# DEFERRED EXCHANGES: AVOIDING TRAPS FOR THE UNWARY

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Tax-deferred exchanges of real estate have been recognized by the Internal Revenue Code since the 1920s. Recently, various factors have converged leading to a marked increase in the use of tax-deferred exchanges as an alternative to outright real property sales. Two of the principal factors resulting in the current popularity of tax-deferred exchanges are the increase in the maximum capital gain rate and the practical implications of the legal decision in *Starker v. United States.*[1] Although simultaneous exchanges had been employed for a long time, the landmark *Starker* case opened a window of opportunity for valid exchanges on a nonsimultaneous basis.

Immediately after the *Starker* decision, a taxpayer would typically transfer property to the purchaser, deposit the proceeds in an escrow or trust account, and within prescribed time limits acquire property from a third-party seller. Placing funds in an escrow or trust account served the dual purpose of keeping the taxpayer from being characterized as in constructive receipt of the money (thereby triggering a sale) and providing security for the purchaser's contractual obligation to transfer replacement property to the taxpayer. Transactions structured in this manner were commonly referred to as *Starker* exchanges and the repositories of funds as *Starker* trusts.

The increased use of *Starker* trusts in the latter part of the 1980s raised many questions and problems. First, although the taxpayer relinquished and acquired properties, often missing was an actual exchange between the parties to the transaction. Second, the structure of these transactions was not based on regulations but rather on loosely derived conclusions stemming from a myriad of case decisions and revenue rulings. To compound matters, *Starker* trusts were being structured differently in various parts of the country.

In response to these problems, the Internal Revenue Service and Department of Treasury promulgated proposed regulations in 1990.[2] After an extended comment period, final regulations were issued in May 1991.[3] The regulations codified many of the court cases and revenue rulings and at the same time addressed certain comments and questions raised by practitioners in this field. The regulations are detailed and provide practical examples in support of its provisions. Despite this fact, as the use of exchanges has increased over the past few years, it has become clear that many advisers are unaware of the consequences of certain actions that they routinely initiate on behalf of clients. The majority of these technical improprieties pertain to the prohibition against constructive receipt of funds. Another general category of errors in this area relates to the identification of replacement property and the assignment of the contract to acquire the replacement property. This article highlights some common practices that might cause an exchange transaction to be

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considered invalid. In some cases, while the individual taxpayer might not be affected, the intermediary's actions might jeopardize the integrity of its exchange program as a whole.

## Constructive Receipt

At the core of the regulations on deferred exchanges are the provisions of Regulation § 1.1031(k)-1(g)(6) (hereinafter the Section 1(g)(6) provisions) which state that subject to certain limited exceptions, each agreement must provide that the taxpayer has no right "to receive, pledge, borrow or otherwise obtain the benefits of money or other property [i.e., proceeds from the disposition of the taxpayer's property] before the end of the exchange period."[4] Exceptions to this rule include failure to have identified property within the 45-day identification period; receipt by the taxpayer of all replacement property to which he is entitled; and the occurrence after the end of the identification period of a material and substantial contingency that invalidates the contract to acquire replacement properties, as long as the contingency (1) relates to the deferred exchange, (2) is provided for in writing and (3) is beyond the control of the taxpayer and of any disqualified period.[5] These rules seem simple and straightforward, but problems can and do occur in everyday practice.

**Return of Funds.** It is not unusual for a taxpayer to establish and fund an exchange account properly with every expectation of finding suitable replacement property. However, the taxpayer frequently searches for satisfactory replacement property but it becomes evident that he will not be able to find such property within the 45-day identification period. In other cases, the taxpayer has sudden pressing and immediate needs for the funds. Consequently, the taxpayer or his representative contacts the intermediary prior to the end of the identification period and requests distribution of the funds, assuring the intermediary that the taxpayer understands that he will no longer be able to claim tax-deferral status and that the taxpayer is willing to recognize the applicable gain.

A similar request is made when a taxpayer duly identifies replacement property within the identification period and subsequently becomes unable or unwilling to complete an exchange prior to the expiration of the exchange period. Perhaps the taxpayer has been unable to negotiate a satisfactory purchase price, or perhaps the identified property did not pass inspection. Again, the taxpayer informs the intermediary that he or she is willing to accept the tax consequences. So why not return the money? Although logic would dictate that the taxpayer be allowed to receive his or her funds in these instances, there is no authority for such disbursement in the regulations. Furthermore, should an intermediary allow for a return of the funds before expiration of the applicable period, the integrity of the exchange program as a whole is placed at risk. Upon audit, the Internal Revenue Service may charge that as the intermediary has allowed the funds to be returned in one or more individual accounts, the intermediary has established a course of conduct contrary to both the regulations and the express provisions of the exchange agreements. In other words, are the limitations binding if they can be dispensed with after a request? This could adversely affect the other exchange accounts in which the intermediary is acting as accommodator even if those accounts are otherwise being handled properly.

**Remaining Funds.** A similar issue frequently arises when a taxpayer has identified several properties, intending one to be the target property and others to be backups. The primary replacement property is duly acquired using a majority of the funds held with the intermediary or in a qualified escrow or trust. A request is made, prior to the expiration of the 180-day exchange period for a return of the remaining balance. A literal reading of the exchange regulations leads to the inescapable conclusion that should the taxpayer so desire, he would be entitled to acquire a second replacement property using the remaining exchange account balance for this purpose. Even though the taxpayer never intended to acquire more than one replacement property, a return of any account balance prior to the end of the exchange period would constitute a violation of the Section 1(g)(6) provisions. If this were to occur, the valid portion of the exchange would be vitiated and once again the intermediary would run the risk of tainting its entire exchange program.

**Notice of Identification.** Another concern for the intermediary as to the identification of replacement property is to whom notice can be made. It is clear that an intermediary may allow for a return of deposited funds to a taxpayer if there has been failure to identify replacement property within the identification period. In these instances, upon request, the intermediary typically checks its files to confirm that no timely identification has been made. Upon confirmation, the intermediary returns the funds to the taxpayer. The often overlooked problem, however, is the fact that the original identification may have properly been made to "the person obligated to transfer the replacement property" or "any other person involved in the exchange other than the taxpayer or a disqualified person."[6]

Examples of persons deemed to be involved in the exchange include the buyer of the relinquished property, the intermediary, the title company, and the escrow agent.[7] The practical difficulty presented for the intermediary is that it has no way of knowing whether proper designation of replacement property might have been tendered to some other appropriate party. Once again, return of the funds after the expiration of the identification period without further inquiry on the part of the intermediary might put an otherwise valid transaction at risk.

**Transaction Costs.** The Section 1(g)(6) provisions allow a payout of exchange funds for certain purposes that are not considered to violate the safe harbor deposit with the intermediary, trustee, or escrowee. One such provision allows for disbursements for "transactional items that relate to the disposition of the relinquished property or the acquisition of the replacement property and appear under local standards in the typical closing statement as the responsibility of a buyer or seller."[8] Specific examples given include commissions, prorated taxes, recording or transfer taxes, and title company fees.[9] This provision is frequently misunderstood. The tendency of practitioners is to focus on the first portion of the provision pertaining to transactional items that relate to the disposition or acquisition of property. This is especially true of attorneys and accountants who are eager to receive their fees at closing. The problem, however, is that transactional items must also be said to appear under local standards in the typical closing statement as the responsibility of a buyer or seller.

Can it be said in every case of a disbursement request for attorney fees that those fees typically appear on closing statements in that jurisdiction? Certainly one would be hard pressed to answer affirmatively to this question in regard to accounting fees. Costs that may satisfy this definition (in addition to those set forth in the Regulations) include survey, prorated utilities, and mortgage payoffs. However, loan commitment fees, points, appraisal fees, environmental due diligence, and property insurance are all costs generally associated with the exchange transaction, but it is doubtful whether they would pass the two-prong test for allowing payment. Providing payment for such costs may disqualify the exchange and jeopardize the intermediary's exchange program.

**Exchange Fees.** A similar issues exists as to the intermediary's accommodation fee. The fee is a transactional cost of the exchange, but is it one that customarily appears on local closing statements? Even assuming that the provision should be interpreted logically to mean that the cost is one that would typically appear on a seller's closing statement involving an exchange, can it be said that the intermediary's fee under local standards is on typical closing statements? In many jurisdictions, the fee is paid by separate check from the taxpayer or taken directly from the account. Assuming that the taxpayer is operating in a jurisdiction where this costs does not normally appear on a typical exchange closing statement, what is the propriety of the intermediary debiting the exchange account for the fee? This is probably an improper action, amounting to receipt of a benefit by the taxpayer by allowing the exchange funds to be used to satisfy the taxpayer's financial obligation before the end of the exchange period. In fact, provisions in the exchange agreement allowing the intermediary to deduct its fee from the exchange account prior to the end of the exchange period may taint the exchange, even if the fee is not taken. Perhaps the safest approach is to have the fee paid by separate check or provide for the intermediary to take the fee after the conclusion of the exchange period.

**Earnest Money.** Another concern is the use of the exchange funds for earnest money on replacement property. It is not uncommon for an intermediary to receive a request to issue an earnest-money check to the seller of replacement property. In many instances, however, the request precedes the assignment to the intermediary of the contract to purchase the replacement property. Prior to the assignment, the taxpayer is the party contractually liable, and payment of earnest money from the exchange balance under these circumstances would be tantamount to allowing the taxpayer to "obtain the benefit of money" before the end of the exchange period, a Section 1(g)(6) violation. The earnest money should be tendered by the intermediary only after the assignment has been made to satisfy the assignee's contractual obligations and not those of the taxpayer.

Similarly, taxpayers may use their own funds for earnest money and subsequently request reimbursement from the escrow account. Taxpayers often furnish earnest money prior to the assignment of the replacement property contract to the intermediary. This situation occurs when the contract is entered into prior to the sale of the relinquished property. Upon assignment of the replacement property contract, a request is made to the intermediary to provide a reimbursement to the taxpayer of the earnest money advanced. This too entails a degree of risk as a probable Section 1(g)(6) violation. One possible solution is for the intermediary to replace the initial deposit with earnest money from the exchange account and have the replacement property seller return the original deposit to the taxpayer.

**Timing.** Frequently, the decision to enter into an exchange is not made until just before the closing on the relinquished property—if not at the closing! The taxpayer phones the exchange facilitator to establish an account and completes the applicable standard documentation using forms on hand and the closing takes place. Shortly thereafter, a net proceeds check is delivered or a wire transfer is made to the intermediary for the disposition proceeds. Unfortunately, at times the receipt of funds has preceded receipt of the taxpayer's exchange agreement. Under what terms, provisions, and restrictions is the intermediary acting? Although as a practical matter the intermediary might insist on compliance with the Section 1(g)(6) limitations, technically, no such provisions govern the receipt of funds until the exchange agreement is delivered and executed by the intermediary. Arguably, the mere receipt of the funds not subject to the express terms of the agreement constitutes violation of the exchange regulations. The taxpayer and intermediary are best served by making sure that a valid exchange agreement is in place before the intermediary's receipt of funds.

**Right to Resign.** Even if a valid exchange agreement is in place properly limiting the taxpayer's right to "receive, pledge, borrow or otherwise obtain the benefits of money,"[10] a seemingly innocuous standard provision appearing in the exchange agreement could be detrimental to the exchange. Many exchange agreements provide the intermediary with the unqualified right to resign. The right to resign, potentially resulting in a return of the exchange balance to the taxpayer, could be a Section 1(g)(6) violation. This remains problematical even if the right to resign is limited to resigning in favor of another qualified intermediary. A qualified intermediary is defined as an entity that acquires and transfers relinquished and replacement property. If a resignation takes place at a time between the disposition of the relinquished property and the acquisition of the replacement property, how can it be said that either intermediary acquired and transferred both properties? These are all issues that do not have clear answers, but prudence dictates the more conservative course of resigning in favor of another qualified intermediary.

## Identification

One factor distinguishing a tax-deferred exchange from a taxable sale and purchase is the limited 45-day period between the transfer of the relinquished property and the identification of the replacement property. The regulations provide that "Replacement property is identified only if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period."[11]

**Co-Owners.** Problems often arise regarding the signature of the taxpayer. At times, a married couple holds title to the relinquished property, and both properly execute the exchange agreement. However, on occasion, when the identification is made, it bears only the signature of the husband. Similarly, several tenants in common may participate in a single exchange transaction and the identification is executed by a designated representative from among the co-owners. In either instance, all participating taxpayers must sign the identification, and failure to do so is likely to disqualify the exchange.[12] Other times, the taxpayer will be unavailable to provide the identification, and it will purportedly be executed by the attorney-in-fact or the taxpayer's attorney pursuant to a power of attorney. This, too, entails a degree of risk, inasmuch as the regulations specifically require the identification to be executed by the taxpayer. The regulations do not provide for signature by a taxpayer's duly authorized representative. Whether a power of attorney valid under local will pass muster is also unclear.

**Three-Property Rule.** Most persons familiar with Section 131 are aware of the "three-property rule." This rule provides that the maximum number of replacement properties the taxpayer may identify is "three properties without regard to the fair market values of the properties."[13] In practice, this provision is much more useful than the "200% rule"[14] or the "95% rule."[15] Problems frequently arise when taxpayers seek to identify a cluster of contiguous buildings from a single seller pursuant to a single contract. The tendency on the part of many taxpayers is to consider this property as a single property for purposes of the three-property rule. There does not appear to be an authority for treating this identification as a single property, although to do so would clearly benefit the taxpayer. The resulting over-identification would likely invalidate the exchange.

**Partial Interests.** Often, upon sale of relinquished property, co-owners of the relinquished property establish individual exchange accounts and end up identifying one or more replacement properties in common. More often than not, each taxpayer identifies the whole replacement property by address or legal description. How can co-owners each acquire the whole of a single property? The regulations require that "The property received is substantially the same property as identified."[16] The regulations provide a conceptual example that makes it clear that the erection of a fence between the time of identification and the receipt of the replacement property does not "alter the basic nature or character" of the property received.[17] It is unlikely that a taxpayer could successfully argue that acquiring a one-half interest in a specific property is substantially the same as acquiring the whole of that property. Taxpayers should be encouraged to identify the fractional interest they actually intend to acquire, while disregarding minor variations. In the case of two taxpayers seeking to jointly identify a replacement property, the identification should refer to "an undivided one-half interest" in the subject property.

**Incidental Property.** The "incidental property rule" is one of the most misunderstood provisions of all the Section 1031 regulations. The rule pertains only to the identification process and provides:

> Solely for purposes of applying this paragraph (c), property that is incidental to a larger item of property is not treated as property that is separate from the larger item of property. Property is incidental to a larger item of property if—(A) In a standard commercial transaction, the property is typically transferred together with the larger item of property, and (B) The aggregate fair market value of all of the incidental property does not exceed 15 percent of the aggregate fair market value of the larger item of property.[18]

In practice, many practitioners mistakenly believe that if the personal property is typically transferred as part of the commercial transaction and the value is less than 15% of the whole, no further analysis for any purpose associated with the exchange must be undertaken. The incidental property rule pertains to the lack of need for separate identification of the of the personal property. Personal property, however incidental, is not of like kind to real estate and may therefore constitute taxable boot.

**Business Exchanges.** As the popularity of exchanges generally seems to be on the increase, exchanges of businesses have also become more prevalent. While these exchanges are certainly feasible under the right factual setting, they are often done incorrectly. Taxpayers and their advisers tend to make sure a taxpayer is "trading up" in value and that the businesses are of like kind to one another. Unfortunately, neither of these considerations is directly relevant to the intended exchange transaction. The exchange of assets of a business has been addressed by the IRS. In Revenue Ruling 89-121,[19] taxpayers exchanged assets of television stations to diversity market share and to comply with Federal Communications Commission ownership requirements. The IRS held that businesses are not treated as a single asset for purposes of like-kind exchanges but rather that the underlying assets of the businesses must be of like kind.

More recently, in PLR 9448001, a taxpayer argued that an exchange of businesses should be analyzed on the basis of the like character of the businesses. The IRS, relying on Rev. Rul. 89-121, reaffirmed that the determination is based on the underlying assets. The IRS provided additional guidance by analyzing the underlying assets. With respect to intangible personal property, the ruling states that the key is the nature or character of the rights involved and the nature or character of the property to which the intangibles are related. In analyzing the exchange of multiple assets, the assets should be placed into like-kind groups.

If the fair market value of the group exceeds the value of the property given up, the excess is reallocated to the other groups as boot. This attempts to equate the values of the acquired and relinquished property. Further, any non-like-kind assets should be allocated as boot to each group again to equalize values. Boot is recognized to the extent it exists in each group.

Thus, in the exchange of businesses, the taxpayer or his representative must make an analysis of the component assets comprising the value of the two businesses. The general asset class or product class must be determined, the like-kind property must be matched up, exchange groups formed, and deficiencies and surpluses calculated. To the extent to which the businesses are of a like kind, the process may be easier, but that fact is not a substitute for analyzing these transactions as exchanges of multiple assets.

## Assignment

Another characteristic distinguishing an exchange from a sale and purchase is the requirement that the intermediary be a direct participant in the acquisition and transfer of the relinquished and replacement properties.[20] Although direct deeding is possible and the intermediary does not have to come into the chain of title, there are several methods set forth in the regulations to satisfy this requirement. The intermediary may choose to take legal title,[21] the intermediary may be a signer on the various property contracts[22] or the rights of a taxpayer under the various contracts may be assigned to the intermediary.[23] In practice, the assignment route is the most practical and most often used. The assignment procedure is value only to the extent that all parties to the agreement receive written notice of the assignment.[24]

**Notice.** In the case of relinquished property, the taxpayer will often notify one of several buyers with whom he dealing without specifically notifying the other persons who are "parties to that agreement."[25] Similarly, in connection with replacement properties, some taxpayers notify a representative from among multiple sellers without specifically notifying all such sellers. An oversight that happens even more frequently occurs when the taxpayer is one of multiple sellers or buyers. The taxpayer provides proper notice of the assignment to the applicable buyers or sellers but fails to giv notice to any of his co-sellers or co-buyers. The tendency is to provide notice to the parties on the other wide of the exchange while forgetting that parties on the taxpayer's side of the exchange are additional "parties to the agreement."[26]

**Fractional Interests.** Another problem arises from time to time in exchanges involving assignments where there are multiple co-sellers or co-buyers with the taxpayer. These other persons may or may not be personally participating in tax-deferred exchanges. The tendency is these situations is for taxpayers to assign the entire relinquished or replacement property contract to the intermediary. In reality, only the taxpayer's undivided fractional interest should be the subject of the assignment. This issue is similar to the identification issue pertaining to the taxpayer's need to identify the portion of the replacement property to be acquired and not the whole property. The taxpayer should provide that the original contract allow for an assignment of fractional rights and only his fractional interest should be assigned.

**Dual-Purpose Property.** It is not unusual for a taxpayer to effectuate an exchange involving property held in part for investment and in part as taxpayer's principal residence.[27] A typical example involves the three-flat apartment when the taxpayer resides in one unit. The tendency of many advisers is to arbitrarily deposit two-thirds of the net proceeds with the intermediary, trustee, or escrowee. However, the prorations of rent, security deposits, and the like affect only the investment portion of the property and should be allocable only to the rental portion of the property. In these instances, the taxpayer would best be served by the use of two separate closing statements or a least a detailed calculation, taking into consideration that certain buyer credits are attributable to the proceeds of the rental portion and not the personal residence component of the sale property.

## Conclusion

While regulation was not the case in the many years prior to 1991, tax-deferred exchange transactions are highly regulated. The regulatory guidance is mostly helpful, but as has been seen, many questions remain. It behooves advisers in this area to adhere to the letter of the regulations to the greatest extent possible and to make reasonable and prudent judgements when there are no regulations on point. Even when attempting to follow the clear terms and provisions of these regulations, there are still many less apparent obstacles along the path leading to a successful exchange. This article has highlighted some traps for the unwary and cautions the reader to be aware that due care must be exercised in advising clients on tax-deferred exchange matters. ■

## Notes

1. 602 F2d 1341, 79-2 USTC ¶ 9541 (CA-9 1979).
2. 55 Fed. Reg. 20.278.
3. TD 8346. April 25, 1991.
4. Treas. Reg. § 1.1031(k)-1(g)(6)(i).
5. Treas. Reg. § 1.1031(k)-1(g)(6)(ii).
6. Treas. Reg. §§ 1.1031(k)-1(c)(2)(i), 1.1031-1(c)(2)(ii).
7. Id.
8. Treas. Reg. § 1.1031(k)-1(g)(7)(ii).
9. Id.
10. Treas. Reg. § 1.1031(k)-1(g)(6).
11. Treas. Reg. § 1.1031(k)-1(c)(2).
12. Under IRC §§ 1033 (Involuntary Conversion) and 1034 (Residence Rollovers), each individual owner of property sold has the right to elect. See Rev. Rul. 74-250, 1974-1 CB 202 and PLR 9022037. These provisions, which are similar to the like kind exchanges rules, apply separately to co-tenants.
13. Treas. Reg. § 1.1031(k)-1(c)(4).
14. Referring to Treas. Reg. § 1.1031(k)-1(c)(4)(i)(B).
15. Referring to Treas. Reg. § 1.1031(k)-1(c)(4)(ii)(B).
16. Treas. Reg. § 1.1031(k)-1(d)(1)(ii).
17. Treas. Reg. § 1.1031(k)-1(d)(2), Example 2.
18. Treas. Reg. § 1.1031(k)-1(c)(5).
19. 1989-2 CB 203.
20. Treas. Reg. § 1.1031(k)-1(g)(4)(iii)(B).
21. Treas. Reg. § 1.1031(k)-1(g)(4)(iv)(A).
22. Treas. Reg. § 1.1031(k)-1(g)(4)(iv)(B).
23. Treas. Reg. § 1.1031(k)-1(g)(4)(v).
24. Id.
25. Id.
26. Id.
27. For a detailed discussion on part residence/part investment exchanges see Segal, "Considering the Options: The Like Kind Exchange and The Personal Residence," *Real Estate Finance Journal,* Spring 1995, pp. 66–71.

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