exchange Group 2, the adjusted basis of the property transferred with respect to that exchange group is $900, increased by the gain recognized with respect to that exchange group at $0, increased by the exchange group surplus of $346, and increased by the liabilities assumed, as allocated, to that exchange group at $254, or $1,500 ($900 + $0 + $346 + $254), where this entire amount represents the basis of Automobile B, as follows:

	METHOD 3	Developed from Table 16 – Exchange Group 2
	$ 900	Adjusted Basis of Property RELINQUISHED
+	$ 0	Gain Recognized in Exchange Group
-/(+)	$ 346	Exchange Group Deficiency/(Surplus)
+	$ 254	Excess Liabilities Assumed Allocated to Exch Grp
=	$ 1,500	Basis of REPLACEMENT Property

Table 17b

6. Use the Table, below, to assist you in responding to this question. Assume that a taxpayer, for an Exchange Group, has an adjusted basis of the property transferred at $900, a gain recognized at $0, an exchange group surplus of $346, and an increase in liabilities assumed, as allocated to that exchange group at $254. What is the basis of the single item of personal property in this Exchange Group?

a. $900
b. $1,500
c. $0, because this is an IRC§1031 tax-free or tax deferred exchange

d. Some other amount

	METHOD 3
	Adjusted Basis of Property RELINQUISHED
+	Gain Recognized in Exchange Group
-/(+)	Exchange Group Deficiency/(Surplus)
+	Excess Liabilities Assumed Allocated to Exchange Group
=	Basis of REPLACEMENT Property

Referring to Table 16 for Exchange Group 3, the adjusted basis of the property transferred with respect to that exchange group is $700, increased by the gain recognized with respect to that exchange group at $715, decreased by the exchange group deficiency of $715, and increased by the liabilities assumed, as allocated, to that exchange group at $115, or $815 ($700 + $715 – $715 + $115), where this entire amount represents the basis of Truck B, as follows:

	METHOD 3	Developed from Table 16 – Exchange Group 3
	$ 700	Adjusted Basis of Property RELINQUISHED
+	$ 715	Gain Recognized in Exchange Group
-/(+)	$ 715	Exchange Group Deficiency/(Surplus)
+	$ 115	Excess Liabilities Assumed Allocated to Exch Grp
=	$ 815	Basis of REPLACEMENT Property

Table 17c

7. Use the Table, below, to assist you in responding to this question. Assume that a taxpayer, for an Exchange Group, has an adjusted basis of the property transferred at $700, a gain recognized at $715, an exchange group deficiency of $715, and an increase in liabilities assumed, as allocated to that exchange group at $115. What is the basis of the single item of personal property in this Exchange Group?

a. $700

b. $815

c. $0, because this is an IRC§1031 tax-free or tax deferred exchange

d. Some other amount

	METHOD 3
	Adjusted Basis of Property RELINQUISHED
+	Gain Recognized in Exchange Group
-/(+)	Exchange Group Deficiency/(Surplus)
+	Excess Liabilities Assumed Allocated to Exchange Group
=	Basis of REPLACEMENT Property

Restatement of the case follows, to prepare you to examine elements of the exchange, but for Exchange Group deficiencies and surpluses (see Table 16):

Assume that taxpayer A exchanges computer A, automobile A and truck A with taxpayer B for computer B, automobile B, truck B and $400 cash. All assets were and will continue to be used for trade or business purposes. Exchange Group analyses, for taxpayer B, follow:

- ✓ Exchange Group 1. The FMV of Computer B is $1,600 and the FMV of Computer A is less, at $1,500, therefore, the first Exchange Group has a deficiency of $100 ($1,500 – $1,600).
- ✓ Exchange Group 2. The FMV of Automobile B is $3,100 and the FMV of Automobile A is less, at $2,500, therefore, the second Exchange Group has a deficiency of $600 ($2,500 – $3,100).
- ✓ Exchange Group 3. The FMV of Truck B is $1,400 and the FMV of Truck A is greater, at $2,000, therefore, the third Exchange Group has a surplus of $600 ($2,000 – $1,400).

Assume that taxpayer A exchanges computer A, automobile A and truck A with taxpayer B for computer B, automobile B, truck B and $400 cash. All assets were and will continue to be used for trade or business purposes. Exchange Group 1 analysis (from Table 16) follows:

Description	FMV
Exch Gr 1	
Computer A	$1,500
Computer B	$1,600
Differences	$ (100)

8. For Exchange Group 1, there will be an Exchange Group
a. surplus
b. deficiency
c. equality
d. insufficient information to answer this question

Assume that taxpayer A exchanges computer A, automobile A and truck A with taxpayer B for computer B, automobile B, truck B and $400 cash. All assets were and will continue to be used for trade or business purposes. Exchange Group 2 analysis (from Table 16) follows:

Description	FMV
Exch Gr 2	
Automobile A	$2,500
Automobile B	$3,100
Differences	$ (600)

9. For Exchange Group 2, there will be an Exchange Group
a. surplus
b. deficiency
c. equality
d. insufficient information to answer this question

Assume that taxpayer A exchanges computer A, automobile A and truck A with taxpayer B for computer B, automobile B, truck B and $400 cash. All assets were and will continue to be used for trade or business purposes. Exchange Group 3 analysis (from Table 16) follows:

Description	FMV
Exch Gr 3	
Truck A	$2,000
Truck B	$1,400
Differences	$ 600

10. For Exchange Group 3, there will be an Exchange Group
a. surplus
b. deficiency
c. equality
d. insufficient information to answer this question

An Extension of EXAMPLE 2 from Lesson 5

Table 15 extends EXAMPLE 1 from Lesson 5. The facts associated with this example are reproduced below:

Assume that taxpayer A exchanges real estate A(1), real estate A(2) and grader A with taxpayer B for real estate B and railroad car B. All assets were and will continue to be used for trade or business purposes. The adjusted basis, FMV, and liability secured by each asset is contained in Table 15 (as adapted from Reg§1.1031(j)-1(c) Example (5)).

Description	Adjusted Basis	FMV	Liability
Real Estate A(1)	$2,000	$ 5,000	$ -0-
Real Estate A(2)	$8,000	$13,500	$ -0-
Grader A	$ 500	$ 2,000	$ -0-
Real Estate B	$2,000	$26,500	$7,000
Railroad Car B	$1,200	$ 1,000	$ -0-

Table 15

Recall that (1) all liabilities assumed by taxpayer A are excess liabilities and (2) the relief of these liabilities will constitute boot to taxpayer B, both in the amount of $7,000.

11. Use the below table to assist you in answering the follow:
Which assets comprise the most apparent Exchange Group?
a. Real Estate A(1), Real Estate A(2) and Real Estate B
b. Real Estate A(1) and Real Estate A(2)
c. Grader A and Railroad Car B
d. All assets will fall within a single Exchange Group

Description	Adjusted Basis	FMV	Liability
Real Estate A(1)	$2,000	$ 5,000	$ -0-
Real Estate A(2)	$8,000	$13,500	$ -0-
Grader A	$ 500	$ 2,000	$ -0-
Real Estate B	$2,000	$26,500	$7,000
Railroad Car B	$1,200	$ 1,000	$ -0-

12. Use the below table to assist you in answering the follow:
If A were to sell Real Estate A(1) for FMV at $5,000, the gain, subject to tax, would be
a. $7,000 [$2,000 + $5,000]
b. $3,000 ($5,000 – $2,000]
c. $5,000
d. Some other amount than those listed above

Description	Adjusted Basis	FMV	Liability
Real Estate A(1)	$2,000	$ 5,000	$ -0-
Real Estate A(2)	$8,000	$13,500	$ -0-
Grader A	$ 500	$ 2,000	$ -0-
Real Estate B	$2,000	$26,500	$7,000
Railroad Car B	$1,200	$ 1,000	$ -0-

13. Use the below table to assist you in answering the follow:
In an IRC§1031 exchange, the basis of Railroad Car B to taxpayer A is
a. $1,200
b. $1,000
c. $200 [$1,200 – $1,000]
d. Some other amount

Description	Adjusted Basis	FMV	Liability
Real Estate A(1)	$2,000	$ 5,000	$ -0-
Real Estate A(2)	$8,000	$13,500	$ -0-
Grader A	$ 500	$ 2,000	$ -0-
Real Estate B	$2,000	$26,500	$7,000
Railroad Car B	$1,200	$ 1,000	$ -0-

Advanced Coverage of IRC§1031

Successful completion of this course suggests the ability to read contemporary planning articles in professional and academic journals on more advanced tax planning for IRC§1031. These matters are covered in the advanced course. However, journal articles are, generally, not authoritative. The Internal Revenue Code is authoritative.

14. Journal articles in professional and academic journals, providing tax planning opportunities, are

a. generally, not authoritative

b. not as useful as the Internal Revenue Code

c. not intended to replace the Internal Revenue Code

d. just as good as the Internal Revenue Code

Journals useful, to those interested in learning more about IRC§1031 exchanges include, but are not limited to:

- ✓ *Journal of Taxation*
- ✓ *Real Estate Taxation*
- ✓ *Practical Tax Strategies*
- ✓ *Real Estate Journal*
- ✓ *National Real Estate Investor*
- ✓ *The Tax Advisor*
- ✓ *Real Estate Finance*
- ✓ *Journal of Accountancy*
- ✓ *The CPA Journal*
- ✓ *Journal of Financial Service Professionals*

When reading these journals, the Realtor® should pay particular attention to the footnotes and citations, and even follow-up, reading these supporting publications or documents.

15. When extending your education beyond this course to learn even more about IRC§1031 exchanges, the professional Realtor® should
a. assume that the author is an expert, even when he/she disagrees with the IRS
b. assume that the author knows more than the IRS
c. follow-up by reading sources cited by the author
d. call the author for free tax advice

When finding an interesting planning idea in a professional or academic journal article, the professional Realtor® is best advised to discuss the article with a tax attorney or accountant with expertise in the area of IRC§1031 exchanges.

16. When finding an interesting planning idea or opportunity in a professional or academic journal article, the professional Realtor® is best advised to
a. tell their client, and proceed without professional tax advice
b. assume that the article and its contents have been verified by the editor and can be relied on
c. discuss the article with a tax attorney or accountant with expertise in the area of IRC§1031 exchanges
d. throw the article in the garbage and read the Internal Revenue Code

The professional Realtor®, having completed this course, should be able to discuss the professional tax accountant or tax attorney's calculations relating to a proposed IRC§1031 exchange, intelligently. If the tax accountant or tax attorney suggests an IRC§1031 exchange transaction that is contained in a recent professional or academic journal, but one that the professional Realtor® does not understand, the Realtor® may wish to ask for (1) a copy of the article, (2) the appropriate IRC section, or (3) other authoritative source. This is not to suggest that the Realtor® would propose to replace the tax professionals advice with their own, but only that an increased understanding of a transaction might enhance the Realtors® ability to employ a useful strategy with other, additional clients.

17. This course should enable the professional Realtor® to

a. replace the tax attorney in an IRC§1031 exchange
b. replace the tax accountant in an IRC§1031 exchange
c. discuss some details associated with specific IRC§1031 exchanges, intelligently, with the tax accountant or tax attorney engaged for the transaction(s)
d. All of the above are true

Advanced Level

LESSON 1

Introduction

Real estate brokers and agents need to have some basic knowledge of the Internal Revenue Code Section (IRC§) 1031 tax-free exchanges. This advanced course is designed to build on the understanding you acquired in the introductory and intermediate courses. The objective of this course is to assist the real estate broker, agent, appraiser, and other Realtor® professional seeking greater depth in their understanding of IRC§1031 exchanges, and willing to do periodic key word searches of recent journal articles on the topic.

Once completed, this advanced course will provide you with additional background and the course will recommend relevant articles that you should read and add to your permanent reference library and materials on IRC§1031 exchanges. However, when using secondary sources (e.g., websites promoting their services and non-refereed professional journal articles), exercise caution and please be sure to verify via primary sources (e.g., the IRS or Treasury Department Regulations and/or refereed academic or professional journal articles). Many web-based sources provide insufficient detail, potentially leading to misunderstandings.

After completing this course you should be able to discuss, in technical terms, the specifics of IRC§1031 exchanges with tax accountants and attorneys. However, as a Realtor®, it remains advisable to continue to rely on these “experts” to advise clients with respect to the tax treatment of IRC§1031 exchanges.

Successful completion of this course suggests the ability to read contemporary planning articles in professional and academic

journals on more advanced tax planning for IRC§1031. These matters are covered in the advanced course. However, journal articles are, generally, not authoritative. The Internal Revenue Code is authoritative. Journals useful, to those interested in learning more about IRC§1031 exchanges include, but are not limited to: *Journal of Taxation*, *Real Estate Taxation*, *Practical Tax Strategies*, *Real Estate Journal*, *National Real Estate Investor*, *The Tax Advisor*, *Real Estate Finance*, *Journal of Accountancy*, *The CPA Journal*, and *Journal of Financial Service Professionals*.

A Review of Intermediate Course Materials

An Internal Revenue Code Section (IRC§) 1031 exchange is named for the IRC Section it refers to, but is also known as a Starker exchange, tax-free exchange, or like kind exchange. The properly executed IRC§1031 exchange provides for a complete tax deferral of the gain that would otherwise be realized and recognized on the sale of one property or piece of real estate, and its replacement, through the purchase of another property or piece of real estate. The IRC§1031 exchange is the result of the intentional desire, by Congress. IRC§1031 is not an elective provision. If the exchange qualifies as like-kind, non-recognition of gain or loss on the exchange is mandatory. Therefore, if a taxpayer prefers to recognize a loss on an exchange transaction, he or she must structure the transaction to avoid having it qualify as a like-kind exchange.

In recent years, public sources have suggested that an increase in flawed IRC§1031 exchanges have been linked to: poor advice from mortgage brokers, focusing, primarily, on the lack of appropriate tax advice; failure to use qualified intermediaries (not monitored by the IRS); mistakes in property analysis or paperwork preparation are becoming increasingly common, as new investors are entering the real estate market; many are unsophisticated and are relying on brokers, often familiar with the 45-day and 180-day

deadlines, but not with other IRS guidelines; failures tend to concentrate on the East Coast, since these exchanges have been more popular on the West Coast; strict rules apply to IRC§1031 exchanges, which became legal in 1921 and continue to be governed by strict rules adopted in 1991; and replacement property must be purchased under the same conditions as the relinquished property.

1. An Internal Revenue Code Section (IRC§) 1031 exchange

a. is named for the IRC Section it refers to, but is also known as a Starker exchange, tax-free exchange, or like kind exchange

b. if properly executed provides for a complete tax deferral of the gain that would otherwise be realized and recognized on the sale of one property or piece of real estate, and its replacement, through the purchase of another property or piece of real estate

c. is <u>not</u> an <u>elective</u> provision. If the exchange qualifies as like-kind, non-recognition of gain or loss on the exchange is mandatory

d. all of the above

2. In recent years, public sources have suggested that an increase in flawed IRC§1031 exchanges have been linked to all of the below, <u>except</u>

a. poor advice from mortgage brokers, focusing, primarily, on the lack of appropriate <u>tax</u> advice

b. failure to use qualified intermediaries (not monitored by the IRS)

c. mistakes in property analysis or paperwork preparation are becoming increasingly common, as new investors are entering the real estate market

d. the proper use of a qualified intermediary

A basic understanding of IRC§1031 exchanges will benefit both the professional Realtor® and their existing and potential clients. These benefits include: “investors” tend to think “long-term,” so good service tends to equal “clients for life”; <u>not</u> knowing the basics of IRC§1031 exchanges may result in a loss of business or clients; clients educated about the benefits of IRC§1031 exchanges are able to buy higher priced properties (i.e., leverage); investors may exchange one property for two, resulting in three commissions; especially applicable in areas where real

estate values have soared, so do not limit yourself to “serial” investors; once expertise is achieved, use your knowledge of IRC§1031 exchanges to promote yourself; taxpayers buying homes for their college-age children near school are also potential clients; may result in access to tenants of income-producing properties – these are future home buyers and potential clients; important to admit ignorance and establish relationships with qualified tax advisors; establish relationships and work with qualified intermediaries; exchange for a property of greater value, resulting from and partially or fully financed by tax deferral/savings (i.e., leveraging); exchange non-revenue-generating property (e.g., raw land) for income-producing property (e.g., residential rental property); exchange non-depreciable property (e.g., raw land) for income-producing property with improvements that generate depreciation (e.g., rental property); exchange property in an already fully appreciated area for one in an area where you anticipate appreciation; exchange property in an area where property values are declining and gentrification is not anticipated for one in an area in the early stages of its life-cycle; and exchange economically or functionally obsolete property, where repairs and costs of maintenance are increasing, for a newer property.

Many cite lower tax basis and, therefore, lower depreciation as a disadvantage of the IRC§1031 exchange, but this position ignores time value of money considerations and the entire concept of tax deferral. The <u>only</u> disadvantage of the IRC§1031 exchange is that losses from tax deferred or tax-free exchanges cannot be deducted; therefore, If a loss is anticipated or desirable, do a <u>sale</u> and do not do an <u>exchange</u>

3. The <u>only</u> <u>disadvantage</u> of the IRC§1031 exchange is that

a. losses from tax deferred or tax-free exchanges cannot be deducted

b. gains from tax deferred or tax-free exchanges cannot be realized

c. losses from tax deferred or tax-free exchanges cannot be realized

d. gains from tax deferred or tax-free exchanges cannot be recognized

4. If a loss is anticipated or desirable from a real property trade or transaction, the taxpayer should be advised to

a. do an exchange and do not do a sale
b. do a sale and do not do an exchange
c. rent with an option to buy
d. keep the real property

The tax forms likely to be used in IRC§1031 exchanges include Form 8824 – Like-Kind Exchanges: Applies to and is required for all like-kind exchanges; Form 6252 – Installment Sale Income: Generally, this form only applies when the exchange has a taxable component and involves installments or payments and the results flow into Form 4797 and/or Form 1040, Schedule D; Form 4797 – Sale of Business Property: Generally, this form only applies when the exchange has a taxable component and facilitates the allocation of gains into varying classifications (e.g., ordinary income or long-term capital gains); and Form 1040, Schedule D – Capital Gains and Losses: Generally, this form only applies when the exchange has a taxable component and facilitates the allocation of gains into varying classifications (e.g., ordinary income or long-term capital gains)

5. Which federal income tax form must be filed with, applied to and is required for all like kind exchanges?

a. Form 8824
b. Form 6152
c. Form 4597
d. Form 1040, Schedule E

Both the property relinquished and the replacement property must meet the specific criteria to be classified as *qualifying* property, as follows: (1) real property held for the production of income and/or used in a trade or business and real property held for investment (IRC§1221) qualify for IRC§1031 exchanges and tax deferral and (2) real property held for personal use (i.e., personal residence, covered by IRC§1034 and already enjoying certain tax exclusions

under IRC§121) and real property held primarily for sale (i.e., dealer property or inventory) does not qualify for IRC§1031 exchanges and tax deferral.

Like kind properties are those that are the same in *nature* or *character*. They may differ in *grade* or *quality*. Therefore, as applied to real property, the exchange of a city property for a farm property would represent a like kind exchange. Similarly, the exchange of an improved property for an unimproved property would qualify for and represent a like-kind exchange. Furthermore, the exchange of real estate for a real estate lease than has a life of 30 years or longer is a like-kind exchange. However, some interests in real property do not qualify. For example, the exchange of a life estate of less than 30 years for a remainder interest does not qualify as a like-kind exchange. Alternatively, the exchange of a remainder interest in real estate for a remainder interest in other real estate would qualify as a like-kind exchange if the *nature* or *character* of the two real property interests is the same. Finally, foreign real property (e.g., not located in the United States or the District of Columbia) and real property located within the United States is not considered like-kind property.

An exchange does not qualify as "like kind" unless the properties exchanged belong to the same class. For example, an exchange of real property for personal property (or visa versa) would not qualify under IRC§1031 and would not be tax-free.

6. An exchange of real property for personal property
a. is not like-kind
b. would not qualify under IRC§1031
c. would not be tax-free
d. all of the above

Property excluded, for the purposes of IRC§1031 tax deferral treatment, include: property used for personal purposes (e.g.,

personal automobile or residence); stocks in trade or other "inventory" held for sale or resale, including short-term real estate holdings by "dealers;" short-term or current assets, including accounts receivable and debt and equity securities; and partnership interests, certificates of trust or beneficial interest, and choses in action. However, these assets may qualify for other forms of nontaxable exchanges, outside of IRC§1031, including corporate and partnership exchanges (see IRC§351, 1032, and 721); stock-for-stock exchanges (see IRC§1036(a)); insurance contract exchanges (see IRC§1035(a)); U.S. obligation exchanges (see IRC§1037(a)); and reacquisition and/or repossession of real property (see IRC§1038).

7. Property excluded, for the purposes of IRC§1031 tax deferral treatment, may qualify for other forms of nontaxable exchanges, outside of IRC§1031. Which of the below (1) would be excluded under IRC§1031, but (2) might be included under some other IRC Section, qualifying for a nontaxable exchange?

a. stock-for-stock exchanges
b. personal residence for personal residence
c. personal automobile for personal automobile
d. all of the above

A *qualified intermediary* (*QI*) is one engaged, with a written agreement, to broker or arrange for the exchange and transfer of the properties. The QI must (1) acquire the relinquished property from the seller, (2) transfer the relinquished property to the buyer, (3) acquire the replacement property for the buyer, and (4) transfer the replacement property to the buyer. Any agreements with qualified intermediaries must expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise benefit from money or other property. It should also be noted that the use of a QI does not, in and of itself, provide a legitimate vehicle for the avoidance of rules concerning "related parties" and related party transactions. Related party transactions result in the imposition of higher standards and greater scrutiny by the Internal Revenue Service (IRS). In the case of IRC§1031, a two-year holding period

requirement is imposed on related parties. If either party disposes of any of the properties exchanged within the two-year period, deferred gain or loss ceases to remain deferred, effective on the date of the disqualifying disposition.

The four basic types or classifications of IRC§1031 exchanges, along with brief definitions, include: (1) simultaneous – closing of relinquished and replacement properties occur on the same day; (2) Delayed – closing is not simultaneous, but sequential; also known as a "Starker Exchange" (so named after the well known Supreme Court case, ruling in the taxpayer's favor). A delayed exchange results in (1) the sale of the relinquished property, (2) the identification of the appropriate or desired replacement property (within 45 days from closing on the relinquished property), and (3) the purchase of the replacement property, all occurring within the maximum allowable time period of 180 days;(3) Reverse – closing sequence is reversed; the replacement property is identified, purchased and closed before the relinquished property is sold. A form of "Title-Holding" exchange and usually involving an intermediary; and (4) Improvement – closing occurs after improvements are made to the replacement property. A form of "Title-Holding" exchange that may be performed is the "Delayed" or "Reverse" exchange.

8. The four basic types or classifications of IRC§1031 exchanges include all of the following, <u>except</u>
a. simultaneous
b. reverse
c. improvement
d. sideways

The 45-Day (Identification) Rule

Taxpayers have 45 days (identification period – including and/or shortened by weekends and holidays) after the sale of the relinquished property to identify up to three replacement

properties. Generally, the taxpayer notifies their intermediary, in writing, of the properties desired. A contract is not necessary at this time, but the property that the taxpayers (eventually) buy must come from this list. For example, in *Dobrich v. Comm., 84 AFTR 2d 99-6131 (188 F.3d 512) (8/25/1999)*, the Tax Court properly determined that the taxpayers could not defer gain. They failed to comply with the 45-day identification period.

9. Failure to properly identify potential replacement properties within 45 days of the sale of the relinquished property will result in
a. disqualification for realized gain deferral
b. disqualification for realized loss deferral
c. disqualification for gain realization
d. disqualification for gain recognition

There are 3 rules and/or exemptions associated with replacement property identification. Any 1 may be satisfied, including: (1) 3-property rule – the taxpayer may select any <u>three</u> qualifying replacement properties as possible replacements for the relinquished property; (2) 200% rule – the taxpayer may identify <u>any number</u> of qualifying properties as possible replacements for the relinquished property as long as their aggregate fair market value does not exceed 200 percent of the value of the relinquished property; and (3) 95% exemption – the taxpayer may identify <u>any number</u> of qualifying properties as possible replacements for the relinquished property as long as the result in the purchase of at least 95 percent of the aggregate value of all properties identified.

10. The 3 rules and/or exemptions associated with replacement property identification include all of the following, <u>except</u>
a. the 3-property rule
b. the 200% rule
c. the 95% exemption rule
d. the 45% and 180% rules

The 180-Day (Purchase) Rule

Taxpayers have 180 days (exchange period) after the sale of the relinquished property to close on the purchase of the replacement property. Extensions have occurred in the case of September 11, 2001 and natural disasters (e.g., Hurricane Katrina in New Orleans). The 180-day requirement is quite strict and is more precisely defined as 'within 180 days OR the tax filing date, whichever is earlier.' For example, in *Christensen v. Comm., 81 AFTR 2d 98-1627 (142 F. 3d 442) (4/10/1998)*, the taxpayers transferred business property to a facilitator on December 22, 1998, identified the replacement properties on February 3, 1989 (within the 45 days permitted for "identification"), and received the properties between April 25 and June 20, 1989 (within the 180 days permitted for "purchase"). However, they filed their tax return on April 15, 1989, prior to the expiration of the 180 days. The purchase of replacement properties occurred after their tax return was filed. Tax Court properly disallowed the tax deferral. They should have filed an extension (Form 4868) on April 15, 1989, to benefit from the full 180 days otherwise available to complete the purchase. In *Knight, et ux. v. Comm., TC Memo 1998-107 (March 16, 1998)*, the Tax Court also found that the taxpayers failed to comply with the 180-day purchase rule.

Nontaxable, Partially Nontaxable/Taxable and Taxable Exchanges

To completely defer/avoid tax in a properly executed IRC§1031 exchange, the taxpayer must (1) buy replacement property with a fair market value equal to or greater than that of the property relinquished; (2) use all of the original equity realized from the sale of the relinquished property to purchase the replacement property; and (3) secure financing of an equal or greater amount on the replacement property, when compared to the amount financed on the relinquished property at the time of its sale.

11. To completely defer/avoid tax in a properly executed IRC§1031 exchange, the taxpayer must do all of the following, except
a. buy replacement property with a fair market value equal to or greater than that of the property relinquished
b. use all of the original equity realized from the sale of the relinquished property to purchase the replacement property
c. secure financing of an equal or greater amount on the replacement property, when compared to the amount financed on the relinquished property at the time of its sale
d. receive money, boot, or unlike property in the transaction

Some "exchanges" include (1) money or (2) unlike property. If a gain is realized, you may be taxed on this gain, but only to the extent of the combined total of the money and the fair market value of the unlike property received. (Note that any "loss" on a nontaxable or tax deferred exchange is never deductible). The maximum amount of your taxable gain is (1) the fair market value of any unlike property received *plus* (2) any money received *less* (3) any closing costs you paid. Your taxable gain is the lesser of this amount or that amount you might pay on a taxable exchange.

To calculate the gain or loss from a taxable exchange, you must first become acquainted with the terminology: (1) the fair market value (FMV) is the price at which a property will change hands between a willing buyer and a willing seller, with neither party compelled or pressured to buy or sell. When an exchange transaction takes place between parties with adverse or self-interests in an arms-length transaction (e.g., unrelated parties), the sale or exchange value is presumed to have taken place at FMV; (2) the *basis* of a property is usually its cost. Exceptions include property acquired by gift, inheritance, or some other means of transfer. (Coverage of these alternative means of transfer, used to determine the basis of a property, is beyond the scope of this introductory course); (3) the *adjusted basis* of a property is the original cost or other basis (see above) plus certain additions or improvements less certain deductions (e.g., depreciation and/or casualty losses). When determining gain or

loss, costs of transferring the property, including selling expenses, are added to the adjusted basis of the property; the amount you *realize* from a sale or exchange is the (a) money *plus* (b) fair market value of property or services received *plus* (c) any of your liabilities assumed by the buyer, which include real estate taxes or a mortgage; (4) a *gain* is the amount *realized* from a sale or exchange of property that is in excess of its *adjusted basis*; (5) a *loss* is the excess of the *adjusted basis*, when this amount exceeds the amount *realized* from a sale or exchange; (6) gain results from (a) past depreciation taken (for tax purposes), (b) the property appreciating in value or, most likely, (c) some combination of depreciation, which lowers the adjusted basis of the property, and appreciation.

Table 1 assumes that a taxpayer sold a building (cost at $55,000) for $90,000 cash plus $10,000 in other property or services. Improvements of $5,000 were made and depreciation expenses of $10,000 were deducted during the period of ownership. The buyer assumed real estate taxes of $1,000 and a mortgage for $9,000. Selling expenses were $4,000. The amount *realized* was $110,000, the *adjusted basis* of the property was $54,000, and the *gain* on the sale or exchange transaction was $56,000. The objective of the IRC§1031 exchange is to legitimately avoid *recognition* of the *realized* gain on the sale.

Amount Realized:		
Cash	$90,000	
plus: FMV of property or services received	$10,000	
plus: Real estate taxes assumed by the buyer	$ 1,000	
plus: Mortgage assumed by the buyer	$ 9,000	$110,000
Adjusted Basis:		
Cost	$55,000	
plus: Improvements	$ 5,000	
equals: Cost plus Improvements	$60,000	
less: Depreciation	$10,000	
equals: Adjusted Basis	$50,000	
plus: Selling Expenses	$ 4,000	$ 54,000
Realized Gain on Sale		$ 56,000

Table 1

12. Assume that a taxpayer purchased a property for $55,000, made improvements of $5,000 and depreciated $10,000 during the period of ownership. The taxpayer's received total consideration of

a. $110,000
b. $54,000
c. $56,000
d. Some amount other than those provided above

13. Assume that a taxpayer purchased a property for $55,000, made improvements of $5,000 and depreciated $10,000 during the period of ownership. The taxpayer's adjusted basis in the property is

a. $55,000
b. $50,000
c. $60,000
d. $70,000

14. Assume that a taxpayer purchased a property for $55,000, made improvements of $5,000 and depreciated $10,000 during the period of ownership. Selling expenses of $4,000 were incurred and paid by the seller/taxpayer. The taxpayer sold this property for $90,000 cash and received $10,000 in FMV or other property, the buyer assumed real estate taxes of $1,000 and also assumed a mortgage of $9,000. The taxpayer's realized gain on the sale was

a. $110,000
b. $54,000

c. **$56,000**
d. Some amount other than those provided above

In Table 1, $56,000 in gain was *realized* by the taxpayer. However, in the case of a nontaxable or IRC§1031 exchange, this deal might have been structured in such a manner that part or all of the gain would have gone *unrecognized*. Therefore, the distinction between *realization* and *recognition* is an important one. A *realized* gain may or may not be subject to tax. A *recognized* gain is always subject to tax. An IRC§1031 exchange reduces or eliminates the amount *recognized* by a taxpayer with a *realized* gain.

Involuntary Conversions

An involuntary conversion occurs through casualty, theft, or condemnation falls outside of the rules of IRC§1031, per se. Involuntary conversions fall under the guidelines contained in IRC§1033, but also represents and exchange involving the non-recognition of gain or loss. Given recent disasters (e.g., 911 in New York City and Katrina in New Orleans), coverage and the distinctions between IRC§1031 and IRC§1033 is warranted. Replacement properties evolving from an involuntary conversion are governed by two <u>mandatory</u> rules for gain or loss recognition, including: (1) no gain is recognized if there is a direct conversion into property that is similar or related in service or use instead of into a money award – the basis of the replacement property is the adjusted basis of the old property and (2) allowable, realized losses must be recognized – the basis of the replacement property is its acquisition cost.

15. Replacement properties evolving from an involuntary conversion are governed by two <u>mandatory</u> rules for gain or loss recognition, including

a. **(1) no gain is recognized if there is a direct conversion into property that is similar or related in service or use instead of into a money award – the basis of the replacement property is the adjusted basis of the old property and (2) allowable, realized**

losses must be recognized – the basis of the replacement property is its acquisition cost.

b. (1) no loss is recognized if there is a direct conversion into property that is similar or related in service or use instead of into a money award – the basis of the replacement property is the adjusted basis of the old property and (2) allowable, realized gains must be recognized – the basis of the replacement property is its acquisition cost.

c. (1) no gain is recognized if there is a direct conversion into property that is similar or related in service or use instead of into a money award – the basis of the replacement property is the adjusted basis of the old property and (2) allowable, realized gains must be recognized – the basis of the replacement property is its acquisition cost.

d. (1) no loss is recognized if there is a direct conversion into property that is similar or related in service or use instead of into a money award – the basis of the replacement property is the adjusted basis of the old property and (2) allowable, realized losses must be recognized – the basis of the replacement property is its acquisition cost.

Related Party Exchanges

Generally, the IRS views transactions between related parties with greater scrutiny. Related party transactions are governed by IRC§1239. Were it not for IRC§1239, related taxpayers could engage in tax planning to shift the deferred gain to a related party in a lower tax bracket, effectively using IRC§1031 for estate planning purposes. Other tax planning opportunities, not intended by Congress, would also be available. In the case of IRC§1031 exchanges, related party exchanges are not "like kind" and do not qualify for tax deferral if either party disposes of the property within 2 years of the exchange. Dispositions due to death, involuntary conversion, or for purposes (clearly) other than tax avoidance are disregarded. Related parties include brothers, sisters, parents, children, and corporations or partnerships where the taxpayer owns or controls at least 50 percent of the stock or value.

16. Generally, the IRS views transactions between related parties with

a. less scrutiny

b. the same level of scrutiny afforded non-related party transactions

c. greater scrutiny
d. less scrutiny, unless between spouses

Treasury Regulations and the Internal Revenue Code

Treasury regulations provide detailed guidance, including excellent illustrations and examples, for many federal income tax issues. (Many textbooks and articles actually use Treasury regulation examples or modifications to explain tax law). They serve as interpretations of the IRC (the highest legislative authority for tax research, planning, and compliance) by the Secretary of the Treasury. They may be issued in proposed (Prop Reg), temporary (Temp Reg), and final (Reg) form, and are interpretive or legislative. Legislative regulations are higher, in terms of authority, than interpretive regulations. Proposed regulations are not authoritative. In all cases, merely add a 1 to the IRC§, moved to the right of a single decimal place, to determine the section in the Treasury Regulation. For example, in the case of IRC§1031, the Treasury regulation counterpart would be §1.1031 (e.g., IRC§1031 and Reg§1.1031).

For those interested in researching the legislative history of Internal Revenue Code Section (IRC§) 1031, a review of 1958 – Public Law (P.L.) 85-866, effective only for 1954 and later tax years; 1959 – P.L. 86-346, effective only for 9/23/1959 and later tax years; 1969 – P.L. 91-172; 1984 – P.L. 98-369, effective only for 7/19/84 and later tax years (modifications address the 45-day and 180-day rules); 1986 – P.L. 99-514; 1989 – P.L. 101-239, effective only for 7/11/1989 and later tax years; 1990 – P.L. 101-508, effective only for 8/4/1990 and later tax years; 1997 – P.L. 105-34, effective only for 6/9/1997 and later tax years; 1999 – P.L. 106-36, effective only for 11/1/1998 and later tax years may prove helpful.

In *Starker v. U.S., 44 AFTR 2d 79-5525 (602 F.2d 1341), 8/24/1979*, the IRS was barred from re-litigating the case, dealing

with the taxpayer's 1976 tax return. In the original case, it was found that the transfer of property need not be simultaneous.

Terminology, Jargon and Acronyms

The below is a fairly comprehensive list of terms/jargon and acronyms associated with IRC§1031 exchanges that you should already be familiar with from the intermediate course:

Term	Definition
Actual Receipt	See Constructive Receipt and Mortgage Boot; Physical possession
Boot	See Cash Boot; Non like kind property received (or given) and potentially taxable
Cash Boot	See Boot and Mortgage Boot; Amounts actually or constructively received (or given)
Constructive Receipt	See Actual Receipt; Legal entitlement to possession, without regard to actual or physical possession
Debt Relief	See Mortgage Boot
Downleg Property	See Relinquished Property
EAT	Exchange Accommodation Titleholder
Exchange Property	See Relinquished Property
Exchanger	Entity or individual performing an exchange
Identification Period	45-day rule; The maximum number of days from the closing on the relinquished property to properly identify potential replacement property(ies)
QEAA	Qualified Exchange Accommodation Arrangements
Mortgage Boot	See Boot and Cash Boot; Also known as "Debt Relief"; Occurs when

	taxpayer fails to acquire debt in an amount equal to or greater than that on the relinquished property(ies) and potentially taxable
Parked	Also known as "held," referring to the period during which property is held by EAT during a reverse exchange
Parking	See Parked
Phase I Client	Seller
Phase II Client	Buyer
Phase I Property	See Relinquished Property
Phase II Property	See Replacement Property
Purchase Property	See Replacement Property
Relinquished Property	Property "given up"; Also known as the Sale, Exchange, Downleg, or Phase I property
Replacement Property	Property "received"; Also known as the Purchase, Target, Upleg, or Phase II property
Reverse Exchange	When Replacement Property is closed before Relinquished Property
Sale Property	See Relinquished Property
Target Property	See Replacement Property
Upleg Property	See Replacement Property

17. Relinquished property in an IRC§1031 exchange is also known as all of the following, <u>except</u>

a. phase I property
b. downleg
c. upleg
d. there are no exceptions

Relevant IRC Sections, and the topics they related to and already addressed in the <u>introductory</u> and <u>intermediate</u> courses include: IRC§121 - tax exclusions for personal residence; IRC§351 -

corporate interest exchanges; IRC§721 - partnership interest exchanges; IRC§1031 - tax-free or tax deferred exchanges; IRC§1032 - corporate and partnership interest exchanges; IRC§1033 - involuntary conversions; IRC§1034 - personal residence; IRC§1035 - insurance contract exchanges; IRC§1036 - stock for stock exchanges; IRC§1037 - U.S. obligation exchanges; and IRC§1038 - reacquisition and/or repossession of real property.

Sequence of a Typical IRC§1031 Exchange

Below is a brief framework of the sequence of events likely to occur in an IRC§1031 exchange. Generally, the sequence can be easily recalled as review, contract-contact-close (relinquished) property(s) and contract-contact-close (replacement) property(s), as follows:

1. Review transactions with tax and/or legal advisors
2. Contract for sale via "assignment" to qualified intermediary (QI) for relinquished property
3. Contact QI prior to closing of sale of relinquished property(s) for exchange document preparation
4. Close relinquished property(s) by assignee (QI); QI receives exchange proceeds; relinquished property deeded directly to the buyer; the 45-day (identification) and 180-day (replacement) periods begin – the latter, as affected by the due date of the tax return
5. Contract for purchase via "assignment" to QI for properly identified replacement property(s)
6. Contact QI prior to closing of purchase of replacement property(s) for exchange document preparation
7. Close on replacement property(s)

LESSON 2

A Review of Intermediate Course Materials (continued)

The Basis of Replacement Property

The taxpayer's original cost, purchase price or basis (comparable terms) is increased by capital improvements (i.e., long-lived improvements that have not been expensed, e.g., repairs and maintenance) and reduced by depreciation (including amortization and depletion). The result is the taxpayer's basis, adjusted basis or net adjusted basis (comparable terms) in the relinquished property. The taxpayer's basis in replacement property is reduced by boot received, liabilities assumed by the transferee, and loss recognized on the exchange. The taxpayer's basis is increased by boot given, liabilities assumed by the transferor, and gain recognized in the exchange. See Table 2, where these components are summarized.

1. The taxpayer's basis in replacement property is <u>reduced</u> by all of the following, <u>except</u>

a. boot received
b. liabilities assumed by the transferee
c. loss recognized on the exchange
d. gain recognized on the exchange

2. The taxpayer's basis in replacement property is <u>increased</u> by all of the following, <u>except</u>

a. boot given
b. gain recognized on the exchange
c. liability assumed by the transferor (seller)
d. loss recognized on the exchange

	Original Cost, Basis or Purchase Price RELINQUISHED Property
+	Capital Improvements
-	Depreciation
=	**Adjusted Basis of RELINQUISHED Property**
+	Boot given
+	Gain recognized
+	Liability assumed by the transferor (seller)
-	Fair market value of boot received
-	Loss recognized
-	Liability assumed by the transferee (buyer)
=	**Basis of REPLACEMENT Property**

Table 2

Receipt of Boot

Because exchanges between taxpayers do not always occur with properties of equal value, non-like-kind property or money may be included in the exchange transaction. Money and any other non-like-kind property (e.g., goods or services at FMV) constitute and are referred to as *boot*. Gain is recognized to the extent that boot is received, but limited by the taxpayer's realized gain, which serves as a ceiling for recognized gain. The receipt of boot in a nontaxable exchange does not, in and of itself, cause a realized loss to be recognized. In fact, if there is a realized loss in a boot received situation, the loss is not recognized. *Mortgage boot* or debt relief occurs when the replacement property debt is less than the relinquished property debt. Mortgage boot is taxable unless offset by contributing an equivalent amount of cash to complete the transaction. The cash contributed has, after all, already been taxed.

3. If there is a realized loss in a boot received situation
a. the loss is recognized
b. the loss is not recognized
c. the loss is realized and recognized
d. the loss is not realized, but is recognized

4. Mortgage boot is taxable
a. if offset by contributing an equivalent amount of cash to complete the transaction
b. unless offset by contributing an equivalent amount of cash to complete the transaction
c. if more than offset by contributing an equivalent amount of cash to complete the transaction
d. all of the above are correct

An example of an exchange involving the receipt of property or money (boot) follows:

- ✓ A taxpayer exchanges real property held for investment (IRC§1221) (adjusted basis of $50,000) for other real property (fair market value of $60,000), to be used in his trade or business, and cash ($20,000). The realized gain is $30,000 ($60,000 + $20,000 = $80,000 - $50,000). This gain, however, is recognized only to the extent of cash or boot, at $20,000. This taxpayer has effectively deferred the gain on the remaining $10,000 ($30,000 - $20,000) (as adapted from Reg§1.1031(b)-1(b) Example (1)).

Realized Gains and Losses and Cases Where Boot is Given

Table 3 begins with a case where the fair market value of the replacement property is held constant at $9,000. No boot is given. In one case (**1a**), the taxpayer has a realized gain. In the other case (**1b**), the taxpayer has a realized loss. Note that neither case results in a <u>recognized</u> gain or loss. Table 3 proceeds with a case where boot is given. In one case (**2a**), the taxpayer has a realized gain. In the other case (**2b**), the taxpayer has a realized loss. Note that neither case results in a <u>recognized</u> gain or loss. Table 3 continues with a case where the fair market value of the replacement property does not remain constant. Boot is received. In one case (**3a**), the taxpayer has a realized gain. In the other case (**3b**), the taxpayer has a realized loss. Note that one case (**3a**) results in a <u>recognized</u> gain. Pay particular

attention to (1) the realized gain or (loss), (2) the recognized gain or (loss) and (3) the new basis for the replacement property.

Question		1a	1b
1	Recognized Gain or (Loss)?	No	No
2	Boot Involved?	No	No
3	Realized Gain or (Loss)?	Gain	Loss
Fair Market Value of REPLACEMENT Property		$9,000	$ 9,000
Adjusted Basis of RELINQUISHED Property		$4,000	$10,000
Boot:			
	Adjusted Basis of Boot Given	$ -0-	$ -0-
	Fair Market Value of Boot Received	$ -0-	$ -0-
Realized Gain or (Loss)		$5,000	$ (1,000)
Recognized Gain or (Loss)		$ -0-	$ -0-
New Basis (REPLACEMENT Property):			
	Adjusted Basis RELINQUISHED Property	$4,000	$10,000
+	Adjusted Basis of Boot Given	$ -0-	$ -0-
+	Recognized Gain or (Loss)	$ -0-	$ -0-
-	Fair Market Value of Boot Received	$ -0-	$ -0-
=	New Basis (REPLACEMENT Property):	$4,000	$10,000

Table 3

Question		2a	2b
1	Recognized Gain or (Loss)?	No	No
2	Boot Involved?	Given	Given
3	Realized Gain or (Loss)?	Gain	Loss
Fair Market Value of REPLACEMENT Property		$9,000	$ 9,000
Adjusted Basis of RELINQUISHED Property		$4,000	$ 4,000
Boot:			
	Adjusted Basis of Boot Given	$2,500	$ 6,000
	Fair Market Value of Boot Received	$ -0-	$ -0-
Realized Gain or (Loss)		$2,500	$ (1,000)
Recognized Gain or (Loss)		$ -0-	$ -0-
New Basis (REPLACEMENT Property):			
	Adjusted Basis RELINQUISHED Property	$4,000	$ 4,000
+	Adjusted Basis of Boot Given	$2,500	$ 6,000
+	Recognized Gain or (Loss)	$ -0-	$ -0-
-	Fair Market Value of Boot Received	$ -0-	$ -0-
=	New Basis (REPLACEMENT Property):	$6,500	$10,000

Question		3a	3b
1	Recognized Gain or (Loss)?	Gain	No
2	Boot Involved?	Rec'd	Rec'd
3	Realized Gain or (Loss)?	Gain	Loss
Fair Market Value of REPLACEMENT Property		$9,000	$3,500
Adjusted Basis of RELINQUISHED Property		$4,000	$4,000
Boot:			
	Adjusted Basis of Boot Given	$ -0-	$ -0-
	Fair Market Value of Boot Received	$3,000	$ 250
Realized Gain or (Loss)		$8,000	$ (250)
Recognized Gain or (Loss)		$3,000	$ -0-
New Basis (REPLACEMENT Property):			
	Adjusted Basis RELINQUISHED Property	$4,000	$4,000
+	Adjusted Basis of Boot Given	$ -0-	$ -0-
+	Recognized Gain or (Loss)	$3,000	$ -0-
-	Fair Market Value of Boot Received	$3,000	$ 250
=	New Basis (REPLACEMENT Property):	$4,000	$3,750

Intangibles and Non-Depreciable Personal Property

Generally, intangibles and non-depreciable personal property qualifies for IRC§1031 non-recognition of gain or loss only if of a like kind, including: the exchange of goodwill associated with one business is not of a like kind to the goodwill of another business (Reg§1.1031(a)-2(c)(2)); the exchange of a copyright on a novel for the copyright on another novel is of a like kind (Reg§1.1031(a)-2(c)(3) Example (1)); and the exchange of a copyright on a novel for the copyright on a song is not of a like kind (Reg§1.1031(a)-2(c)(3) Example (2)).

IRC§1231 Property and IRC§1245 and 1250 Property Recapture

In the introductory course, applicable long-term capital gains tax rates for 2004 and 2005 were summarized and it was noted that recapture of IRC§1250 gain was taxed at 25 percent:

	Option 1 Sale & Purchase	Option 2 Exchange
Sales Price/Fair Market Value	$100,000	na
less: Cost or Adjusted Basis	$ 50,000	na
equals: Taxable Gain	$ 50,000	na
Taxed at 25%:		
Fair Market Value	$100,000	$100,000
less: Tax ($50,000 x 25%)	$ 12,500	$ -0-
equals: Remaining Equity (12.5% equity lost)	$ 87,500	$ 100,000
Taxed at 15%:		
Fair Market Value	$100,000	$100,000
less: Tax ($50,000 x 15%)	$ 7,500	$ -0-
equals: Remaining Equity (7.5% equity lost)	$ 92,500	$100,000
Taxed at 5%:		
Fair Market Value	$100,000	$100,000
less: Tax ($50,000 x 5%)	$ 2,500	$ -0-
equals: Remaining Equity (2.5% equity lost)	$ 97,500	$100,000

Table 4

2004-2005 Marginal Federal Income Tax Rate or Tax Bracket	Applicable Long-Term Capital Gains Tax Rate
5% & 10%	5%
25%, 28%, 33% & 35%	15%

Table 5

A complete understanding of IRC§1250 requires greater understanding of IRC§1221 (investment) and IRC§1231 (trade or business use) property and IRC§1245 (personal) and 1250 (real) property recapture. Generally, the IRC§1031 exchanges most realtors are likely to be involved in will be comprised of and include IRC§1231 property. IRC§1231 property includes real or depreciable property used in a trade or business and held for more than one-year; timber, coal or domestic iron ore; livestock; and unharvested crops. IRC§1245 property includes automobiles, livestock, railroad grading, and single-purpose agricultural or

horticultural structures. Generally, the IRC§1031 exchanges most realtors are likely to be involved in will be comprised of and require some working knowledge of the recapture provisions of IRC§1250. IRC§1250 property is any depreciable property, other than IRC§1245 property, and includes: (1) low-income housing; (2) depreciable residential rental property; and (3) all other depreciable real property except nonresidential, qualifying as recovery property (placed in service after 1980 and before 1987) unless the straight-line method of cost recovery was elected and used

Generally, in the case of the purchase of a residential rental property, the purchase price is allocated between land, improvements, and personal property. Land is not a wasting asset, so no depreciation is permitted. Real property improvements are depreciated, as are personal property items included in the sale/purchase (e.g., refrigerator, washer and dryer). The purchaser seeks, within reason, to allocate higher costs to personal property items, real property improvements and land, in that order, since the shortest depreciable life is associated with personal property and land is not depreciable. This maximizes the depreciable base (and depreciation expense) available to the taxpayer. The allocation of purchase price to personal property, real property improvements and land is made using what is often referred to as the *relative sales value* approach (i.e., pro rated).

Depreciation allows the taxpayer to match an expense, representing the functional or economic obsolescence of an asset with an estimated useful life exceeding one-year, against the revenue generated from these long-lived or fixed assets. The modified accelerated cost recovery system (MACRS) system applies for assets placed in service after December 31, 1986. There are six categories for assets classified as tangible personal property, as follows:

- ✓ 3-year- tractor units, race horses over 12 years old, and special tools
- ✓ 5-year - automobiles, light and heavy-duty general purpose trucks, computers, and research and experimental equipment
- ✓ 7-year - office furniture and equipment, horses, single-purpose agricultural or horticultural structures, and property not otherwise classified; most machinery
- ✓ 10-year - barges, vessels, and petroleum and food processing equipment
- ✓ 15-year - billboards, service station buildings, and land improvements
- ✓ 20-year - utilities and sewers

The above are calculated based on a 200 percent or double declining (DDB) balance method, switching to straight-line (SL) at the mid-life point or where the application of SL results in a higher amount of depreciation. Their application is likely to be most relevant when like kind exchanges include farm properties or rental properties, where non-real properties are included in the transaction and must be separately evaluated for tax deferral (covered later). A half-year (HY) convention is applied in the year of acquisition and disposition. (For all practical purposes, the application of the fist year, half-year, modifying convention adds one-year to the lives presented above.) There are two categories for assets classified as <u>real</u> property, as follows:

- ✓ 27.5 years - residential rental property
- ✓ 39 years - nonresidential rental property

The above are calculated using the SL method and require the application of a mid-month (MM) convention for the year of acquisition and disposition.

5. <u>Residential</u> <u>rental</u> property has a MACRS life of

a. 15 years

b. 20 years

c. 27.5 years

d. 39 years

6. Nonresidential rental property has a MACRS life of
a. 15 years
b. 20 years
c. 27.5 years
d. 39 years

7. The two MACRS categories for real property include
a. 10 years and 15 years
b. 15 years and 20 years
c. 20 years and 27.5 years
d. 27.5 years and 39 years

8. The two MACRS categories for real property
a. are calculated using the straight-line (SL) method
b. require the application of a mid-month (MM) convention for the year of acquisition
c. require the application of a mid-month (MM) convention for the year of disposition
d. all of the above

Realized Gains and Losses and Cases Where Boot is Given – An Extension

The introductory course provided several illustrations for the calculation of (1) realized gain or (loss), (2) recognized gain or (loss), and (3) new basis in the replacement property (METHOD 1). This intermediate course provides an alternative method (METHOD 2), focusing, primarily, on the new basis in the replacement property, but using the same examples or fact patterns. Note that the same “Basis of REPLACEMENT Property” should result from both methods:

METHOD 1

	Original Cost, Basis or Purchase Price RELINQUISHED Property
+	Boot given (Adjusted Basis)
+	Gain recognized
+	Liability assumed by the transferor (seller)
-	Boot received (Fair Market Value)
-	Loss recognized
-	Liability assumed by the transferee (buyer)
=	Basis of REPLACEMENT Property

METHOD 2

	Fair Market Value of REPLACEMENT Property
-	Deferred (Realized *less* Recognized) Gain
+	Deferred Loss
=	Basis of REPLACEMENT Property

Same

Table 6

Assume the following facts:

Question			1a	1b
	1	Recognized Gain or (Loss)?	No	No
	2	Boot Involved?	No	No
	3	Realized Gain or (Loss)?	Gain	Loss
Fair Market Value of REPLACEMENT Property			$9,000	$ 9,000
Adjusted Basis of RELINQUISHED Property			$4,000	$10,000
Boot:				
		Adjusted Basis of Boot Given	$ -0-	$ -0-
		Fair Market Value of Boot Received	$ -0-	$ -0-
Realized Gain or (Loss)			$5,000	$ (1,000)
Recognized Gain or (Loss)			$ -0-	$ -0-
New Basis (REPLACEMENT Property):				
		Adjusted Basis RELINQUISHED Property	$4,000	$10,000
	+	Adjusted Basis of Boot Given	$ -0-	$ -0-
	+	Recognized Gain or (Loss)	$ -0-	$ -0-
	-	Fair Market Value of Boot Received	$ -0-	$ -0-
	=	New Basis (REPLACEMENT Property):	$4,000	$10,000

Table 7

Note that METHOD 1 and METHOD 2 generate the same result:

	1a	1b	(000 omitted)
			METHOD 1
			Original Cost/ Basis/Purchase Price
	$4	$10	RELINQUISHED Property
+	-0-	-0-	Boot given (Adjusted Basis)
+	-0-	-0-	Gain recognized
+	-0-	-0-	Liability assumed by the transferor (seller)
-	-0-	-0-	Boot received (Fair Market Value)
-	-0-	-0-	Loss recognized
-	-0-	-0-	Liability assumed by the transferee (buyer)
=	$4	$10	Basis of REPLACEMENT Property
			METHOD 2
	$9	$ 9	Fair Market Value of REPLACEMENT Property
-	$5	$ (1)	Deferred (Realized *less* Recognized) Gain
+	-0-	-0-	Deferred Loss
=	$4	$10	Basis of REPLACEMENT Property

Same

Table 7a

Assume the following facts:

Question		2a	2b
1	Recognized Gain or (Loss)?	No	No
2	Boot Involved?	Given	Given
3	Realized Gain or (Loss)?	Gain	Loss
Fair Market Value of REPLACEMENT Property		$9,000	$ 9,000
Adjusted Basis of RELINQUISHED Property		$4,000	$ 4,000
Boot:			
	Adjusted Basis of Boot Given	$2,500	$ 6,000
	Fair Market Value of Boot Received	$ -0-	$ -0-
Realized Gain or (Loss)		$2,500	$ (1,000)
Recognized Gain or (Loss)		$ -0-	$ -0-
New Basis (REPLACEMENT Property):			
	Adjusted Basis RELINQUISHED Property	$4,000	$ 4,000
+	Adjusted Basis of Boot Given	$2,500	$ 6,000
+	Recognized Gain or (Loss)	$ -0-	$ -0-
-	Fair Market Value of Boot Received	$ -0-	$ -0-
=	New Basis (REPLACEMENT Property):	$6,500	$10,000

Table 8

Note that METHOD 1 and METHOD 2 generate the same result:

	2a	**2b**	
			METHOD 1
	$4,000	$ 4,000	Original Cost/Basis/Purchase Price of RELINQUISHED Property
+	$2,500	$ 6,000	Boot given (Adjusted Basis)
+	-0-	-0-	Gain recognized
+	-0-	-0-	Liability assumed by the transferor (seller)
-	-0-	-0-	Boot received (Fair Market Value)
-	-0-	-0-	Loss recognized
-	-0-	-0-	Liability assumed by the transferee (buyer)
=	$6,500	$10,000	Basis of REPLACEMENT Property ◄ Same
			METHOD 2
	$9,000	$ 9,000	Fair Market Value REPLACEMENT Property
-	$2,500	$ (1,000)	Deferred (Realized *less* Recognized) Gain
+	-0-	-0-	Deferred Loss
=	$6,500	$10,000	Basis of REPLACEMENT Property ◄

Table 8a

Assume the following facts:

Question		3a	3b
1	Recognized Gain or (Loss)?	Gain	No
2	Boot Involved?	Rec'd	Rec'd
3	Realized Gain or (Loss)?	Gain	Loss
Fair Market Value of REPLACEMENT Property		$9,000	$3,500
Adjusted Basis of RELINQUISHED Property		$4,000	$4,000
Boot:			
	Adjusted Basis of Boot Given	$ -0-	$ -0-
	Fair Market Value of Boot Received	$3,000	$ 250
Realized Gain or (Loss)		$8,000	$ (250)
Recognized Gain or (Loss)		$3,000	$ -0-
New Basis (REPLACEMENT Property):			
	Adjusted Basis RELINQUISHED Property	$4,000	$4,000
+	Adjusted Basis of Boot Given	$ -0-	$ -0-
+	Recognized Gain or (Loss)	$3,000	$ -0-
-	Fair Market Value of Boot Received	$3,000	$ 250
=	New Basis (REPLACEMENT Property):	$4,000	$3,750

Table 9

Note that METHOD 1 and METHOD 2 generate the same result:

	3a	3b	
			METHOD 1
	$4,000	$4,000	Original Cost/Basis/Purchase Price RELINQUISHED Property
+	-0-	-0-	Boot given (Adjusted Basis)
+	$3,000	-0-	Gain recognized
+	-0-	-0-	Liability assumed by the transferor (seller)
-	$3,000	$ 250	Boot received (Fair Market Value)
-	-0-	-0-	Loss recognized
-	-0-	-0-	Liability assumed by the transferee (buyer)
=	$4,000	$3,750	Basis of REPLACEMENT Property
			METHOD 2
	$9,000	$3,500	Fair Market Value REPLACEMENT Property
-	$5,000	$ (250)	Deferred (Realized *less* Recognized) Gain
+	-0-	-0-	Deferred Loss
=	$4,000	$3,750	Basis of REPLACEMENT Property

Same

Table 9a

9. There are two methods that have been presented in the lesson and both may be used for the calculation of the basis of replacement property.

a. both methods result in the same basis for the replacement property

b. both methods begin with original cost, basis or purchase price of the relinquished property

c. both methods begin with the fair market value of the replacement property

d. the use of both methods will result in a different, method-based basis for the replacement property

10. There are two methods that have been presented in the lesson and both may be used for the calculation of the basis of replacement property. One method begins with

a. the use of both methods result in a different, method-based basis for the replacement property

b. original cost, basis or purchase price of the relinquished property

c. fair market value of the replacement property

d. **both b. and c. are correct and represent the two, different starting points for the two methods**

The purpose of IRC§1245 is to eliminate tax advantages otherwise available via the reduction of ordinary income through depreciation, only to receive IRC§1231 treatment for subsequent gains. To understand this provision of the IRC, you must first understand that ordinary income (e.g., salary, interest and dividend income, and business income) is taxed at a higher rate than long-term capital gain (LTCG). IRC§1245 recapture provisions prevent net IRC§1231 gains from being treated as LTCG and receiving preferential tax treatment. So, for example, the depreciation expense on your rental property that you deducted while in a 35 percent marginal federal income tax bracket (e.g., tax savings or deferral of $35 per $100 depreciation deduction), will <u>not</u> be taxed at the lesser rate of 15 percent, when the rental property is sold for a profit (see Table 5). The taxpayer does, however, continue to benefit from time value of money or tax deferral (i.e., a dollar today is worth more than a dollar tomorrow, so the $35 savings in, for example, the 2000 tax year, still benefited the taxpayer deferring and paying this amount in the 2005 tax year, when the depreciated must be recaptured under IRC§1245 and the property is sold).

IRC§1245 affects the <u>character</u> of the gain, not the <u>amount</u> of the gain; does not apply to assets sold or exchanged at a loss; ordinary income is never greater than the realized gain; recapture applies to total depreciation (or amortization) allowed (or allowable), but not to exceed the realized gain; property includes depreciable <u>personal</u> property (and amortizable intangible assets); property includes <u>nonresidential</u> <u>real</u> property placed in service after 1980 and before 1987 under the accelerated cost recovery system (ACRS), unless the taxpayer elected straight-line (SL) depreciation; and does not apply to any buildings placed in service after 1986.

IRC§1250 converts a portion of IRC§1231 gains into ordinary income when real property is sold or exchanged. IRC§1250 recapture can be avoided by using straight-line (SL) depreciation, as it is the accelerated depreciation component (e.g., DDB or double-declining balance) that IRC§1250 converts into ordinary income. IRC§1250 recapture can also be avoided by simply keeping the property for its entire useful or depreciable life, since the accumulated depreciation is the same under both SL and DDB at the end of the useful life of an asset. IRC§1250 affects the character of the gain, not the amount of the gain; does not apply to assets sold or exchanged at a loss; ordinary income is never greater than the realized gain; ordinary income is never greater than the additional depreciation allowed (e.g., DDB in excess of SL depreciation); property includes depreciable real property, unless nonresidential and placed in service in 1980 and before 1987 under the accelerated cost recovery system (ACRS) and the taxpayer did not elect straight-line (SL) depreciation; and does not apply if SL depreciation is used.

11. Generally, recapture for depreciable personal property (and amortizable intangible assets) is covered under
a. IRC§1250
b. IRC§1245
c. IRC§1231
d. IRC§1031

12. Generally, recapture for depreciable real property is covered under
a. IRC§1250
b. IRC§1245
c. IRC§1231
d. IRC§1031

This course deals, primarily, with IRC§1031 as applied to real property. However, a transaction may also involve depreciable tangible personal property (e.g., furniture and fixtures in a business exchange). IRC§1031 applies to depreciable tangible personal property if the property is exchanged for property of a

like kind or class. Revenue Procedure (Rev. Proc.) 87-56, 1987-2 C.M. 674 describes General Asset Classes (in parentheses). Those frequently used in many businesses follow (Reg§1.1031(a)-2(b)(2)):
(i) - Office furniture, fixtures, & equipment (00.11)
(ii) - Information systems (computers & peripheral equipment) (00.12)
(iii) - Data handling equipment, except computers (00.13)
(iv) - Airplanes (airframes & engines), except those used in commercial or contract carrying of passengers or freight, & all helicopters (airframes & engines) (00.21)
(v) - Automobiles, taxis (00.22)
(vi) - Buses (00.23)
(vii) - Light general purpose trucks (00.241)
(viii) - Heavy general purpose trucks (00.242)
(ix) - Railroad cars & locomotives, except those owned by railroad transportation companies (00.25)
(x) - Tractor units for use over-the-road (00.26)
(xi) - Trailers & trailer-mounted containers (00.27)
(xii) - Vessels, barges, tugs, & similar water-transportation equipment, except those used in marine construction (00.28)
(xiii) - Industrial steam & electric generation and/or distribution systems (00.4)

An example of a like kind exchange of depreciable tangible personal property, and qualifying for IRC§1031 tax deferral includes that where a taxpayer exchanges a personal computer to another taxpayer for a printer (Reg§1.1031(a)-2(b)(7)Example (1)) – see asset class (00.12).

An example of depreciable tangible personal property that is <u>not</u> of a like kind, and does <u>not</u> qualify for IRC§1031 tax deferral includes that where a taxpayer transfers an airplane to another taxpayer for a heavy general purpose truck (Reg§1.1031(a)-2(b)(7)Example (2)) – see asset class (00.21 & 00.242).

Exchange Group Surpluses, Deficiencies and Basis Determination

The example that follows involves multiple personal property components. It is a fairly complex, but not comprehensive example (as adapted from Reg§1.1031(j)-1(c) Example (1)). *Realized* and *recognized* are terms that were developed and defined in the introductory course. You should already feel comfortable with these terms, as well as *replacement* property and *relinquished* property. This example introduces two new terms: exchange group *surplus* and exchange group *deficiency*. These terms are important in understanding the computation of *basis* in the replacement properties. The example follows:

✓ Taxpayer A exchanges his computer (adjusted (adj.) basis at $375 and fair market value (FMV) at $1,000) and automobile (adj. basis at $1,500 and FMV at $4,000) with taxpayer B for B's printer (FMV at $2,050) and automobile (FMV at $2,950). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The basic facts from this above case are summarized in Table 10, below:

Description	Adjusted Basis	Fair Market Value
Computer A	$ 375	$1,000
Automobile A	$1,500	$4,000
Printer B	$ -0-	$2,050
Automobile B	$ -0-	$2,950

Table 10

- Step 1 – separate the assets into exchange groups to calculate A's *surplus* or *deficiency*:
    - computer (00.12) & printer (00.12)
      relinquish computer (adj. basis at $375; FMV at $1,000)
      replace with printer (FMV at $2,050)

exchange group *surplus* ($1,050) = replaced at $2,050 – relinquished at $1,000

- automobile (00.22) & automobile (00.22)
  relinquish automobile (adj. basis at $1,500; FMV at $4,000)
  replace with automobile (FMV at $2,950)
  exchange group *deficiency* ($1,050) = replaced at $2,950 – relinquished at $4,000

If taxpayer As Replacement Property FMV > Relinquished Property FMV, an Exchange Group *Surplus* is established with respect to taxpayer A. Alternatively, if taxpayer As Replacement Property FMV < Relinquished Property FMV, an Exchange Group *Deficiency* exists with respect to taxpayer A.

- Step 2 – evaluate *realized* and *recognized gain* or *loss* for each exchange group:
  - computer (00.12) & printer (00.12)
    realized gain ($625) = FMV ($1,000) – adj. basis ($375)
    recognized gain (**$-0-**) = lesser of realized gain ($625) or exchange group deficiency ($-0-)
    Note: The was no exchange group *deficiency*; there was an exchange group *surplus*
  - automobile (00.22) & automobile (00.22)
    realized gain ($2,500) = FMV ($4,000) – adj. basis ($1,500)
    recognized gain (**$1,050**) = lesser of realized gain ($2,500) or exchange group deficiency ($1,050)

The Recognized Gain or Loss for each Exchange Group is the lesser of the (1) Realized Gain or the (2) Exchange Group Deficiency. If there is no Exchange Group Deficiency or if there is an Exchange Group Surplus, the Exchange Group Deficiency is equal to zero.

- Step 3 – combine *recognized gains* from both exchange groups:

  - the sum of gains recognized for both exchange groups (**$1,050**) = ($-0-) + ($1,050)
- Step 4 – determine *basis*:
  - computer (00.12) & printer (00.12)
    basis of replacement printer ($1,425) = adj. basis of relinquished computer ($375) + gain recognized ($-0-) + exchange group *surplus* ($1,050)
  - automobile (00.22) & automobile (00.22)
    basis of replacement automobile ($1,500) = adj. basis of relinquished automobile ($1,500) + gain recognized ($1,050) – exchange group *deficiency* ($1,050)

The example that follows extends the earlier example. It, too, involves multiple personal property components (as adapted from Reg§1.1031(j)-1(c) Example (2)), including corporate stock and cash. The example follows:

✓ Taxpayer A exchanges his computer (adjusted (adj.) basis at $375 and fair market value (FMV) at $1,000) and automobile (adj. basis at $3,500 and FMV at $4,000) with taxpayer B for B's printer (FMV at $800), automobile (FMV at $2,950), corporate stock (FMV at $750) and cash ($500). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The basic facts from this case are summarized in Table 11, below:

Description	Adjusted Basis	Fair Market Value
Computer A	$ 375	$1,000
Automobile A	$3,500	$4,000
Printer B	$ -0-	$ 800
Automobile B	$ -0-	$2,950
Corporate Stock B	$ -0-	$ 750
Cash B	$ -0-	$ 500

Table 11

- Step 1 – separate the assets into exchange groups to calculate A's *surplus* or *deficiency*:
  - computer (00.12) & printer (00.12)
    relinquish computer (adj. basis at $375; FMV at $1,000)
    replace with printer (FMV at $800)
    exchange group *deficiency* ($200) = replaced at $800 – relinquished at $1,000
  - automobile (00.22) & automobile (00.22)
    relinquish automobile (adj. basis at $3,500; FMV at $4,000)
    replace with automobile (FMV at $2,950)
    exchange group *deficiency* ($1,050) = replaced at $2,950 – relinquished at $4,000
  - residual group ($1,250) = corporate stock ($750) + cash ($500)
- Step 2 – evaluate realized and recognized gain or loss for each exchange group:
  - computer (00.12) & printer (00.12)
    realized gain ($625) = FMV ($1,000) – adj. basis ($375)
    recognized gain (**$200**) = lesser of realized gain ($625) or exchange group deficiency ($200)
  - automobile (00.22) & automobile (00.22)
    realized gain ($500) = FMV ($4,000) – adj. basis ($3,500)
    recognized gain (**$500**) = lesser of realized gain ($500) or exchange group deficiency ($1,050)
  - residual group is not applicable
- Step 3 – combine recognized gains from both exchange groups:
  - the sum of gains recognized for both exchange groups (**$700**) = ($200) + ($500)
- Step 4 – determine *basis*:
  - computer (00.12) & printer (00.12)
    basis of replacement printer ($375) = adj. basis of relinquished computer ($375) + gain recognized ($200) - exchange group *deficiency* ($200)
  - automobile (00.22) & automobile (00.22)

basis of replacement automobile ($2.950) = adj. basis of relinquished automobile ($3,500) + gain recognized ($500) – exchange group *deficiency* ($1,050)

- residual group basis in stock and cash is $750 and $500, respectively

This final example in this lesson further extends the earlier examples. It involves multiple personal property components (as adapted from Reg§1.1031(j)-1(c) Example (3)), but includes real property. Therefore, this example prepares the Realtor® for those exchanges involving both real and personal property. The example follows:

✓ Taxpayer A exchanges two computers – adjusted (adj.) basis at $1,500 and fair market value (FMV) at $5,000 for computer (A)(1) and adj. basis at $500 and FMV at $3,000 for computer (A)(2), a printer with adj. basis at $2,000 and FMV at $1,500; two pieces of real property – parcel (A)(1) with an adj. basis at $1,200 and FMV at $2,000 and parcel (A)(2) with an adj. basis at $-0- and FMV at $1,800; a scraper with an adj. basis at $3,300 and FMV at $2,500; and inventory with an adj. basis at $1,000 and FMV at $1,700 with taxpayer B for B's computer (FMV at $4,500); printer (FMV at $2,500); two real property parcels – parcel (B)(1) (FMV at $1,000) and parcel (B)(2) (FMV at $4,000); a grader (FMV at $2,000); truck (FMV at $1,700); and cash ($1,800). Assume that both taxpayers are using these assets for productive business purposes and will do so, also, after the exchange. The basic facts from this case are summarized in Table 12, below:

Description	Relinquished Adjusted Basis	Relinquished Fair Market Value	Replacement Fair Market Value
Computer A(1)	$1,500	$5,000	na
Computer A(2)	$ 500	$3,000	na
Computer B	na	na	$4,500

Printer A	$2,000	$1,500	na
Printer B	na	na	$2,500
Real Estate A(1)	$1,200	$2,000	na
Real Estate A(2)	$ -0-	$1,800	na
Real Estate B(1)	na	na	$1,000
Real Estate B(2)	na	na	$4,000
Scraper A	$3,300	$2,500	na
Grader B	na	na	$2,000
Truck B	na	na	$1,700
Inventory A	$1,000	$1,700	na
Cash B	na	na	$1,800

Table 12

- Step 1 – separate the assets into exchange groups to calculate A's *surplus* or *deficiency*:
  - computers (00.12) & printers (00.12)
    relinquish computers & printer (adj. basis at $4,000 = $1,500 + $500 + $2,000; FMV at $9,500 = $5,000 + $3,000 + $1,500)
    replace with computer & printer (FMV at $7,000 = $4,500 + $2,500)
    exchange group *deficiency* ($2,500) = replaced at $7,000 – relinquished at $9,500
  - real property
    relinquish real property (adj. basis at $1,200 = $1,200 + $-0-; FMV at $3,800 = $2,000 + $1,800)
    replace with real property (FMV at $5,000 = $1,000 + $4,000)
    exchange group *surplus* ($1,200) = replaced at $5,000 – relinquished at $3,800
  - scraper & grader
    relinquish scraper (adj. basis at $3,300; FMV at $2,500)
    replace with grader (FMV at $2,000)
    exchange group *deficiency* ($500) = replaced at $2,500 – relinquished at $2,000

    - residual groups ($1,800) = cash ($1,800), where inventory (adj. basis at $1,000; FMV at $1,700) is exchanged for a truck (FMV at $1,700); the inventory is taxable and the truck is not of a like class to any property transferred in the exchange
- Step 2 – evaluate realized and recognized gain or loss for each exchange group:
    - computer (00.12) & printer (00.12)
      realized gain ($5,500) = FMV ($9,500) – adj. basis ($4,000)
      recognized gain (**$2,500**) = lesser of realized gain ($5,500) or exchange group deficiency ($2,500)
    - real property
      realized gain ($2,600) = FMV ($3,800) – adj. basis ($1,200)
      recognized gain (**$-0-**) = lesser of realized gain ($2,600) or exchange group deficiency ($-0-)
    - scraper & grader
      realized loss ($800) = FMV ($2,500) – adj. basis ($3,300)
      recognized loss (**$-0-**) under IRC§1031
    - residual group
      realized gain ($700) = FMV ($,1700) – adj. basis ($1,000)
      recognized gain **($700**)
- Step 3 – combine recognized gains from all exchange groups:
    - the sum of gains recognized for all exchange groups (**$2,500**) = ($2,500) + ($-0-) + ($-0-)
    - gain recognized from residual group (**$700**)
- Step 4 – determine *basis*:
    - computer (00.12) & printer (00.12)
      basis of computer and printer ($4,000) = adj. basis of relinquished computer ($4,000) + gain recognized ($2,500) – exchange group *deficiency* ($2,500) + excess liabilities assumed ($-0-)
        - *allocation* to <u>computer</u> ($2,571) = $4,000 x [$4,500/$7,000]
        - *allocation* to <u>printer</u> ($1,429) = $4,000 x [$2,500/$7,000]
    - real property

basis of real property ($2,400) = adj. basis of ($1,200) + gain recognized ($-0-) – exchange group surplus ($1,200) + excess liabilities assumed ($-0-)

- *allocation* to real property parcel (c) ($480) = $2,400 x [$1,000/$5,000]
- *allocation* to real property parcel (d) ($1,920) = $2,400 x [$4,000/$5,000]

- scraper & grader
  basis of grader ($2,800) = adj. basis of ($3,300) + gain recognized ($-0-) – exchange group deficiency ($500) + excess liabilities assumed ($-0-)
- residual group basis in cash and truck is $1,800 and $1,700, respectively

In summary, there are four steps involved in the determination of basis for exchanges involving more than one group or classification of like-kind replacement properties, as follows:

- Step 1 – separate the assets into exchange groups to calculate *surplus* or *deficiency*:
- Step 2 – evaluate realized and recognized gain or loss for each exchange group:
- Step 3 – combine recognized gains from all exchange groups:
- Step 4 – determine *basis*

13. In summary, there are four steps involved in the determination of basis for exchanges involving more than one group or classification of like-kind replacement properties. The first step is to

a. separate the assets into exchange groups to calculate *surplus* or *deficiency*:
b. evaluate realized and recognized gain or loss for each exchange group:
c. combine recognized gains from all exchange groups:
d. determine *basis*

14. In summary, there are four steps involved in the determination of basis for exchanges involving more than one group or classification of like-kind replacement properties. The fourth and final step is to

a. separate the assets into exchange groups to calculate *surplus* or *deficiency*:
b. evaluate realized and recognized gain or loss for each exchange group:
c. combine recognized gains from all exchange groups:
d. determine *basis*

An Introduction to the Impact of Debt and Equity, Using an Accounting Approach

In financial accounting, the accounting equation follows:
Assets (A) = Liabilities (L) + Owners' Equity (OE)

Generally, A consists of Debits and L and OE consist of Credits, therefore, an extension of the basic accounting equation follows:
Debits (DR) = Credits (CR)

While A = L + OE and DR = CR focus on the Balance Sheet or, in FMV terms, the individual's Net Worth, Gains and Losses may also be viewed in this same framework, where Gains = CR and result in an increase in both net A (A-L) and OE and Losses = DR and result in a decrease in both net A (A-L) and OE.

Table 13a summarizes 3 cases, where (**1a**) a taxpayer's relinquished property is of a lesser FMV than the replacement property, (**1b**) a taxpayer's relinquished property is of equal FMV when compared to the replacement property, and (**1c**) a taxpayer's relinquished property is of lesser FMV when compared to the replacement property. These are relatively simple examples, intended to focus on developing your understanding of the basic and extended accounting equation. They will prepare you to read contemporary professional journal articles on IRC§1031 exchanges, where authors sometimes employ these equations.

(**1a**) the taxpayer exchanged a $1M property for a $1.1M property. Debt (L) remained constant at $½M, therefore, Equity increased by $100,000 as a direct result of the exchange. In this case, no gain or loss is realized, no gain or loss is recognized, and the basis of the replacement property is equivalent to that of the relinquished property.

(**1b**) the taxpayer exchanged a $1M property for a $1M property. Debt (L) remained constant at $0.5M; therefore, Equity also remained constant at $100,000. In this case, also, no gain or loss is realized, no gain or loss is recognized, and the basis of the replacement property is equivalent to that of the relinquished property.

(**1c**) the taxpayer exchanged a $1M property for a $0.9M property. Debt (L) remained constant at $0.5M, therefore, Equity decreased by $100,000 as a direct result of the exchange. Finally, in this case, the potential for realized and recognized gain is possible (up to $100,000), as the taxpayer failed to "trade up" in terms of FMV, however, this simple illustration has not provided sufficient information (i.e., adj. basis for relinquished property) to determine the amount of the deferred gain, if any. If, however, this taxpayer were to have received cash of $100,000, a realized and recognized gain of $100,000 would have resulted from the exchange. Understanding this is important, and leads to the following *rule of thumb* with respect to IRC§1031 exchanges:

Case		Relinquished	Replaced	Difference
1a	**DEBITS (DR):**			
	Asset (FMV)	$1,000,000	$1,100,000	$ 100,000
	CREDITS (CR):			
	Debt	$ (500,000)	$ (500,000)	$ -0-
	Equity	$ (500,000)	$ (600,000)	$(100,000)
	A=L+OE or **DR=CR**	$ -0-	$ -0-	$ -0-
1b	**DEBITS (DR):**			
	Asset (FMV)	$1,000,000	$1,000,000	$ -0-
	CREDITS (CR):			
	Debt	$ (500,000)	$ (500,000)	$ -0-
	Equity	$ (500,000)	$ (500,000)	$ -0-
	A=L+OE or **DR=CR**	$ -0-	$ -0-	$ -0-
1c	**DEBITS (DR):**			
	Asset (FMV)	$1,000,000	$ 900,000	$(100,000)
	CREDITS (CR):			
	Debt	$ (500,000)	$ (500,000)	$ -0-
	Equity	$ (500,000)	$ (400,000)	$ 100,000
	A=L+OE or **DR=CR**	$ -0-	$ -0-	$ -0-

Table 13a

Always trade "across" (**1a**) or "up" (**1b**); never trade "down" (**1c**). Trading "down" (typically) results in boot received. The receipt of boot results in a taxable component to the exchange.

15. To completely avoid the payment of tax in an IRC§1031 exchange, always trade
a. across
b. up
c. down
d. either a. or b.

16. Which of the following is correct?
a. A = L + OE
b. DR = CR
c. A = DR + OE
d. both a. and b.

Table 13b summarizes 3 cases, where (**2a**) a taxpayer's relinquished property is of a lesser FMV than the replacement property, (**2b**) a taxpayer's relinquished property is of equal FMV when compared to the replacement property, and (**2c**) a taxpayer's relinquished property is of lesser FMV when compared to the replacement property. These, also, are relatively simple examples, intended to focus on developing your understanding of the basic and extended accounting equation.

(**2a**) the taxpayer exchanged a $1M property for a $1.1M property. Equity remained constant and Debt (L) increased by $100,000 as a direct result of the exchange. In this case, no gain or loss is realized, no gain or loss is recognized, and the basis of the replacement property is equivalent to that of the relinquished property.

(**2b**) the taxpayer exchanged a $1M property for a $1M property. Equity remained constant and Debt (L) remained constant, therefore, in this case, also, no gain or loss is realized, no gain or loss is recognized, and the basis of the replacement property is equivalent to that of the relinquished property.

(**2c**) the taxpayer exchanged a $1M property for a $0.9M property. Equity remained constant and Debt (L) decreased by $100,000 as a direct result of the exchange. Finally, in this case, the potential for realized and recognized gain is quite likely (up to $100,000), as the taxpayer reduced their debt and "traded down" in terms of FMV.

Case		Relinquished	Replaced	Difference
2a	**DEBITS (DR):**			
	Asset (FMV)	$1,000,000	$1,100,000	$ 100,000
	CREDITS (CR):			
	Debt	$ (500,000)	$ (600,000)	$(100,000)
	Equity	$ (500,000)	$ (500,000)	$ -0-
	A=L+OE or **DR=CR**	$ -0-	$ -0-	$ -0-
2b	**DEBITS (DR):**			
	Asset (FMV)	$1,000,000	$1,000,000	$ -0-
	CREDITS (CR):			
	Debt	$ (500,000)	$ (500,000)	$ -0-
	Equity	$ (500,000)	$ (500,000)	$ -0-
	A=L+OE or **DR=CR**	$ -0-	$ -0-	$ -0-
2c	**DEBITS (DR):**			
	Asset (FMV)	$1,000,000	$ 900,000	$ (100,000)
	CREDITS (CR):			
	Debt	$ (500,000)	$ (400,000)	$ 100,000
	Equity	$ (500,000)	$ (500,000)	$ -0-
	A=L+OE or **DR=CR**	$ -0-	$ -0-	$ -0-

Table 13b

Examples That Includes Debt and *Excess Liabilities*

Excess liabilities is that amount of net debt assumed by one party in an IRC§1031 exchange. This amount must be allocated to exchange groups, based on the relative FMV of the assets contained within each group.

Example 1

Assume that taxpayer A exchanges computer A, automobile A and truck A with taxpayer B for computer B, automobile B, truck B and $400 cash. All assets were and will continue to be used for trade or business purposes. The adjusted basis, FMV, and liability secured by each asset is contained in Table 14 (as adapted from Reg§1.1031(j)-1(c) Example (4)).

Description	FMV	Adjusted Basis	Liability	Equity
Computer A	$1,500	$ 800	$ -0-	$1,500
Computer B	$1,600	$1,100	$ -0-	$1,600
Automobile A	$2,500	$ 900	$ 500	$2,000
Automobile B	$3,100	$2,100	$ 750	$2,350
Truck A	$2,000	$ 700	$ -0-	$2,000
Truck B	$1,400	$ 600	$ 250	$1,150
Cash B	$ 400	$ -0-	$ -0-	$ 400

Table 14

Taxpayer A will assume $1,000 ($750+$250) in liabilities from taxpayer B. Taxpayer B will only assume $500 in liabilities from taxpayer A. Therefore, Taxpayer A is assuming $500 ($1,000-$500) in excess liabilities from taxpayer B, which must be allocated to each of the 3 exchange groups (e.g., computers, automobiles and trucks) based on the relative FMV of each exchange group.

Table 14a illustrates the allocation of *excess liabilities* to assets in each of the exchange groups:

Computer B $131 = $500 x [$1,600 / $6,100]
Automobile B $254 = $500 x [$3,100 / $6,100]
Truck B $115 = $500 x [$1,400 / $6,100]

Description	FMV	Adj Basis	Liability	Liability Allocated
Computer B	$1,600	$1,100	$ -0-	$ 131
Automobile B	$3,100	$2,100	$ 750	$ 254
Truck B	$1,400	$ 600	$ 250	$ 115
Exch to A	$6,100	$3,800	$1,000	$ 500

Table 14a

Table 15 extends Example 1. The liabilities have been allocated based on the relative FMV of the assets contained within each

group. The exchange groups have been fully developed and a gain realized column has been added. The facts associated with this example are reproduced below:

Assume that taxpayer A exchanges computer A, automobile A and truck A with taxpayer B for computer B, automobile B, truck B and $400 cash. All assets were and will continue to be used for trade or business purposes. Exchange Group analyses follow:

- ✓ Exchange Group 1. Recall that *gain realized* is the FMV of Computer A at $1,500 less adjusted basis of $800 or $700 (see Table 16) and the *gain recognized* is the lesser of gain realized at $700 and the *exchange group deficiency* at $31 ($131 - $100) or $31.
- ✓ Exchange Group 2. Also recall that *gain realized* is the FMV of Automobile A at $2,500 less adjusted basis of $900 or $1,600 (see Table 16) and *gain recognized* is the lesser of gain realized at $1,600 and the *exchange group deficiency* at $0 or $0.
- ✓ Exchange Group 3. Finally, the *gain realized* is the FMV of Truck A at $2,000 less adjusted basis of $700 or $1,300 (see Table 16) and *gain recognized* is the lesser of gain realized at $1,300 and the *exchange group deficiency* at $715 or $715.

Description	FMV	Adj Basis	Liability	Liability Allocated	Equity	Gain Realized
Exch Gr 1:						
Comp A	$1,500	$ 800	$ -0-		$1,500	$ 700
Computer B	$1,600	$ 1,100	$ -0-		$1,600	$ 500
Differences	$ (100)	$ (300)	$ -0-	$ 131	$ (100)	$ 200
Exch Gr 2:						
Auto A	$2,500	$ 900	$ 500		$2,000	$1,600
Automobile B	$3,100	$ 2,100	$ 750		$2,350	$1,000
Differences	$ (600)	$(1,200)	$(250)	$ 254	$ (350)	$ 600
Exch Gr 3:						
Truck A	$2,000	$ 700	$ -0-		$2,000	$1,300
Truck B	$1,400	$ 600	$ 250		$1,150	$ 800
Differences	$ 600	$ 100	$(250)	$ 115	$ 850	$ 500
Residual Gr :						
Cash B	$ 400	$ -0-	$ -0-		$ 400	$ 400
Differences	$ 300	$(1,400)	$(500)		$ 800	$1,700
Alloc Excess L:						
Computer B	$1,600	$1,100	$ -0-	$ 131	$1,600	
Automobile B	$3,100	$2,100	$ 750	$ 254	$2,350	
Truck B	$1,400	$ 600	$ 250	$ 115	$1,150	
Exch to A	$6,100	$3,800	$1,000	$ 500	$5,100	

Table 15

Under IRC§1031, the total amount of the gain recognized by a taxpayer is the sum of the gains recognized with respect to each exchange group.

17. Under IRC§1031, the total amount of the gain recognized by a taxpayer is

a. the net of the gains less losses recognized by the taxpayer

b. the sum of the gains recognized with respect to each exchange group

c. realized losses less recognized gains

d. the amount of boot received

Comparison of METHOD 2 to METHOD 3 - Recall that the *basis* of replacement property may be determined by METHOD 2. Apply an extended form of METHOD 2, which will be referred to as METHOD 3, to the Exchange Groups in this extension of Example 1.

	METHOD 2
	Fair Market Value of REPLACEMENT Property
-	Deferred (Realized *less* Recognized) Gain
+	Deferred Loss
=	Basis of REPLACEMENT Property
	METHOD 3
	Adjusted Basis Property RELINQUISHED
+	Gain Recognized in Exchange Group
-/(+)	Exchange Group Deficiency/(Surplus)
+	Excess Liabilities Assumed Allocated to Exchange Group
=	Basis of REPLACEMENT Property

Same

Table 16

Therefore, referring to Table 15 for Exchange Group 1, the adjusted basis of the property transferred with respect to that exchange group is $800, increased by the gain recognized with respect to that exchange group at $31, decreased by the exchange group deficiency of $31, and increased by the liabilities assumed, as allocated, to that exchange group at $131, or $931 ($800 + $31 – $31 + 131), where this entire amount represents the basis of Computer B, as follows:

	METHOD 3	Developed from Table 15 – Exchange Group 1
	$ 800	Adjusted Basis of Property RELINQUISHED
+	$ 31	Gain Recognized in Exchange Group
-/(+)	$ (31)	Exchange Group Deficiency/(Surplus)
+	$ 131	Excess Liabilities Assumed Allocated to Ex Grp
=	$ 931	Basis of REPLACEMENT Property

Table 17a

Referring to Table 15 for Exchange Group 2, the adjusted basis of the property transferred with respect to that exchange group is $900, increased by the gain recognized with respect to that exchange group at $0, increased by the exchange group surplus of $346, and increased by the liabilities assumed, as allocated, to that exchange group at $254, or $1,500 ($900 + $0 + $346 + $254), where this entire amount represents the basis of Automobile B, as follows:

	METHOD 3	Developed from Table 15 – Exchange Group 2
	$ 900	Adjusted Basis of Property RELINQUISHED
+	$ 0	Gain Recognized in Exchange Group
-/(+)	$ 346	Exchange Group Deficiency/(Surplus)
+	$ 254	Excess Liabilities Assumed Allocated to Ex Grp
=	$ 1,500	Basis of REPLACEMENT Property

Table 17b

Referring to Table 15 for Exchange Group 3, the adjusted basis of the property transferred with respect to that exchange group is $700, increased by the gain recognized with respect to that exchange group at $715, decreased by the exchange group deficiency of $715, and increased by the liabilities assumed, as allocated, to that exchange group at $115, or $815 ($700 + $715 – $715 + $115), where this entire amount represents the basis of Truck B, as follows:

	METHOD 3	Developed from Table 15 – Exchange Group 3
	$ 700	Adjusted Basis of Property RELINQUISHED
+	$ 715	Gain Recognized in Exchange Group
-/(+)	$ 715	Exchange Group Deficiency/(Surplus)
+	$ 115	Excess Liabilities Assumed Allocated to Ex Grp
=	$ 815	Basis of REPLACEMENT Property

Table 17c

Restatement of the case follows, to prepare you to examine elements of the exchange, but for Exchange Group deficiencies and surpluses (see Table 15):

Assume that taxpayer A exchanges computer A, automobile A and truck A with taxpayer B for computer B, automobile B, truck B and $400 cash. All assets were and will continue to be used for trade or business purposes. Exchange Group analyses, for taxpayer B, follow:

- ✓ Exchange Group 1. The FMV of Computer B is $1,600 and the FMV of Computer A is less, at $1,500, therefore, the first Exchange Group has a deficiency of $100 ($1,500 – $1,600).
- ✓ Exchange Group 2. The FMV of Automobile B is $3,100 and the FMV of Automobile A is less, at $2,500, therefore, the second Exchange Group has a deficiency of $600 ($2,500 – $3,100).
- ✓ Exchange Group 3. The FMV of Truck B is $1,400 and the FMV of Truck A is greater, at $2,000, therefore, the third Exchange Group has a surplus of $600 ($2,000 – $1,400).

Example 2

Assume that taxpayer A exchanges real estate A(1), real estate A(2) and grader A with taxpayer B for real estate B and railroad car B. All assets were and will continue to be used for trade or business purposes. The adjusted basis, FMV, and liability secured by each asset is contained in Table 18 (as adapted from Reg§1.1031(j)-1(c) Example (5)).

Description	FMV	Adjusted Basis	Liability
Real Estate A(1)	$ 5,000	$2,000	$ -0-
Real Estate A(2)	$13,500	$8,000	$ -0-
Real Estate B	$26,500	$2,000	$7,000
Grader A	$ 2,000	$ 500	$ -0-
Railroad Car B	$ 1,000	$1,200	$ -0-

Table 18

Taxpayer A will assume $7,000 in liabilities from taxpayer B. Taxpayer B will not assume any liabilities from taxpayer A. Therefore, all liabilities assumed by taxpayer A are excess liabilities.

Table 18a illustrates the allocation of the entire amount of *excess liability* to real estate B:

Description	FMV	Adj Basis	Liability	Liability Allocated
Real Estate B	$26,500	$20,000	$7,000	$7,000
Railroad Car B	$ 1,000	$ 1,200	$ -0-	$ -0-
Exch to A	$27,500	$21,200	$7,000	$7,000

Table 18a

Table 19 extends Example 1. The facts associated with this example are reproduced below:

Assume that taxpayer A exchanges real estate A(1), real estate A(2) and grader A with taxpayer B for real estate B and railroad car B. All assets were and will continue to be used for trade or business purposes. The adjusted basis, FMV, and liability secured by each asset is contained in Table 19 (as adapted from Reg§1.1031(j)-1(c) Example (5)).

Description	Adjusted Basis	FMV	Liability
Real Estate A(1)	$2,000	$ 5,000	$ -0-
Real Estate A(2)	$8,000	$13,500	$ -0-
Grader A	$ 500	$ 2,000	$ -0-
Real Estate B	$2,000	$26,500	$ 7,000
Railroad Car B	$1,200	$ 1,000	$ -0-

Table 19

Recall that (1) all liabilities assumed by taxpayer A are excess liabilities and (2) the relief of these liabilities will constitute boot to taxpayer B, both in the amount of $7,000.

LESSON 3

Reverse or *Parking* Exchanges – 3 Articles on Revenue Procedure 2000-37

This Lesson contains references to three articles explaining Revenue Procedure 2000-37 and the additional guidance that it provided on reverse or parking exchanges. By going to your local library and acquiring copies of all three articles and the source documents referenced, you will increase your understanding of IRC§1031 exchanges and become more comfortable when reading IRS-written documents. The featured article was extremely well-written and provides an excellent job of summarizing and interpreting Revenue Procedure 20000-37. By reading Revenue Procedure 2000-37 and the first or featured article, you will take a step toward becoming a critical consumer of professional journal articles on IRC§1031 exchanges and taxation, in general.

An Excellent Article, Summarizing the Contents of Revenue Procedure 2000-37

The below was adapted from “Reverse Exchanges Come of Age” written by Ronald L. Raitz and Bridgette M. Raitz and published in the August 2001 issue of ***Journal of Accountancy***, Volume 192, Number 2, pages 57-60 and 63. It was the first of three article cited in this lesson and, clearly, the most well-documented and clearly written of the three. The ***Journal of Accountancy*** (***JofA***) is the top-ranked professional journal in accounting, and the high-quality of this article is typical of this journal, the official publication of the American Institute of Certified Public Accountants.

This article makes reference to the following terms and definitions:
- ✓ Revenue Procedure – a published official statement of the IRS regarding and providing guidance on a matter of federal tax

procedure, published by the *National Office* of the IRS in *Internal Revenue Bulletins* and *Cumulative Bulletins*

- ✓ Safe Harbor – provisions in the Internal Revenue Code (IRC) or Treasury Regulations (Treas Regs), the effect of which is to assure a particular tax result if objective conditions are met. Safe harbors contribute to administrative efficiency for both taxpayers and the government.
- ✓ Tax Court (T.C.) – a trial court of original jurisdiction (as opposed to appellate court) headquartered in Washington, D.C., but hearing cases on a traveling basis and deciding tax disputes (except employment taxes) and, some excise tax disputes. Appeals are heard in the federal courts of appeal.
- ✓ Technical Advice Memorandum (TAM) – issued by the *National Office* of the IRS, the TAM is a response to a request for technical advice by a taxpayer and IRS administrative personnel involved in an audit.
- ✓ Private Letter Ruling (PLR) – a writing issued in response to a taxpayer or taxpayer representative by personnel of the *National Office* of the IRS, and is synonymous with "letter ruling" and "ruling," but is distinguished from a "revenue ruling," where the former is not public and may not be relied on by other taxpayers and the latter is public and may be relied on by other taxpayers.

1. Revenue Procedures (Rev Proc) are

a. published official statements of the IRS regarding and providing guidance on a matter of federal tax procedure

b. published in *Internal Revenue Bulletins*

c. published in *Cumulative Bulletins*

d. all of the above are correct

2. Safe harbors

a. contribute to administrative efficiency for both taxpayers and the government

b. are provisions contained in the Internal Revenue Code (IRC) or Treasury Regulations (Treas Regs)

c. have the effect of assuring a particular tax result if objective conditions are met

d. all of the above are correct

3. A Technical Advice Memorandum (TAM)
a. is issued by the National Office of the IRS
b. is a response to a request for technical advice by a taxpayer and IRS administrative personnel involved in an audit
c. must be requested by a taxpayer before filing documents to proceed to Tax Court
d. both a. and b. are correct

4. The Tax Court (T.C.)
a. is headquartered in Washington, D.C.
b. hears cases on a traveling basis
c. decides tax disputes (except employment taxes)
d. all of the above are correct

5. A Private Letter Ruling (PLR)
a. is a term that is synonymous with "letter ruling"
b. is a term that is synonymous with "ruling"
c. is a term that is <u>not</u> synonymous with "revenue ruling"
d. all of the above are correct

6. A Private Letter Ruling (PLR)
a. is not public
b. may not be relied on by other taxpayers
c. is distinguished from a "revenue ruling"
d. all of the above are correct

The authors cited recent developments Revenue Procedure 2000-46, Revenue Procedure 2000-37, PLR 200111025, PLR200109022, PLR200027028, *Donald DeCleen v. Commissioner*, 115 T.C. no. 34, *J. Clark Bundren v. Commissioner*, T.C. Memo 2001-2, and TAM 200039005. They provided 4 motivational factors for taxpayer selection of the reverse or parking exchange, as follows:

✓ taxpayer preference to identify the perfect replacement property before agreeing to relinquish his or her existing property

- ✓ having identified the perfect replacement property, the seller of the replacement property insists on a quick closing, even thought the relinquished property is not yet under contract for sale
- ✓ the relinquished property closing becomes delayed, post-replacement property closing, or the sales transaction falls apart
- ✓ replacement property is under construction and not likely to be completed before the expiration of the 180-day acquisition period

7. Motivating factors for a reverse or parking exchange include

a. taxpayer preference to identify the perfect replacement property before agreeing to relinquish his or her existing property

b. having identified the perfect replacement property, the seller of the replacement property insists on a quick closing, even thought the relinquished property is not yet under contract for sale

c. the relinquished property closing becomes delayed, post-replacement property closing, or the sales transaction falls apart

d. all of the above are correct

Their executive summary, a requirement by ***JofA*** for feature articles, and noted the relevance of Revenue Procedure 2000-37 as:

- ✓ ending a long debate and endorsing “reverse” exchanges
- ✓ establishing safe harbors and offering long-awaited guidance on the execution of “reverse” exchanges
- ✓ specifically stating that the entity performing the parking service may be the same entity that performs the qualified intermediary function
- ✓ creating new terminology, offering specific requirements and approving several steps for a successful parking exchange
- ✓ elaborating on two ways to structure the parking exchange:
  1. the “exchange last” technique, where the parking entity buys the replacement property first, selling it to the taxpayer at some later date

2. the less common "exchange first" technique, where the taxpayer parks the relinquished property with the warehousing entity followed by the purchase of the replacement property

8. The two ways to structure the parking or reverse exchange, elaborated on in Revenue Procedure 2000-37, included
a. the "exchange last" technique, where the parking entity buys the replacement property first, selling it to the taxpayer at some later date
b. the less common "exchange first" technique, where the taxpayer parks the relinquished property with the warehousing entity followed by the purchase of the replacement property
c. the most common "exchange first" technique, where the taxpayer parks the relinquished property with the warehousing entity followed by the purchase of the replacement property
d. both a. and b.

9. Revenue Procedure 2000-37
a. established safe harbors on the execution of "reverse" exchanges
b. specifically stated that the entity performing the parking service may be the same entity that performs the qualified intermediary function
c. elaborated on two ways to structure the parking or reverse exchange
d. all of the above are correct

New acronyms and terms contained in Revenue Procedure 2000-37 included:

- ✓ AT – the exchange *accommodation title holder*, also known as a parking entity, special purpose entity or single purpose entity
- ✓ QEAA – *qualified exchange accommodation agreement*, also known as the written exchange agreement between the taxpayer and the AT
- ✓ QIC – *qualified indicia* of ownership, where the AT must actually have title, as well as the burdens and benefits of ownership or own 100 percent of the entity whose sole asset is the property

10. New acronyms contained in Revenue Procedure 2000-37 included all of the following, <u>except</u>
a. AT

b. QEAA
c. QIC
d. TAM

11. Revenue Procedure 2000-37 noted that the AT must actually have title, as well as the burdens and benefits of ownership or own 100 percent of the entity whose sole asset is the property. This is referred to as
a. the exchange accommodation title holder
b. the qualified exchange accommodation agreement
c. the qualified indicia of ownership
d. all of the above

12. Revenue Procedure 2000-37 referred to the written exchange agreement between the taxpayer and the AT as
a. the exchange accommodation title holder
b. the qualified exchange accommodation agreement
c. the qualified indicia of ownership
d. all of the above

13. Revenue Procedure 2000-37 referred to the parking entity, special purpose entity or single purpose entity as
a. the exchange accommodation title holder
b. the qualified exchange accommodation agreement
c. the qualified indicia of ownership
d. all of the above

Historically, IRC§1031 related concerns about parking and reverse exchange arrangements included:
- ✓ a lack of explicit IRS approval
- ✓ doubts with respect to the requirement that the parking entity had the full “burdens and benefits” of ownership required by the transaction
- ✓ this, despite the fact that the IRS appeared to lack any interest in attacking reverse exchanges

14. Historically, and prior to Revenue Ruling 2000-37, tax experts were concerned by
a. the lack of explicit IRS approval
b. doubts with respect to the requirement that the parking entity had the full “burdens and benefits” of ownership required by the transaction

c. the fact that the IRS appeared to lack any interest in attacking reverse exchanges

d. both a. and b.

Actions specifically approved by the IRS in Revenue Procedure 2000-37 included the requirements (or lack of requirements) that the AT

- ✓ need not have an equity investment in the transaction
- ✓ need not be required to guarantee debt involved in the exchange, which may be guaranteed by the taxpayer
- ✓ may receive required funds by way of loans from the taxpayer
- ✓ may be indemnified against any costs/expenses associated with the exchange
- ✓ may delegate operational or management of either replacement or relinquished properties parked to the taxpayer under management or lease agreements
- ✓ need not profit from the transfer of parked property to the taxpayer
- ✓ need not bear any significant risk loss
- ✓ may hire the taxpayer to supervise the construction of property improvements
- ✓ can sell the parked property to the taxpayer based on a fixed-price formula

15. Actions specifically approved by the IRS in Revenue Procedure 2000-37 included the requirements (or lack of requirements) that the AT

a. need not bear any significant risk loss

b. may hire the taxpayer to supervise the construction of property improvements

c. can sell the parked property to the taxpayer based on a fixed-price formula

d. all of the above

16. Actions specifically approved by the IRS in Revenue Procedure 2000-37 included the requirements (or lack of requirements) that the AT

a. may be indemnified against any costs/expenses associated with the exchange

b. may delegate operational or management of either replacement or relinquished properties parked to the taxpayer under management or lease agreements
c. need not profit from the transfer of parked property to the taxpayer
d. all of the above

17. Actions specifically approved by the IRS in Revenue Procedure 2000-37 included the requirements (or lack of requirements) that the AT
a. need not have an equity investment in the transaction
b. need not be required to guarantee debt involved in the exchange, which may be guaranteed by the taxpayer
c. may receive required funds by way of loans from the taxpayer
d. all of the above

Other, Later Articles Summarizing Author's Thoughts on Revenue Procedure 2000-37

Additional readings include (1) "New Safe Harbor for Reverse Like-Kind Exchanges" written by Linda Garrett Levy, Richard L. Levy and J. David Mason and published in the January 2003 issue of ***The CPA Journal***, Volume 73, Number 1, pages 42-47 and (2) "Reverse Real Estate Exchanges – Inside and Outside the Safe Harbor," written by Richard M. Heller and published in the November 2003 issue of ***Journal of Financial Service Professionals***, Volume 57, Number 6, pages 12, 14 and 16.

LESSON 4

Related-Party Exchanges – Economic *Substance* over *Form*

"*Teruya Brothers* and Related-Party Exchanges – How Much More Do We Know Now?" written by Terrence Floyd Cuff and published in the April 2005 issue of ***Journal of Taxation***, Volume 102, Number 4, pages 220-224 and 226-228. The ***Journal of Taxation*** is written in a style that tends to be more technical (and is more likely to be read by tax attorneys, with frequent legal citations and numerous legal footnotes) when compared to those published in the ***Journal of Accountancy*** (Lesson 3).

This article examines *Teruya Brothers, Ltd. & Subsidiaries v. Commissioner*, 124 TC 45 (Docket Number 17955-03; decision issued February 9, 2005). The case involved the 1995 tax year, where the taxpayers interposed an intermediary solely for the purpose of tax avoidance. Specifically, the taxpayer designed the transaction to avoid the anti-abuse rule of IRC§1031(f)(4), which was applied to disallow non-recognition treatment of two exchanges, resulting in more than $4.1 million federal income tax liability.

The taxpayer used a qualified intermediary to structure the like-kind exchange, but IRC§1031(f) requires the recognition of gain or loss between related parties (IRC§267(b) or IRC§707(b)(1)), if either the replacement or relinquished property is disposed of within two years of the exchange. Non-recognition treatment does not apply to exchanges if part of a transaction (or series of transactions) if structured solely for the purpose of defeating the intent of the related party exchange rule (IRC§1031(f)(4)). Therefore, as with all tax transactions, economic reality and "substance" supercedes "form." Though IRC§1031(f)(2)(C) will not force non-recognition if neither the original transaction or later disposition had, as a principal purpose the avoidance of federal

income tax (e.g., no business or profit motive or a "sham"), the taxpayer's could show no other reason for the transactions. It was not helpful, in defending or establishing evidence of the taxpayer's motivation, when this transaction also resulted in the sheltering of the gain resulting from the transaction, by using a net operating loss (NOL) to offset the gain.

1. In cases involving the application of tax law
a. "substance" supercedes "form"
b. a transaction designed for no other purpose than to avoid tax is considered a "sham" transaction and is collapsed by the IRS
c. the economic reality of a transaction is examined by the IRS and Tax Court
d. all of the above

2. In *Teruya Brothers, Ltd. & Subsidiaries v. Commissioner*, 124 TC 45
a. the taxpayers interposed an intermediary solely for the purpose of tax avoidance
b. the taxpayer's could show no other reason for the transactions, using a qualified intermediary, other than the avoidance of tax
c. the taxpayer's failed to achieve the desired non-recognition treatment, which did not apply to their exchange, because it was part of a transaction (or series of transactions) structured solely for the purpose of defeating the intent of the related party exchange rule (IRC§1031(f)(4))
d. all of the above

Selected, summarized facts from the *Teruya Brothers* case follows:

- ✓ Teruya Brothers Ltd. transferred real (relinquished) properties to a qualified intermediary (QI), T.G. Exchange, Inc. (TGE)
- ✓ TGE, the QI, sold the properties to unrelated third parties
- ✓ TGE used sales proceeds, in addition to other funds provided by Teruya, to buy like kind replacement properties for Teruya from Times
- ✓ Teruya owned 62.5 percent of the common shares of Times
- ✓ Transaction involved the receipt of boot from Teruya to Times

- ✓ Teruya (seller of relinquished property) and Times (seller of replacement property) were related under IRC§267(b)

3. In *Teruya Brothers, Ltd. & Subsidiaries v. Commissioner*, 124 TC 45
a. Teruya attempted to use a qualified intermediary to disguise a related party transaction
b. Teruya owned 62.5 percent of the common shares, or a controlling interest, in the seller of the replacement property
c. Teruya received boot from the seller of the replacement property (Times)
d. all of the above

Additional, selected and sequentially summarized facts from the *Teruya Brothers* case follows:

- ✓ Teruya owned a fee simple interest in Ocean Vista
- ✓ Teruya's interest in Ocean Vista was subject to a long-term lease held by Golden Century Investments Co. (Golden)
- ✓ Golden was subject to a sublease held by the Association of Apartment Owners of Ocean Vista (Association)
- ✓ Association approached and inquired about buying Teruya's interest in Ocean Vista (March 1993)
- ✓ Teruya was not interest in the sale of Ocean Vista
- ✓ Golden proposed the acquisition of Ocean Vista as part of a like kind exchange
- ✓ Golden (Teruya) agreed to purchase (sell) Ocean Vista for $1,468,500 (August 1993)
- ✓ amendment that exchange was conditional on successful IRC§1031 exchange (November 1993)

4. Teruya became interested in the sale of their Ocean Vista interest only
a. if the sale failed to require the non-elective imposition of IRC§1031 exchange treatment
b. if the sale qualified as an IRC§1031 exchange
c. if Teruya could recognize a tax loss on the transaction
d. if Teruya could defer recognition of the tax loss on the transaction

Additional, selected facts from the *Teruya Brothers* (Teruya) case follows:

- ✓ Teruya had a $93,270 basis in Ocean Vista (see Table 20)
- ✓ Ocean Vista was sold to the Association for $1,468,500 (see Table 20)
- ✓ Teruya provided additional cash of $1,366,056 to acquire property from Kupuohi for $2,828,000 [$1,468,500 + $1,366,056 + $6,556 (plug)]
- ✓ Times owned Kupuohi prior to the transaction
- ✓ Times had a $1,475,361 basis in Kupuohi (see Table 20)
- ✓ Times recognized a $1,352,369 gain on the sale of Kupuohi [$2,828,000 - $1,475,361] (see Table 20)

Teruya's Ocean Vista:	
Sales Price	$1,468,500
Basis	$ 93,270
Times' Kupuohi:	
Sales Price	$2,828,000
Basis	$1,475,361

Table 20

5. Teruya
a. had a cost or basis that was significantly <u>below</u> the sales price of their Ocean Vista or replacement property
b. provided additional cash to acquire replacement property from Times
c. had a cost or basis that was significantly <u>above</u> the sales price of their Ocean Vista or replacement property
d. both a. and b.

6. Times
a. had a cost or basis that was significantly <u>below</u> the sales price of their Kupuohi or replacement property
b. provided additional cash to acquire replacement property from Teruya
c. had a cost or basis that was significantly <u>above</u> the sales price of their Kupuohi or replacement property
d. both a. and b.

Additional, selected facts from the *Teruya Brothers* (Teruya) case follows:

- ✓ Teruya owned a fee simple interest in Royal Towers Apartment building (Royal)
- ✓ Teruya and Savio Development co. (Savio) entered into a contract for the sale of Royal (December 1994)
- ✓ the sales price for Royal was established at $11,932,000 (see Table 21)
- ✓ Teruya had a basis of $670,506 in Royal (see Table 21)

Teruya's Royal:	
Sales Price	$11,932,000
Basis	$ 670,506

Table 21

7. Teruya

a. had a cost or basis that was significantly <u>below</u> the sales price of their Royal or relinquished property

b. provided additional cash to effect the sale of their relinquished property to Savio

c. had a cost or basis that was significantly <u>above</u> the sales price of their Royal or relinquished property

d. both a. and b.

It is not uncommon for the IRS and Tax Court to examine how taxpayers, at opposite ends of a transaction, treat realized and recognized gains and losses for tax purposes. In this case, the treatment was quite different and/or inconsistent, as follows:

- ✓ Times realized a $6 million loss on the sale of Kupuohi ($9 million sales price – $15 million adjusted basis – these are rounded measures), but did not recognize the loss on its tax return, because of restrictions on related taxpayer transactions under IRC§267. They did, however, realize and recognize a $2 million gain ($4 million sales price less $2 million adjusted basis – these are rounded measures).
- ✓ Teruya deferred $1 million (rounded) in realized gains from Ocean and $11 million (rounded) in realized gains from Royal.

8. Times

a. did not recognize the loss from Kupuohi on its tax return
b. realized the gain from Kupuohi on its tax return
c. recognized the gain from Kupuohi on its tax return
d. all of the above

9. Teruya
a. deferred $1 million in realized gains from Ocean
b. deferred $11 million in realized gains from royal
c. engaged in tax treatment that was quite different and/or inconsistent with that by Times
d. all of the above

Other Exchanges Involving Intermediaries

Recall that an Internal Revenue Service (IRS) Letter Ruling (Ltr Rul) is not broad in its application and cannot be relied on by taxpayers, other than those seeking the ruling. However, a review tends to provide a consistent theme and more fully develop the taxpayer's understanding of what will and what will not represent an acceptable transaction for, in this case, non-recognition of gain under IRC§1031.

10. IRS Ltr Ruls
a. are not to be relied on by other taxpayers
b. may be relied on by other taxpayers
c. applies only to taxpayers seeking the ruling
d. both a. and c.

Selected facts from Internal Revenue Ruling (Rev Rul) 2002-83 and 2002-49 Internal Revenue Bulletin (IRB) follows:

- ✓ taxpayer transfers relinquished property to a QI
- ✓ exchange is for replacement property formerly owned by a related party
- ✓ exchange does not qualify for non-recognition treatment under IRC§1031(a), because the transaction would have allowed a taxpayer with low-basis property to cash out of the investment without gain recognition
- ✓ transaction was designed to avoid IRC§1031(f)

Congress intended that related persons not be permitted to circumvent the intent of IRC§1031:

> Non-recognition will not be accorded to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of related party rules. For example, if a taxpayer, pursuant to a prearranged 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 non-recognition treatment under section 1031. See House Conference Report 101-247, at 1341 (1989).

11. Congress was concerned that
a. related party taxpayers would attempt to circumvent the legislative intent of IRC§1031
b. related party taxpayers would attempt to structure exchanges involving unrelated parties as intermediaries, in an effort to circumvent the intent of IRC§1031
c. related party taxpayers with low-basis property would attempt to use IRC§1031 to cash out investments without gain recognition
d. all of the above

Selected facts from Internal Revenue Service Letter Ruling (IRS Ltr Rul) 9232030 follow:
- ✓ the QI had been the taxpayers' attorney
- ✓ the QI had not been the taxpayers' attorney within two years of the first real property transfer
- ✓ the exchange qualified for non-recognition

12. The two-year rule for related parties
a. was reinforced in IRS Ltr Rul 9232030
b. was applied to the QI in IRS Ltr Rul 9232030
c. failed to apply in IRS Ltr Rul 9232030
d. both a. and b.

Selected facts from IRS Ltr Rul 9439007 follow:

- ✓ neither taxpayers nor any disqualified persons served as the QI in the exchange
- ✓ written agreements existed between the QI, taxpayers and other parties
- ✓ the transaction qualified as a nontaxable exchange under IRC§1031

13. In the case of IRS Ltr Rul 9439007

a. the transaction qualified as a nontaxable exchange under IRC§1031
b. the transaction failed to qualify as a nontaxable exchange under IRC§1031
c. the transaction involved the use of a disqualified person as the QI in the exchange
d. both b. and c.

Selected facts from IRS Ltr Rul 9807013 follow:

- ✓ a limited partnership created single-asset entities to receive replacement properties
- ✓ the use of a non-corporate entity as an intermediary was disregarded
- ✓ partnership assets were treated as non-separable from the original entity
- ✓ non-recognition fails under IRC§1031

14. The use or establishment of separate legal entities, in and of itself,

a. successfully disguises the intent of taxpayers in a transaction (IRS Ltr Rul 9807013)
b. fails to successfully disguise the intent of taxpayers in a transaction (IRS Ltr Rul 9807013)
c. provides guidance on how to structure a successful IRC§1031 exchange
d. all of the above

Selected facts from IRS Ltr Rul 9748006 (TAM) follow:

- ✓ the taxpayer sold the 1st property to an unrelated 3rd party

- ✓ the taxpayer acquired a 2nd property from their mother, through a QI
- ✓ the economic reality of the transaction was identical to a direct exchange, followed by the sale of the 1st property to a 3rd party – a violation of IRC§1031(f)(1)
- ✓ the gain must be recognized
- ✓ the taxpayer failed to show that the use of the QI was not for the purpose of avoiding IRC§1031(f) related party rules

15. IRS Ltr Rul 9748006 (TAM)
a. failed to meet the requirements of a successful IRC§1031 exchange
b. failed to show that use of the QI was not for the purpose of avoiding IRC§1031(f) related party rules
c. required the recognition of gain
d. all of the above

Selected facts from IRS Ltr Rul 200111025 follow:

- ✓ the transaction failed to meet applicability requirements of Reg § 1.1031(k)-1 or Rev Proc 2000-37, 2000-2 CB 308, with respect to safe harbor relief
- ✓ the accommodation party was not the taxpayer's agent
- ✓ the taxpayer was consistent in their intent to make a qualified IRC§1031 exchange
- ✓ the Supreme Ct. established that the mere use of an accommodator did not, in and of itself, classify the accommodator as the taxpayer's agent
- ✓ the exchange qualified for non-recognition treatment under IRC§1031

16. In IRS Ltr Rul 200111025
a. the transaction failed to meet the requirements of safe harbor relief
b. the exchange qualified for non-recognition treatment under IRC§1031
c. the mere use of an accommodator did not, in and of itself, classify the accommodator as the taxpayer's agent
d. all of the above

Selected facts from IRS Revenue Procedure (Rev Proc) 2003-39, 2003-22 Internal Revenue Bulletin (IRB) follow:

- ✓ taxpayers may qualify exchanges for like-kind exchange (LKE) non-recognition under IRC§1031 by satisfying one or more of the safe harbors provided
- ✓ LKE programs may qualify for non-recognition treatment even if the facts and circumstances fall outside of those specifically provided for under these safe harbors

17. If the specific fact pattern of a taxpayer's IRC§1031 exchange does not meet the safe harbors provided

a. the exchange may still qualify for non-recognition under IRC§1031
b. the exchange will not qualify for non-recognition under IRC§1031
c. the exchange will be deemed more creative than permissible, and will fail for non-recognition
d. both b. and c.

Other Articles Summarizing and Interpreting Implications of the *Teruya Brothers* Case

Additional readings include: (1) "Related-Party Exchange Denied Tax-Free Treatment Despite Use of Intermediary" written by Joseph C. Mandarino and published in the 2005 (3rd Quarter) issue of ***Real Estate Taxation***, Volume 32, Number 4, pages 167-173, (2) "Related Parties, Tax-Deferred Sales, and Cashing Out" written by Burgess J.W. Raby and William L. Raby and published in ***Tax Analysts Document Service*** (Doc 2005-3174) at 7 pages, (3) "Like-Kind Exchange Treatment Foiled By Related-Party Rule" written by Anonymous and published in the April 2005 issue of ***Practical Tax Strategies***, Volume 74, Number 4, pages 250-251, and (4) "Exchange By Related Partnerships Qualified For Nonrecognition – Neither Party 'Cashed Out' Its Investment" written by David L. Forst, Charles E. Hodges II, Edward M. Manigault, David J. Kautter, and Belinda F. Eichel and published in the December 2004 issue of ***Journal of Taxation***, Volume 101, Number 6, pages 375-377.

LESSON 5

Combining the Home-Sale Exclusion with Tax-Free Exchange

The owner-occupied residence is excluded from tax deferral under IRC§1031 exchanges. Instead, IRC§121 provides the taxpayer with a capital gain exemption, provided that the property is the taxpayer's primary residence and the owner has lived there for at least 2 of the past 5 years. If taxpayers meet the requirements under IRC§121, single taxpayers are exempt from the first $250,000 of capital gain and married taxpayers, filing joint individual federal income tax returns, are exempt from the first $500,000 of capital gain.

1. IRC§121 relates to
a. capital gain exemptions for taxpayer's selling their principal residence
b. lower capital gain tax rates for homeowners
c. IRC§1031 exchanges by homeowners
d. all of the above

2. Under IRC§121, taxpayers selling their principal residence are
a. exempt for the first $250,000 of capital gain
b. exempt for the first $500,000 of capital gain
c. exempt for all capital gain
d. both a. and b., depending on the taxpayer's filing status

3. The gain for an owner-occupied residence
a. is excluded, using tax deferral options available under IRC§1031
b. enjoys exemptions for the first $250,000 of capital gain, under IRC§1031, for single taxpayers
c. enjoys exemptions for the first $500,000 of capital gain, under IRC§1031, for married taxpayers, filing joint individual federal income tax returns
d. both b. and c.

4. The gain for an owner-occupied residence
a. is excluded, using tax deferral options available under IRC§1031

b. enjoys exemptions for the first $250,000 of capital gain, under IRC§121, for single taxpayers
c. enjoys exemptions for the first $500,000 of capital gain, under IRC§121, for married taxpayers, filing joint individual federal income tax returns
d. both b. and c.

Complexities arise when the taxpayer has mixed use of their personal residence with (1) investment and/or (2) business use, as follows:

- ✓ Investment – the best example is that of a duplex, where the taxpayer resides in one unit and uses the second unit as an investment or rental property
- ✓ Business use – the best example is that of a single residence, but where the taxpayer both resides in and uses the residence as their principal place of business

5. Cases where the interaction between IRC§121 and IRC§1031 may <u>both</u> be applicable, include
a. the case where the taxpayer uses one unit in a duplex for their personal residence and the other unit as investment or rental income property
b. the case where the taxpayer uses their personal residence as their principal place of business
c. the case where the taxpayer uses one unit in a triplex for their personal residence and the other two units as investment or rental properties
d. all of the above

Mixed Use as Residence and Investment or Rental Income Property

Table 22 summarizes a fact pattern where a taxpayer owns a triplex, residing in 38 percent of the total square footage. Units 1 and 2 are residential rental units. Unit 3 is the taxpayer's residence.

	Investmt Unit 1	Investmt Unit 2	Investmt Units 1&2	Residence Unit 3	Total
Square Footage	1,240	1,240	2,480	1,520	4,000
Percentage	31%	31%	62%	38%	100%
Sales Price			$620	$380	$1,000
(000 omitted)					
Cost			$496	$380	$ 800
less:					
Depreciation			$100	$ -0-	$ 100
equals:					
Adjusted Basis			$396	$304	$ 700
equals:					
Realized Gain			$224	$ 76	$ 300

Table 22

The taxpayer could, in this case, use IRC§121 to exclude the gain of $76,000 on Unit 3 – the residence, and use IRC§1031 to defer the gain of $224,000 on Units 1 and 2 – the residential rental units.

6. Assume that a taxpayer has a triplex – 2 rental units and 1 residence unit. Which is the <u>best</u> answer? The taxpayer could
   a. use IRC§121 to exclude any gain on the personal residence ($250,000 for single taxpayers and $500,000 for married taxpayers, filing a joint return)
   b. use IRC§1031 to defer the gain on the 2 rental units
   c. use IRC§121, but not IRC§1031, to exclude gain on the rental units
   d. legitimately combine IRC§121 and IRC§1031 to completely avoid capital gains tax

7. When a single property is both a primary residence and used in a trade or business or as a rental property
   a. only IRC§121 may be used to exclude or defer gain
   b. only IRC§1031 may be used to exclude or defer gain
   c. neither IRC§121 or IRC§1031 may be used to exclude or defer gain
   d. both IRC§121 and/or IRC§1031 may be used to exclude or defer gain

Mixed Use as Residence and Business Property

When the taxpayer operates a trade or business from their personal residence, there are two broad categories with different treatment, when combining IRC§121 or IRC§1031, as follows:

1. the taxpayer has a separate structure on, for example, a relatively large parcel of land, for residence and trade or business
2. the taxpayer uses a room in their residence for their trade or business

In the first case, let's assume that the taxpayer's house and separate building for the taxpayer's business are located on the same piece of real property. In this case, the same treatment applied to the triplex example would apply. The taxpayer would allocate the sales price and basis, and so on. In the second case, the taxpayer would, first, recapture depreciation taken on the business use portion of their personal residence. There would be no need for any allocation.

8. Assume that a taxpayer has a personal residence with a room used for business purposes. The taxpayer, if seeking IRC§121 tax exclusion, would

a. elect IRC§1031 exchange treatment, to minimize gain recognition

b. recapture depreciation previously deducted, before applying IRC§121 to exclude gain up to $250,000 for single taxpayers and $500,000 for married taxpayers, filing a joint individual federal income tax return

c. elect to recapture IRC§1031 exchange treatment, to minimize gain recognition on the recapture of depreciation previously deducted

d. both a. and c.

9. Assume that a taxpayer has a personal residence with a separate structure used for business purposes. The taxpayer, if seeking IRC§1031 tax deferral, would

a. elect IRC§1031 exchange treatment, to minimize gain recognition

b. recapture depreciation previously deducted, before applying IRC§121 to exclude gain up to $250,000 for single taxpayers and $500,000 for married taxpayers, filing a joint individual federal income tax return
c. elect to recapture IRC§1031 exchange treatment, to minimize gain recognition on the recapture of depreciation previously deducted
d. allocate sales price, basis, and so on, to determine the amount of the realized gain available for IRC§121 exclusion and to determine the amount of the realized gain available for IRC§1031 tax deferral

10. Assume that a taxpayer has a personal residence with a room used for business purposes. The taxpayer, if seeking IRC§121 tax exclusion, would
a. elect IRC§1031 exchange treatment, to minimize gain recognition
b. recapture depreciation previously deducted
c. elect to recapture IRC§1031 exchange treatment, to minimize gain recognition on the recapture of depreciation previously deducted
d. both a. and b.

Anticipated benefits that may occur in IRC§1031 exchanges involving residences partially used for trade or business purposes include:

- ✓ the increase in the basis of replacement propert(ies) received,
- ✓ the avoidance of tax on otherwise taxable boot,
- ✓ the avoidance of tax on otherwise taxable recapture of IRC§1250 gain, and
- ✓ the non-recognition of gain exceeding otherwise applicable ceilings (e.g., $250,000 for single and $500,000 for married taxpayers, filing jointly)

11. IRC§1031 exchanges involving residences partially used for trade or business purposes may include
a. the increase in the basis of replacement propert(ies) received
b. the avoidance of tax on otherwise taxable boot
c. the avoidance of tax on otherwise taxable recapture of IRC§1250 gain
d. all of the above

12. Which is the <u>best</u> answer? IRC§1031 exchanges involving residences partially used for trade or business purposes may include
a. the avoidance of tax on otherwise taxable recapture of IRC§1250 gain

b. the non-recognition of gain exceeding otherwise applicable ceilings (e.g., $250,000 for single and $500,000 for married taxpayers, filing jointly)
c. the non-recognition of gain up to the amount of applicable ceilings (e.g., $250,000 for single and $500,000 for married taxpayers, filing jointly)
d. both a. and b.

Converting a personal residence to a rental property to maximize the benefits of IRC§1031 exchanges is a strategy that taxpayer's may wish to consider. A rule of thumb, taken from IRC§280A, is that the taxpayer's principal residence should be rented for at least one year to be legitimately re-classified as an income or rental property, but longer periods only strengthen the taxpayer's position. All personal use should cease and there should be no evidence of a pre-arrangement, where this might suggest that the only motivation for conversion from personal to trade or business use was to permit the taxpayer to benefit from the IRC§1031 exchange.

13. To maximize the benefits available from the IRC§1031 exchange, some taxpayers may choose to convert their principal residence to trade or business use (e.g., rental property). These taxpayers should
a. rent the property for at least one year before seeking the IRC§1031 exchange
b. not have a pre-arranged IRC§1031 exchange before converting the property from personal to trade or business use
c. notify the IRS of their motivation for the conversion from personal to business use
d. both a. and b.

According to an article written by William R. Siegel, interpreting the interaction of Internal Revenue Procedure 2005-14, 2005-7, and Internal Revenue Bulletin 528,

- ✓ a taxpayer's excluded gain under IRC§121 can shelter what otherwise would be taxable boot under IRC§1031(b),

- ✓ the basis of like-kind replacement business property is increased by any gain attributable to the relinquished business property excluded under IRC§121,
- ✓ realized gain from the business portion of dual-use relinquished property may be excluded under IRC§121 but excess gain allocable to a residence cannot be deferred under IRC§1031, and
- ✓ if a taxpayer has previously taken depreciation deductions with respect to any portion of its relinquished property, then IRC§1031 produces a better outcome than IRC§121.

14. According to an article written by William R. Siegel
a. a taxpayer's excluded gain under IRC§121 can shelter what otherwise would be taxable boot under IRC§1031(b)
b. the basis of like-kind replacement business property is increased by any gain attributable to the relinquished business property excluded under IRC§121
c. realized gain from the business portion of dual-use relinquished property may be excluded under IRC§121 but excess gain allocable to a residence cannot be deferred under IRC§1031
d. all of the above

15. According to an article written by William R. Siegel, a taxpayer's excluded gain under IRC§121
a. produces a better outcome than IRC§1031
b. can shelter what otherwise would be taxable boot under IRC§1031(b)
c. results in a realized gain from the business portion of dual-use relinquished property
d. results in a decrease in the basis of like-kind replacement business property

16. According to an article written by William R. Siegel
a. if a taxpayer has previously taken depreciation deductions with respect to any portion of its relinquished property, then IRC§1031 produces a better outcome than IRC§121.
b. Internal Revenue Procedure 2005-14, 2005-7, and Internal Revenue Bulletin 528 provide guidance for tax breaks for those taxpayers able to legitimately combine home sale and IRC§1031 exchanges

c. results in a decrease in the basis of like-kind replacement business property
d. both a. and b.

In the rare case where a taxpayer exchanges their primary residence for another primary residence, both of which are personal use, the rules providing for the exclusion of gain on the sale of a personal residence continue to apply (e.g., IRC§121) and the rules relating to tax deferral of gains on like-kind property (e.g., IRC§1031) continue to be not applicable. It is the mixed use between personal and trade or business or income or rental property that the IRS has provided additional guidance for (e.g., Internal Revenue Procedure 2005-14) and to which the majority of this lesson has been devoted.

17. In the rare case where a taxpayer upgrades their personal residence, exchanging one primary residence for another
a. the rules providing for the exclusion of gain on the sale of a personal residence continue to apply (e.g., IRC§121)
b. the rules relating to tax deferral of gains on like-kind property (e.g., IRC§1031) continue to be not applicable
c. there is no mixed use between personal and trade or business or income or rental property that the IRS has provided additional guidance for (e.g., Internal Revenue Procedure 2005-14)
d. all of the above

Recommended Readings

Recommended readings for this Lesson include: (1) “Tax Bonuses on Exchanges of Residences Partially Used for Business” written by Gerald J. Robinson and published in the Volume 32, Number 4 (3rd Quarter) 2005 issue of ***Real Estate Taxation***, 154-159, (2) “Combine Tax-Free Exchange with Home-Sale Exclusion” written by Michael Schlesinger and published in the Volume 74, Number 6 (June) 2005 issue of ***Practical Tax Strategies***, 343-350, (3) “New Procedure on Taxation of Dual-Use Property Governs Interaction of Sections 121 and 1031” written by William R. Siegel and published in the Volume 25, Number 5 (May) 2005 issue of

Journal of Taxation, 282-289, (4) “Combining Home-Sale Exclusion and Exchange Breaks” written by Anonymous and published in the Volume 74, Number 3 (March) 2005 issue of ***Practical Tax Strategies***, 188-189, (5) “Planning Opportunities for the Sale of Appreciated, Dual-Use Property under Rev. Roc. 2005-14” written by Scott Usher and published in the Volume 36, Number 10 (October) 2005 issue of ***The Tax Advisor***, 602-606, (6) “IRS Guidance ‘Opens the Door’ to Tax Deferral for Some Home Sellers” written by Robyn L. Dahlin and Andrew J. Alltizer and published in the Volume 32, Number 3 (2nd Quarter) 2005 issue of ***Real Estate Taxation***, 137-140, (7) “How Section 1031 and 121 Work Together For You” written by Adam T. Skarsgard and published in the Volume E109 issue of the ***North American Exchange 1031 Exchange Newsletter*** (available at <www.naexchange>), 2 pages.

LESSON 6

A Bit More on Rev. Proc. 2005-14

The following Tables contain a fact pattern adapted from "Planning Opportunities for the Sale of Appreciated, Dual-Use Property under Rev. Proc. 2005-14" written by Scott Usher and published in the Volume 36, Number 10 (October) 2005 issue of ***The Tax Advisor***, 602-606. ***The Tax Advisor*** is an official publication of the American Institute of Certified Public Accountants (AICPA). It is a superior source of information and a copy of this article should be added to your collection as a part of your permanent library.

Assume that a taxpayer, married, filing a joint individual federal income tax return, sells a townhouse in 2006 for $1.2 million (relinquished property). The replacement property has a fair market value of $1.25 million for business property, including $750,000 for a separate, personal residence. The gain on the townhouse is $466,667. The remaining $33.333 of the taxpayer's $500,000 exclusion is applied to business portion of the townhouse to reduce possible gain. Note that the applications of both IRC§121 and IRC§1031 reduces tax by $70,000 for personal and $41,737 for business property. There is an additional benefit – the combined IRC§121 exclusion and the taxpayer's decision to shift $166,667 in proceeds from the sale of the relinquished residence to the purchase of the business replacement property results in what is referred to as a stepped-up basis, subject to depreciation.

		2/3rd Personal		1/3rd Business
Sale		$ 800,000		$400,000
Sale Exp		$(133,333)		$(66,667)
Net		$ 666,667		$333,333
Adj Basis:				
Cost	$200,000		$100,000	
Depr 27.5	$(43,639)		$(21,816)	
Depr 39	$ -0-	$ 156,361	$ (5,128)	$ 73,056
Realized		$ 510,306		$260,277
IRC§121		$(466,667)		$(33,333)
Remainder		$ 43,639		$226,944
IRC§1250		$ 43,639		
IRC§1031				$226,944

Table 23

	Replacement Property		2/3rd Personal		1/3rd Business
FMV			$ 500,000		$750,000
Cash Paid	New Debt		$(166,667)		$416,667
Boot Rec'd			$ 20,000		$ 10,000
Basis:	Relinquished	$ 156,361		$ 73,056	
	IRC§121	$ 466,667		$ 33,333	
	Cash Paid	$(166,667)		$416,667	
	Recognized	$ 43,639		$ -0-	
	Boot Rec'd	$ (20,000)	$ 480,000	$(10,000)	$513,056
Tax			$ 80,909		$ 41,737
Tax Saved	IRC§121		$ (70,000)		$(41,737)
Tax Saved	IRC§1031		$ 10,909		$ -0-

Table 24

1. Which accurately describes the portion of the transaction, reproduced from Table 23, below?

a. The taxpayer is relinquishing or selling property at a sales price of $1.2 million

b. The taxpayer's property is dual-use

c. The taxpayer's property is 2/3rd personal and 1/3rd business use

d. all of the above

2. Which represents an incorrect description of the portion of the transaction, reproduced from Table23, below?
a. Selling expenses (Sale Exp) are allocated based on the relative sales value approach
b. The taxpayer's property is dual-use
c. The taxpayer's property is 2/3rd personal and 1/3rd business use
d. none of the above are incorrect; all of the above correctly describe the below

	2/3rd Personal	1/3rd Business	Total
Sale	$ 800,000	$400,000	$1,200,000
Sale Exp	$(133,333)	$(66,667)	$ (200,000)
Net	$ 666,667	$333,333	$1,000,000

3. Which accurately describes the portion of the transaction, reproduced from Table 23, below?
a. the taxpayer's adjusted basis (Adj Basis) in personal use property is $156,361
b. the taxpayer's adjusted basis (Adj Basis) in business use property is $73,056
c. the taxpayer's adjusted basis (Adj Basis) was allocated between personal use and business use by applying the relative sales value approach
d. both a. and b. are correct

4. Which represents an incorrect description of the portion of the transaction, reproduced from Table 23, below?
a. the taxpayer's adjusted basis (Adj Basis) in personal use property is $156,361
b. the taxpayer's adjusted basis (Adj Basis) in business use property is $73,056
c. the taxpayer's adjusted basis (Adj Basis) was allocated between personal use and business use by applying the relative sales value approach
d. the taxpayer's adjusted basis (Adj Basis) in combined properties is $229,417

	Relinquished Property		2/3rd Personal		1/3rd Business
Adj Basis:	Cost	$200,000		$100,000	
	Depr (27.5)	$(43,639)		$(21,816)	
	Depr (39)	$ -0-	$156,361	$ (5,128)	$73,056

What About So-Called "Vacation" Homes?

Personal use realty is not eligible for IRC§1031 exchanges. When involving "vacation" propert(ies), the personal usage component may be significant or insignificant. The rules of IRC§280A and the (1) 10 percent of days rented and/or (2) 14-day tests should be reviewed for this purpose. These rules relate to the appropriate application of rental property deductions for real property used for both personal and business use by the taxpayer. The purchase and sales contracts for dual-use propert(ies) should include allocations between personal and business use. Real property should be held for the long-term capital gain period of at least one year prior to disposition to satisfy the IRC§1031 requirements and replacement propert(ies) should also be held for at least one year.

5. A so-called "vacation" home that also generates tax deductible expenses for a taxpayer is one that is used, personally, by the taxpayer for

a. less than 10 percent of the days rented
b. less than 14 days per year
c. vacations, but rented out and, therefore, treated as a trade or business or rental or income property, given certain limitations on personal use
d. all of the above

6. The purchase and sales contracts for dual-use propert(ies)

a. should include allocations between personal and business use
b. should be held for the long-term capital gain period of at least one year prior to disposition to satisfy the IRC§1031 requirements and replacement propert(ies) should also be held for at least one year
c. should be vague with respect to personal and business use allocations
d. both a. and b.

Some Additional Issues

Generally, "dealers" in real estate may not take advantage of IRC§1031. This is because "dealers" are presumed to hold real property as "inventory" and "inventory" is a short-term or "current" asset. Since a current asset is one that, by definition, is expected to be converted to cash within one year, this classification precludes the long-term holding period required for the taxpayer to benefit from the long-term capital gains tax deferral motivation for engaging in an IRC§1031 exchange. The IRS and tax professionals refer to this as "dealer taint." Perhaps the best mechanism for the dealer to avoid "dealer taint" for a specific piece of real property is to do what other business do – classify some real propert(ies) as "current" assets or "inventory" and other real propert(ies) as "non-current" or "long-term." The "long-term" propert(ies) will qualify for the IRC§1031 exchange and tax deferral.

7. Generally, "dealers" in real estate
a. are presumed to hold real property as "inventory" and "inventory" is a short-term or "current" asset
b. are legally prohibited from engaging in IRC§1031 exchanges
c. suffer from a condition referred to as "dealer taint," which always prevents them from successfully executing an IRC§1031 exchange, regardless of the underlying facts and circumstances
d. all of the above

8. Generally, "dealers" in real estate
a. like other taxpayers, may take advantage of IRC§1031
b. may not take advantage of IRC§1031
c. may take advantage of IRC§1031, but only if they "deal" from the bottom of the deck
d. are presumed to be holding real property as a "long-term" asset

A rule of thumb for the timing of an IRC§1031 exchange is when the equity in real property approaches 50 percent of the real property's fair market value. This allows the taxpayer to "trade up," while reaping the "leverage" associated with tax deferral.

9. A rule of thumb for the timing of an IRC§1031 exchange is when
a. the equity in real property approaches 50 percent of the real property's fair market value
b. the equity in real property allows the taxpayer to "trade up"
c. the equity in real property allows the taxpayer to reap the rewards associated with the "leverage" generated by tax deferral
d. all of the above

Generally, a real estate investment trust (REIT) or any interest in a REIT is defined as a security. Securities do not qualify for IRC§1031 (see Letter Ruling 82061109). However, for this form of extremely complex transaction, see your tax attorney or tax accountant. It may be possible to reap the tax-free rewards from these transactions under IRC§721.

10. A REIT is
a. a real estate investment trust
b. a real estate inventory trust
c. a real estate inventory transaction
d. a real estate investment transaction

11. Generally, a REIT
a. is a security
b. is covered under IRC§721
c. is not covered under IRC§1031
d. all of the above

A chose in action represents the right to receive money or other personal property by a judicial proceeding. IRC§1031(a)(2) excludes exchanges involving choses in action from like-kind exchange treatment.

12. A chose in action
a. represents the right to receive money or other personal property by a judicial proceeding
b. may be included in like-kind exchanges under IRC§1031(a)(2)
c. is specifically excluded from like-kind treatment under IRC§1031(a)(2)
d. both a. and c.

The Form 8824, Like-Kind Exchanges, has three parts. Part 1 requires descriptions of the propert(ies) relinquished and replacements. Compliance with the 45-day and 180-day rules is also established in this section. Part II requires additional information to provide clarity with respect to the taxpayer's intent if related parties are involved in the transaction(s). Part III requires the reporting of detailed financial information, including the original cost, current basis, fair market valuation, boot and the amount of deferred gain. This last section is useful to the taxpayer in determining depreciation deductions and basis for later transactions.

13. The Form 8824
a. has three parts
b. is called "Like-Kind Exchanges"
c. requires reporting of relinquished and replacement properties
d. all of the above

14. The Form 8824
a. includes reporting of compliance with the 45-day and 180-day rules
b. requires information with respect to related parties involved in the transaction
c. includes information relating to the original cost, current basis, fair market valuation, boot and the amount of deferred gain
d. all of the above

Exchanges of real propert(ies) often involve personal property issues, which complicate the transaction. Furthermore, tax planning strategies may affect taxpayer plans to improve propert(ies) prior to the exchange. Finally, exchanges involving partners and partnerships may create obstacles, frequently circumvented through expert tax planning, and require careful consideration to generate solutions.

15. Exchanges of real propert(ies)
a. often involve personal property issues, which complicate the transaction

b. may affect taxpayer plans to improve propert(ies) prior to the exchange
c. involving partners and partnerships may create obstacles, frequently circumvented through expert tax planning, and require careful consideration to generate solutions
d. all of the above

When basis carryover results in a more accelerated recovery period (or a shorted depreciable life) than might be permitted had the exchange not occurred, the carryover is not permitted. IRC§179 may be made, but only for excess basis. Both exchanged basis and excess basis are eligible for the additional first year depreciation. Taxpayers considering a like-kind exchange of property placed in service in that same tax year may prefer to delay the exchange to a later year, to maximize depreciation deductions.

16. IRC§179 may be made,
a. but only for excess basis
b. but only when basis carryover results in a more accelerated recovery period (or a shorted depreciable life) than might be permitted had the exchange not occurred
c. but only when the results maximize depreciation deductions
d. all of the above

17. In the case of additional first year depreciation,
a. both exchanged basis and excess basis are eligible
b. only exchanged basis is eligible
c. only excess basis is eligible
d. neither exchange basis nor excess basis are eligible

Recommended Readings

Recommended readings for this Lesson include: (1) "20 Questions About Deferred Realty Exchanges Under IRC Section 1031" written by Peter A. Karl III and published in Volume 23, Number 5 (May) 2003 issue of ***The CPA Journal***, 32-38, (2) "IRS Expands Replacement Property in 1031 Exchanges" written by Ronald L. Raitz and published in Volume 194, Number 1 (July)

2002 issue of ***Journal of Accountancy***, 69, (3) "Consider a Section 1031 Exchange" written by Dorothy Guerrin Overholt and published in Volume 182, Volume 1 (July) 1996 issue of the ***Journal of Accountancy***, 45-47, (4) "Section 1031 Exchanges: Underused Tax-Planning Tool" written by Stephen A. Wayner and published in Volume 75, Number 6 (June) 2005 issue of ***The CPA Journal***, 16-17, (5) "Like-Kind Real Estate Exchanges Under IRC Section 1031" written by William J. Coffey and Lewis Schler and published in Volume 71, Number 11 (November) 2001 issue of ***The CPA Journal***, 58-59, (6) "Like-Kind Exchanges – Common Problems and Solutions" written by Robert A. Briskin and published in Volume 36, Number 4 (April) 2005 issue of ***The Tax Advisor***, 204-213, and (7) "Tax-Free Exchanges Complicate Depreciation Calculations" written by William P. Brown and Evelyn C. Hume and published in Volume 74, Number 1 (January) 2005 issue of ***Practical Tax Strategies***, 4-16.