

# EVERYTHING YOU EVER WANTED TO KNOW ABOUT 1031 EXCHANGES AND THE TAX-SAVING OPPORTUNITIES

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## About 1031 Corporation And Our Qualifications

**We are experienced.** 1031 Corporation has been offering Intermediary services since 1990. We have been a leader in the development of exchange technology, approaches and solutions and have participated in thousands of successful exchanges. Our services include, at no additional cost, detailed consultation on exchange structure and requirements as well as assistance throughout the exchange process.

**We provide a fidelity bond** and carry professional liability insurance for maximum security and assurance to our clients.

**Our clients' exchange proceeds are maintained in segregated money market accounts** for security and safety. Funds are held at FirstBank – Colorado's largest locally-owned bank.

**We are members of the Federation of Exchange Accommodators**, the only national trade association organized to represent professionals who conduct like-kind exchanges under Internal Revenue Code §1031. All our exchange officers are Certified Exchange Specialist (CES®) designees and have met the work experience, continuing education and professional knowledge criteria established by the FEA.

**Our fees are competitive.**

- Our fees are straightforward, flat and simple with no additional, hidden costs.
- Our fee includes assistance during every step of the exchange.

**We are experienced with a variety of complex exchanges** and can provide assistance on deferred exchanges, reverse exchanges and improvement exchanges. We can take temporary title to Replacement Property in one of our single-asset subsidiary LLCs on behalf of our clients for reverse and improvement exchanges. We are familiar with reverse and improvement exchange financing issues and can provide guidance on available options.

**Our experience includes -**

- Nationwide service with the expertise to conduct exchanges in any state
- Exchanges ranging from a few thousand dollars to multi-million dollar exchanges
- Multi asset exchanges.

**We work together with our clients' Realtors, lenders and settlement agents** and provide complete exchange support. Realtors working with 1031 Corporation remain informed and confident that their client is receiving competent assistance. We work closely with the settlement agent to ensure all closing documents are properly completed in compliance with our clients' 1031 exchange requirements.

**We collaborate with our clients' accountant, attorney and/or financial advisor** by providing documents necessary to accomplish reporting of the tax-deferred exchange. We are available to consult, at no additional cost, with our clients' advisors on strategy and any issues or concerns with the like-kind exchange process.

**The Client is our #1 Priority.** We are confident that our level of service will measure up to the highest standards of ethics, competence, friendliness and professionalism. We will settle for nothing less and appreciate working with clients who expect nothing less.

**Please feel free to call us at (888) 367-1031 with any questions:**

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## **DISCLAIMER**

This Exchange Manual is provided as a basic guide to taxpayers to help them understand the potential tax-saving opportunities available under Section 1031 of the Internal Revenue Code. This manual should not be relied upon as a substitute for professional tax consultation or final reference for the current Internal Revenue Code. Taxpayers are advised to consult with their CPA or attorney for advice in conducting a 1031 Exchange, calculation of any tax liability, and the preparation of tax returns.

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# Everything You Ever Wanted To Know About 1031 Exchanges and the Tax-Saving Opportunities

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## Introduction to 1031 Exchanges

**A 1031 Exchange (Tax-Deferred Exchange) Is One Of The Most Powerful Tax Deferral Strategies Remaining Available For Taxpayers.** Section 1031 of the Internal Revenue Code is the basis for tax-deferred exchanges. Taxpayers should never have to pay income taxes on the sale of property if they intend to reinvest the proceeds in similar or like-kind property. Professionals involved with advising or counseling real estate investors need to know about tax-deferred exchanges, including Realtors, lawyers, accountants, financial planners, tax advisors, escrow and closing agents and lenders.

**The Advantage of a 1031 Exchange** is the ability of a taxpayer to sell income, investment or business property and replace with **like-kind Replacement Property** without having to pay federal or state income taxes on the transaction. A sale of property and subsequent purchase of a Replacement Property doesn't work; there must be an Exchange.

**The Disadvantages of a Section 1031 Exchange** include a reduced basis for depreciation on the Replacement Property. The tax basis of Replacement Property is essentially the purchase price of the Replacement Property minus the gain which was deferred on the sale of the Relinquished Property as a result of the exchange. The Replacement Property thus includes a deferred gain that will be taxed in the future if the taxpayer cashes out of his investment.

**Exchange Techniques.** There is more than one way to structure a tax-deferred exchange under Section 1031 of the Internal Revenue Code. However, the 1991 "safe harbor" Regulations established procedures which include the use of an Intermediary, direct deeding, the use of qualified escrow accounts for temporary holding of "exchange funds" and other procedures which have the official blessing of the IRS. Therefore, it is desirable to structure exchanges so that they can be in harmony with the 1991 Regulations. As a result, exchanges commonly employ the services of a facilitator known as a Qualified Intermediary.

**Exchanges can also occur without the services of an Intermediary** when parties to an exchange are willing to exchange deeds or if they are willing to enter into an Exchange Agreement with each other. However, two-party exchanges are uncommon since, in the typical Section 1031 transaction, the seller of the Replacement Property is not the buyer of the taxpayer's Relinquished Property.



## The Basic Rules For A 1031 Exchange

**1. The Relinquished Property Must Be Qualifying Property.** Qualifying property is property held for investment purposes or used in a taxpayer's trade or business. Investment property includes real estate, improved or unimproved, held for investment or income producing purposes. Property used in a taxpayer's trade or business includes his office facilities or place of doing business. Real estate must be replaced with like-kind real estate.

**2. Property Which Does Not Qualify For A 1031 Exchange** includes –

- A personal residence
- Land under development for resale
- Construction or fix/flips for resale
- Property purchased or held for resale
- Inventory property
- Corporation common stock
- Partnership interests
- LLC membership interests
- Bonds
- Notes

**3. Replacement Property Title Must Be Taken In The Same Name As The Relinquished Property Was Titled.** If a husband and wife own property in joint tenancy or as tenants in common, the Replacement Property must be deeded to both spouses, either as joint tenants or as tenants in common. Corporations, partnerships, limited liability companies and trusts must be in title on the Replacement Property the same as they were on the Relinquished Property.

**4. The Replacement Property Must Be Like Kind.** For real estate exchanges, like-kind Replacement Property means any improved or unimproved real estate held for income, investment or business use. For instance -

- Improved real estate can be replaced with unimproved real estate.
- Unimproved real estate can be replaced with improved real estate.
- A 100% interest can be exchanged for an undivided percentage interest with multiple owners and vice versa.
- One property can be exchanged for two or more properties. Two or more properties can be exchanged for one Replacement Property.
- A duplex can be exchanged for a four-plex. Investment property can be exchanged for business property and vice versa.

As referenced above, a taxpayer's personal residence cannot be exchanged for income property and income or investment property cannot be exchanged for a personal residence which the taxpayer will reside in. See an expanded explanation below of different kinds of real estate interests which are like kind for real estate exchanges.





**5. Any Boot Received In Addition To Like-kind Replacement Property Will Be Taxable (to the extent of gain realized on the exchange).** This is okay when a seller desires some cash or debt reduction and is willing to pay some taxes. Otherwise, boot should be avoided in order for a 1031 Exchange to be completely tax free.

The term "boot" is not used in the Internal Revenue Code or the Regulations but is commonly used in discussing the tax consequences of a Section 1031 tax-deferred exchange. Boot received is the money, debt relief or the fair market value of "other property" received by the taxpayer in an exchange. Money includes all cash equivalents received by the taxpayer. Debt relief is any net debt reduction which occurs as a result of the exchange taking into account the debt on the Relinquished Property and the Replacement Property. "Other property" is property that is non-like-kind, such as personal property received in an exchange of real property, property used for personal purposes, or "non-qualified property." "Other property" also includes such things as a promissory note received from a buyer (Seller Financing).

**A Rule Of Thumb for avoiding "boot" is to always replace with property of equal or greater value** than the Relinquished Property. Never "trade down." Trading down always results in boot received, either cash, debt reduction or both. Boot received is mitigated by exchange expenses paid. See *The Rules Of Boot In A Section 1031 Exchange* (below) for a detailed explanation of these rules.

## Real Estate Interests Which Qualify as Like-Kind for a 1031 Exchange

The following types of real estate interests are deemed by Congress and the IRS to qualify as like-kind to each other for a 1031 Exchange –

- Fee interest
- Fractional (tenancy-in-common) interest
- Leasehold interest, 30-year plus lease
- Easements for conservation
- Easements for right of way
- Water rights
- Mineral Rights
- Oil & Gas interests
- Transferrable Development Rights
- Mutual Irrigation Ditch Stock

## The Basic Types of Exchanges

**A Simultaneous Exchange** is an exchange in which the closing of the Relinquished Property and the Replacement Property occur on the same day, usually back to back. There is no interval of time between the two closings. This type of exchange is covered by the Safe harbor Regulations.

**A Delayed Exchange** is an exchange where the Replacement Property is acquired at a later date than the closing of the sale of the Relinquished Property. The exchange is not simultaneous or on the same day. This type of exchange is sometimes referred to as a



"Starker Exchange" after the well known Supreme Court case which ruled in the taxpayer's favor for a delayed exchange before the Internal Revenue Code provided for such exchanges. There are strict time frames established by the Code and Regulations for completion of a delayed exchange, namely the 45-Day Clock and the 180-Day Clock (see detailed explanation below).

**A Reverse Exchange** (Title-Holding Exchange) is an exchange in which the Replacement Property is purchased and closed on before the Relinquished Property is sold. Usually the Intermediary takes title to the Replacement Property and holds title until the taxpayer can find a buyer for the Relinquished Property and close on the sale under an Exchange Agreement with the Intermediary. Subsequent to the closing of the Relinquished Property (or simultaneous with this closing), the Intermediary conveys title to the Replacement Property to the taxpayer. The IRS has issued safe harbor guidance on Reverse Exchanges (see below).

**An Improvement Exchange** (Title-Holding Exchange) is an exchange in which a taxpayer desires to acquire a property and arrange for construction of improvements on the property before it is received as Replacement Property. The improvements are usually a building on an unimproved lot, but can also include enhancements made to an already improved property in order to create adequate value to close on the Exchange with no boot occurring. The Code and Regulations do not take into account for exchange purposes improvements made to a property after the closing on the Replacement Property has occurred. Therefore, it is necessary for the Intermediary to close on, take title and hold title to the property until the improvements are constructed and then convey title to the improved property to the taxpayer as Replacement Property. Improvement Exchanges are done in the context of both Delayed Exchanges and Reverse Exchanges, depending on the circumstances. The IRS has issued safe harbor guidance on Reverse Exchanges (including title-holding exchanges for construction or improvement)

## **The "Held For" Requirement for 1031 Property Received or Exchanged**

**In order to qualify for a 1031 Exchange**, the Relinquished and the Replacement Properties must both have been acquired and "held for" investment or for use in a trade or business. The amount of time that the property must be "held for" use in a trade or business is not specified in either the Code or the Regulations.

**The position of the IRS has been** that if a taxpayer's property was acquired immediately before an exchange, or if the Replacement Property is disposed of immediately after an exchange, the property was not held for the required purpose and the "held for" requirement was not met.



**There is no safe harbor holding period** for complying with the “held for” requirement. The IRS interprets compliance based on their view of the taxpayer’s intent. Intent is demonstrated by facts and circumstances surrounding the taxpayer’s acquisition of ownership of the property and what the taxpayer does with the property. The courts have been more liberal than the IRS on these issues.

Here are some examples of transactions that should be considered to have potential for a finding by the IRS that the “held for” requirement has not been met -

- The taxpayer acquires Replacement Property and immediately lists the property for sale. The IRS will interpret the intent to acquire the property for resale instead of for investment purposes.
- The taxpayer receives the Relinquished Property by deed from a partnership and immediately proceeds to sell/exchange it (aka “drop and swap”).
- The taxpayer acquires Replacement Property and immediately converts the property to a personal residence.
- The taxpayer acquires Replacement Property and immediately transfers the property to a corporation, partnership or LLC.

**A cushion of time between events** such as these is desirable in order to reduce the risk of possible “held for” issues in an exchange. Exchange Professionals recommend one year for the Replacement Property. The IRS has ruled that two years was adequate in a private letter ruling (Ltr Rul 8429039) but this was not made mandatory. In any event, the burden is on the taxpayer to support compliance with the “held for productive use in investment or a trade or business” requirement.

## **Delayed Exchanges – The Exchange Process And Time Clocks**

A taxpayer desiring to do a 1031 Exchange lists and/or markets the property for sale in the normal manner without regard to the contemplated 1031 Exchange. A buyer is found and a contract to sell the property is executed. Accommodation language is usually placed in the contract securing the cooperation of the buyer to the seller's intended 1031 Exchange, but such accommodation language is not mandatory.

When contingencies are satisfied and the contract is scheduled for a closing, services of an Intermediary are arranged. The taxpayer enters into an Exchange Agreement with the Intermediary, which permits the Intermediary to become the “substitute seller” in accordance with the requirements of the Code and Regulations.



The Exchange Agreement usually provides for:

- An assignment, to the Intermediary, of the seller's Contract to Buy and Sell Real Estate.
- A closing where the Intermediary receives the proceeds due the seller at closing. Direct deeding is used. The Exchange Agreement will comply with the requirements of the Code and Regulations wherein the taxpayer can have no rights to the funds being held by the Intermediary until the exchange is completed or the Exchange Agreement terminates. The taxpayer cannot touch the funds.
- An interval of time where the seller proceeds to locate suitable Replacement Property and enter into a contract to purchase the property. The interval of time is subject to the 45-Day and 180-Day rules.
- An assignment, to the Intermediary, of the contract to purchase Replacement Property.
- A closing where the Intermediary uses the exchange funds in its possession and direct deeding to acquire the Replacement Property for the seller.

**The 45-Day Rule for Identification.** The first timing restriction for a delayed Section 1031 exchange is for the taxpayer to either close on the purchase of the Replacement Property or to identify the potential Replacement Property within 45 days from the date of transfer of the Relinquished Property. . The 45-Day Rule is satisfied if Replacement Property is received before 45 days have expired. Otherwise, the identification must be by written document (the identification notice) signed by the taxpayer and hand delivered, mailed, faxed, or otherwise sent to the Intermediary. The identification notice must contain an unambiguous description of the Replacement Property. This includes, in the case of real property, the legal description, street address or a distinguishable name.

The 45-Day Rule for Identification imposes limitations on the number of potential Replacement Properties, which can be identified and received as Replacement Properties. More than one potential Replacement Property can be identified by one of the following three rules:

**The Three-Property Rule** - Any three properties regardless of their market values.

**The 200% Rule** - Any number of properties as long as the aggregate fair market value of the replacement properties does not exceed 200% of the aggregate FMV of all of the exchanged properties as of the initial transfer date.

**The 95% Rule** - Any number of replacement properties if the fair market value of the properties actually received by the end of the exchange period is at least 95% of the aggregate FMV of all the potential replacement properties identified.



Although the Regulations only require written notification within 45 days, it is recommended practice for a solid contract to be in place by the end of the 45-day period. Otherwise, a taxpayer may find himself unable to close on any of the properties which are identified in the 45-day letter. **After 45 days have expired, it is not possible to close on any property which was not identified in the 45-day letter.** Failure to submit the 45-Day Letter causes the Exchange Agreement to terminate and the Intermediary will disburse all unused funds in his possession to the taxpayer.

**The 180-Day Rule for Receipt of Replacement Property.** The Replacement Property must be received and the exchange completed no later than the earlier of

- 180 days after the transfer of the exchanged property or
- The due date of the income tax return, including extensions, for the tax year in which the Relinquished Property was transferred.

The Replacement Property received must be substantially the same as the property that was identified under the 45-day rule described above. There is no provision for extension of the 180 days for any circumstance or hardship. There are provisions for extensions for presidentially declared disaster areas.

As noted above, the 180-Day Rule is shortened to the due date of a tax return if the tax return is not put on extension. For instance, if an Exchange commences late in the tax year, the 180 days can be later than the April 15 filing date of the return. **If the Exchange is not completed by the time for filing the return, the return must be put on extension.** Failure to put the return on extension can cause the replacement period for the Exchange to end on the due date of the return. This can be a trap for the unwary.

## **Reverse Exchanges – The Exchange Process and Time Clocks**

**Safe Harbor Reverse Exchanges** - Rev. Proc. 2000-37 issued by the IRS on September 15, 2000 established recognition of and “safe harbor” guidance for Reverse Exchanges complying with the guidelines. These are known as “Safe Harbor Reverse Exchanges.” Reverse Exchanges which are not in compliance with the guidelines are not prohibited by Rev. Proc. 2000-37 but must stand or fall on their own merits and are referred to as “Non-Safe Harbor Reverse Exchanges.”

Reverse Exchanges of either type are common and occur when a taxpayer arranges for an Exchange Accommodation Titleholder (EAT) (usually the Intermediary) to take and temporarily hold title to Replacement Property before a taxpayer finds a buyer for his Relinquished Property. Sometimes the exchange accommodation titleholder will take and hold title to the Relinquished Property until a buyer can be found for it. Reverse Exchanges of either type are useful in circumstances where a taxpayer needs to close



on the purchase of Replacement Property before a Relinquished Property can be sold or where the taxpayer desires ample time to search for suitable Replacement Property before selling a Relinquished Property which starts the 45-day and 180-day clocks for Delayed Exchanges. Reverse Exchanges are also common where a taxpayer wants to acquire a property and construct improvements on it before taking title to the property as Replacement Property. This is necessary if the value of the improvements is important for replacing with property of equal or greater value in order to avoid a taxable "trade-down."

**Rev. Proc. 2004-51 issued in 2004** added an additional requirement for Reverse Exchanges to be under the safe harbor "umbrella." Any property which has been previously owned by the taxpayer within the prior 180 days is declared ineligible for protection under the Rev. Proc. 2000-37 safe harbor procedures.

**The Safe Harbor Reverse Exchange Time-Clocks.** The safe-harbor procedures impose compliance requirements which require analysis for impact and planning that can be summarized as follows –

- **The Five-Day Rule.** A "Qualified Exchange Accommodation Agreement" must be entered into between the taxpayer and the exchange accommodation titleholder (Qualified Intermediary in most cases) within five business days after title to property is taken by the exchange accommodation titleholder in anticipation of a Reverse Exchange.
- **The 45-Day Rule.** The property to be "relinquished" (the Relinquished Property) must be identified within 45 days. More than one potential property to be sold can be identified in a manner similar to the rules of delayed exchanges (i.e., the three-property rule, the 200% rule, etc.)
- **The 180-Day Rule.** The Reverse Exchange must be completed within 180 days of taking title by the exchange accommodation titleholder.

**The 180-Day Clock.** As with Delayed Exchanges, Reverse Exchanges must be completed within 180 days. Prior to the issuance of Rev. Proc. 2000-37 there was no statutory limitation of time in which to be in title. It was common for the Exchange Accommodation Titleholder to be in title on the parked property for a year or more. The taxpayer would search for a buyer for his Relinquished Property or have improvements constructed on the property being held by the Titleholder. 180 days may be a suitable time for a buyer to be found for the Relinquished Property. However, 180 days is a problem with respect to construction/improvement exchanges. The 180 day time limit within which to complete a Safe Harbor Reverse Exchange is probably insufficient for most large "build to suit" exchanges.

**What if the taxpayer has not yet found a buyer for his Relinquished Property by the end of 180 days?** In this case, the taxpayer can discontinue his attempt to accomplish a Reverse Exchange and take deed to the Replacement Property.





The taxpayer may decide to extend his Reverse Exchange outside of the protection of the safe harbor procedures. The safe harbor guidance issued by the IRS is not mandatory. Reverse Exchanges that do not comply with the requirements of Rev. Proc. 2000-37 stand or fall on their own merits and should be considered to have a higher degree of audit risk.

**Rev. Proc. 2000-37 imposes responsibilities and burdens on the Exchange Accommodator Titleholder.** The Accommodator is required to report, for federal income tax purposes, the "tax attributes" of ownership of the property it is in title on. Rents and expenses attributed to ownership of the property may have to be reported by the Accommodator. It is unclear if the Accommodator has to also report depreciation on the property it is in title on just as a true owner would be compelled to do.

## The Role of the Qualified Intermediary

The role of the Qualified Intermediary is essential to completing a successful and valid delayed exchange. The Qualified Intermediary is the glue that puts the buyer and seller of property together into the form of a 1031 Exchange. Where such an intermediary (often called an exchange facilitator) is used, the intermediary will not be considered the agent of the taxpayer for constructive receipt purposes notwithstanding the fact that he may be an agent under state law and the taxpayer may gain immediate possession of the money or property under the laws of agency.

In order to take advantage of the qualified intermediary "safe harbor" there must be a written agreement between the taxpayer and intermediary expressly limiting the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of the money or property held by the intermediary.

A Qualified Intermediary is formally defined as a person who is not the taxpayer or a disqualified person and who enters into a written agreement (the "exchange agreement") with the taxpayer. The Qualified Intermediary acquires the Relinquished Property from the taxpayer, transfers the Relinquished Property to the buyer, acquires the Replacement Property and transfers the Replacement Property to the taxpayer. The Qualified Intermediary does not actually have to be in the chain of title.

The Intermediary is treated as entering into a contract for sale if the rights of a party to the contract are assigned to the Intermediary and all parties to the contract are notified in writing of the assignment on or before the date of the relevant transfer of property. This provision allows a taxpayer to enter into a contract for the transfer of the Relinquished Property and thereafter to assign his rights in the contract to the Intermediary. Providing all parties to the agreement are notified in writing of the assignment on or before the date of the transfer of the Relinquished Property, the intermediary is treated as the seller and funds are wired to the Intermediary.

There are no licensing requirements for Intermediaries established by the IRS. They need merely be not an unqualified person as defined by the Internal Revenue Code in



order to be qualified. The Code prohibits certain "agents" of the taxpayer from being qualified. Accountants, attorneys and realtors who have served taxpayers in their professional capacities within the prior two years are disqualified from serving as a Qualified Intermediary for a taxpayer in an exchange. Related parties are also disqualified.

## Criteria for Selecting a Qualified Intermediary

Intermediaries serve as a limited purpose depository institution and hold all of the Exchange Cash during the course of a 1031 Exchange. As a result, Intermediaries usually hold substantial sums of money on behalf of their exchange clients. With the exception of a few states, including Nevada, California, Idaho, Colorado and Arizona, there are no federal or state regulations or supervision of Intermediaries. Taxpayers are unsecured creditors when an Intermediary becomes bankrupt or insolvent. Funds held by Intermediaries are invested in a variety of ways, including pooled cash funds with stock brokerages and segregated liquid asset money market accounts. Obviously, the selection of an Intermediary who will be entrusted with the funds of a 1031 Exchange is an important matter.

Intermediaries offer widely varying services and have widely varying professional training, skills and competence. Intermediaries are usually attorneys, tax accountants, bank affiliates, title company affiliates or realtors. Many Intermediaries have no training as a tax professional or as an exchange professional and offer no consultation to a taxpayer on tax issues related to the exchange or on the technical requirements for completion of a successful exchange. Some Intermediaries simply bank funds.

Intermediaries take their fees or compensation in a variety of ways. Some Intermediaries charge little or no fees for their services and retain all or a portion of the interest earned on the funds in their possession. Some Intermediaries charge higher fees for their services and forward all interest earned on funds in their possession to the client at the end of the exchange. Some do a little of both. Interest earned on funds held by an Intermediary can vary widely also, depending on where the funds are invested or held on deposit.

Here are some of the things taxpayers should consider when engaging the services of an Intermediary -

- Does the Intermediary have tax professionals or Certified Exchange Specialists capable of consulting you on 1031 tax issues?
- Does the Intermediary deposit Exchange Funds in segregated and FDIC insured accounts?
- Is the Intermediary a member of the Federation Of Exchange Accommodators, a professional organization that expects its members to perform services at the highest level of competence and trust?
- Does the Intermediary have experience and a verifiable reputation?





- Is the Intermediary willing to meet with you, consult with you on exchange strategies, issues and execution of exchange documents?
- Is the Intermediary bonded with a fidelity bond?
- Are Exchange Funds available for disbursement within 24 hours?
- Does the Intermediary manage closings in order to avoid inadvertent boot and related taxes, which can cost you more than the fees they charge?

**1031 Corporation complies with all of these expectations.**

## **The Rules of “Boot” In A Section 1031 Exchange**

**A Taxpayer Must Not Receive "Boot"** from an exchange in order for a Section 1031 exchange to be completely tax free. Any boot received is taxable (to the extent of gain realized on the exchange). This is acceptable when a seller desires some cash and is willing to pay some taxes. Otherwise, boot should be avoided in order for a 1031 Exchange to be tax free.

**The term "boot"** is not used in the Internal Revenue Code or the Regulations, but is commonly used in discussing the tax consequences of a Section 1031 tax-deferred exchange. Boot received is the money, debt relief or the fair market value of "other property" received by the taxpayer in an exchange. Money includes all cash equivalents received by the taxpayer. Debt relief is any net debt reduction which occurs as a result of the exchange taking into account the debt on the Relinquished Property and the Replacement Property. "Other property" is property that is non-like-kind such as personal property received in an exchange of real property, property used for personal purposes, or "non-qualified property." "Other property" also includes a promissory note received from a buyer (Seller Financing).

**Boot can be in advertent and result from a variety of factors.** It is important for a taxpayer to understand what can result in boot if taxable income is to be avoided. The most common sources of boot include the following:

- **Cash boot received** during the exchange. This will usually be in the form of "net cash received" at the closing of either the Relinquished Property or the Replacement Property.
- **Debt reduction boot** which occurs when a taxpayer's debt on Replacement Property is less than the debt which was on the Relinquished Property. As with cash boot, debt reduction boot can occur when a taxpayer is "trading down" in the exchange.
- **Sale proceeds** being used to service costs at closing which are not closing expenses. If proceeds of sale are used to service non-transaction costs at closing, the result is the same as if the taxpayer received cash from the



exchange, and then used the cash to pay these costs. Taxpayers are encouraged to bring cash to the closing of the sale of their Relinquished Property to pay for the following non-transaction costs:

- a. Rent prorations.
- b. Utility escrow charges.
- c. Tenant damage deposits transferred to the buyer.
- d. Property tax prorations? Possibly, see explanation below.
- e. Any other charges unrelated to the closing.

**Tax prorations** on the Relinquished Property settlement statement can be considered as service of debt based on PLR 8328011. Under this rationale exchange cash used to service tax prorations should not result in taxable boot. However, taxpayers may want to bring cash to the Relinquished Property closing anyway in order to resolve this issue.

**Excess borrowing to acquire Replacement Property.** Borrowing more money than is necessary to close on Replacement Property will cause cash being held by an Intermediary to be excessive for the closing. Excess cash held by an Intermediary is distributed to the taxpayer, resulting in cash boot to the taxpayer. Taxpayers must use all cash being held by an Intermediary for Replacement Property. Additional financing must be no more than what is necessary, in addition to the cash, to close on the property.

**Loan acquisition costs** for the Replacement Property, which are serviced from exchange funds being brought to the closing. Loan acquisition costs include origination fees and other fees related to acquiring the loan. Taxpayers usually take the position that loan acquisition costs are being serviced from the proceeds of the loan. However, the IRS may take a position that these costs are being serviced from Exchange Funds. There is no guidance which is helpful in the form of Treasury Regulations on this issue at the present time.

**Non-like-kind property**, which is received from the exchange, in addition to like-kind property (real estate). Non-like-kind property could include the following:

- Seller financing, promissory note
- Furniture and fixtures acquired with purchase of real estate
- Sprinkler equipment acquired with farm land

**Boot Offset Rules** - Only the *net* boot received by a taxpayer is taxed. In determining the amount of net boot received by the taxpayer, certain offsets are allowed and others are not, as follows:



- **Cash boot paid offsets cash boot received** (but only at the same closing table).

*Cash boot paid at the Replacement Property closing table does not offset cash boot received at the Relinquished Property closing table (Reg. §1.1031(k)-1(j)(3) Example 2). This rule probably also applies to inadvertent boot received at the Relinquished Property closing table because of prorations, etc. (see above).*

- **Debt incurred on the Replacement Property offsets debt-reduction boot received** on the Relinquished Property.
- **Cash boot paid offsets debt-reduction boot received.**
- **Debt boot paid never offsets cash boot received** (net cash boot received is always taxable).
- **Exchange expenses (transaction and closing costs) paid** offset net cash boot received.

#### Rules of Thumb:

- Always trade "across" or up. Never trade down (the "even or up rule"). Trading down **always** results in boot received, either cash, debt reduction or both. The boot received is mitigated by exchange expenses paid.
- Bring cash to the closing of the Relinquished Property to pay for charges which are not transaction costs (see above).
- Do not receive non-like-kind property (or if you do, pay for it).
- Do not over finance Replacement Property. Financing should be limited to the amount of money necessary to close on the Replacement Property in addition to exchange funds which will be brought to the Replacement Property closing.

## Related Party Exchanges

(Two-Year Holding Period Requirement)

**Exchange of property between related parties.** There is a rule for exchanges between related parties (IRC §1031(f)), which requires related taxpayers exchanging property with each other to hold the exchanged property for at least two years following the exchange to qualify for non-recognition treatment. If either party disposes of the property received in the exchange before the running of the two-year period, any gain or loss that would have been recognized on the original exchange must be taken into account on the date that the disqualifying disposition occurs.

**Sale to an unrelated party, replacement from a related party.** A taxpayer will often desire to sell to an unrelated party and receive Replacement Property from a related party. This type of related party transaction does not work, according to the IRS, if the related party receives cash (Rev. Rul. 2002-83). The IRS reasons that if the taxpayer or a related party "cashes out" of property in this manner, IRC §1031(f)(4) "kicks in" and



the exchange is disallowed. However, if the related party is also doing an exchange (and is not “cashing out”) then it is okay to receive Replacement Property from a related party according to PLR 200440002 and PLR 200616005.

**Sale to a related party, replacement from an unrelated party.** A taxpayer will often sell to a related party but receive Replacement Property from an unrelated party. This is OK but it has been unclear whether the related party was required to hold the property it acquired from the taxpayer for two years. Instructions to Form 8824 seem to imply that the two-year rule applies. However, PLR 200706001, PLR 200712013, PLR 200728008 and PLR 2010227036 released in 2007 and 2010 say that **the two-** year rule does not apply to a related party who purchases the Relinquished Property from the taxpayer.

### **Related parties under the rules are the following -**

- Members of a family, including only brothers, sisters, half-brothers, half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.);
- An individual and a corporation when the individual owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation;
- Two corporations that are members of the same controlled group as defined in IRC §1563(a), except that "more than 50%" is substituted for "at least 80%" in that definition;
- A trust fiduciary and a corporation when the trust or the grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation;
- A grantor and fiduciary, and the fiduciary and beneficiary, of any trust;
- Fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts;
- A tax-exempt educational or charitable organization and a person who, directly or indirectly, controls such an organization, or a member of that person's family;
- A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or profits interest, in the partnership;
- Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation;
- Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation; or
- An executor of an estate and a beneficiary of such estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.
- Two partnerships if the same persons own directly, or indirectly, more than 50% of the capital interests or profits in both partnerships, or
- A person and a partnership when the person owns, directly or indirectly, more than 50% of the capital interest or profits interest in the partnership.



A disqualifying disposition does not include dispositions by reason of the death of either party, the compulsory or involuntary conversion of the exchanged property if the exchange occurred before the threat or imminence of the conversion, or dispositions where it is established to the satisfaction of the IRS that neither the exchange nor the disposition had as one of their principal purposes the avoidance of federal income tax.

## **Multiple-Asset Exchanges And Personal Residences**

A Multiple-Asset Exchange occurs when a taxpayer is selling/exchanging a property which includes more than one type of asset. A common example is a farm property including a personal residence and farmland.

The Treasury Department has issued Regulations, which govern how multiple-asset exchanges are to be reported. The Regulations establish "exchange groups" which are separately analyzed for compliance with the like-kind replacement requirements and rules of boot. Farmland must be replaced with qualifying like-kind real property. A personal residence is not 1031 property and is accounted for under the rules applicable to the sale of a personal residence.

The Multiple-Asset Regulations are ambiguous concerning how the personal residence portion of a multiple-asset exchange should be accounted for. However, it is common practice for the closing on the Relinquished Property to be bifurcated into two separate closings; one for the personal residence and the other for the remainder of the property. The proceeds applicable to the sale of the personal residence are usually disbursed to the taxpayer and not retained by the Intermediary in the exchange escrow. The balance of the proceeds is retained by the Intermediary for use in acquiring like-kind Replacement Property under the Exchange Agreement.

Another common example of multiple-asset exchanges is a real property sale that includes personal property (i.e. furniture and appliances). Hotel properties are a good example of a multiple-asset exchange including real and personal property.

Even a sale/exchange of a rental property includes a combination of real and personal property. In practice, the value of the personal property that is transferred with a rental property is commonly disregarded for calculation and income tax reporting purposes. However, there is no de minimus rule which permits a taxpayer to disregard the value of personal property, even if it is nominal.

The Multiple-Asset Regulations are complex and require the services of a tax professional for analysis purposes and income tax reporting. The tax professional is essential and will help in determining values, allocations of sale price and purchase prices to the elements of the transaction. Exchanges that include personal property of significant value should be referenced in the contract as it is non-qualifying property.



## Partnership and Co-Ownership Issues

Investment real estate is commonly owned by co-owners in a partnership containing two or more partners or by co-owners as tenants in common. An exchange of a tenant in common interest in real estate poses no problems and is eligible for 1031 Exchange treatment. However, an exchange of an interest in a partnership is not permitted under the Code and Regulations.

If a partnership owns property and desires to sale/exchange the property, then the partnership is the entity that is the Exchanger and party to the Exchange Agreement. The partnership will take title to the Replacement Property.

Frequently, individual partners in a partnership desire to take their share of the proceeds of sale of the partnership property, replace with qualifying 1031 Replacement Property in their own names and end their relationship with the partnership. This presents problems that require careful planning and is not without tax risk.

If a partnership involving two or more partners wishes to discontinue the partnership, sell the property, and go their separate ways with either the cash or a 1031 Exchange, it is necessary for the individual partners to receive deed to the property in advance of the sale. This is done in the context of a distribution of property from the partnership to its partners who then hold the property as tenants in common. Each individual partner then is positioned to sell or exchange his tenancy in common ownership in the real estate. This is known in the industry as a "drop and swap" and is often done at the same closing table. However, it is better for the "drop" to be performed some time before the "swap" is done in order to comply with the "held for investment" rule by the individual partners. Simultaneous "drop and swaps" have been challenged in past years by the IRS. The courts have been more lenient.

If a partnership with multiple partners wishes to exchange property in the name of the partnership but some of the partners want to "cash out" or go separate ways, it is common for the partnership to do a "split-off." The partnership distributes tenancy in common title to a portion of the partnership property to those individual partners who wish to proceed in separate directions, and the partnership (and its remaining partners) proceed with an exchange in the name of the partnership.

The services of a tax professional is essential for tax planning and structuring for successful exchanges of partnership and co-ownership interests in real estate.





## What is a TIC?

(Tenancy In Common Investment)

Tenancy in common investments (“TIC” or “TIC Investments”) have become a booming industry in the United States in recent years. A tenancy in common investment (better known as a TIC) is an investment by the taxpayer in real estate which is co-owned with other investors. Since the taxpayer holds a deed to real estate as a tenant in common, the investment qualifies under the like-kind rules of IRC §1031. TIC investments are typically made in projects such as apartment houses, shopping centers, office buildings, etc. TIC sponsors arrange TIC syndications to comply with the limitations specified by the IRS with Rev Proc 2002-22 which, among other things, limits the number of investors to 35.

This type of an investment can appeal to taxpayers who are tired of managing real estate. TICs can provide a secure investment with a predictable rate of return on investment. Management responsibilities are provided by management professionals. Cash returns on these types of investments are typically in the 6% to 7% range. Syndicators of TICs are called “sponsors.” Investment offerings can be made directly by the sponsor or by brokers who can assist taxpayers with an assortment of offerings currently on the market.

TIC investments are treated by most sponsors as securities because they meet the definition of securities either in the state where the property resides or in the various states where the sponsor intends to offer the investment for sale. The SEC has not ruled on this issue but most states are quite clear in their statutes that these investments are securities under state law. This means that only licensed security dealers may market these investments. However, even though the investments may be securities under state law, the investment is a real estate investment for purposes of §1031.

Some sponsors of TIC investments structure their TIC so that the investment is a real estate investment not subject to state security laws. Usually this means that the TIC sponsor will not be responsible for management of the investment and independent management will be employed.

TIC investments are commonly structured in one of the following ways –

- A single-tenant property with an established credit rating,
- Multiple tenants subject to a single master lease with the TIC sponsor who subleases to the tenants,
- Multiple tenants each with separate leases managed by professional management.

Taxpayers considering a TIC investment should be prepared for an investment which may last for several years with limited liquidity. As with any other real estate investment, an investment in a TIC can be subject to various business risks. Taxpayers should research track records and management performance of sponsors who are



offering TIC investments. They should also carefully review any available proforma operating statements and prospectus. A financial advisor should be consulted when necessary.

A list of TIC sponsors and brokers by state can be found on the website of the Tenant In Common Association (TICA) at [www.ticassoc.org](http://www.ticassoc.org).

## **What is a Section 721 Exchange into an UPREIT?**

A REIT is a Real Estate Investment Trust whose stock is publically traded. An UPREIT is a real estate investment operating partnership in which the REIT is the general partner and real estate investors are limited partners. A Section 721 Exchange is the method by which real estate investors can transfer a real estate investment into an UPREIT tax-free (or tax-deferred). IRC §721 deals with tax-free contributions of real estate to an operating partnership in exchange for an interest in the partnership.

UPREITs use IRC §721 to acquire property from investors who want to exchange out of their real estate investment into an investment which is managed by professionals. Subsequently, at a point in time which is suitable for the investor, UPREIT partnership ownership units are exchanged for shares for publically traded stock in the REIT which are then sold on the securities market. The exchange of units of the UPREIT operating partnership for stock shares in the REIT is a taxable event. But this is done at the same time that the REIT stock shares are sold so at this time the investor is cashing out of all or part of his investment at capital gains rates. This arrangement provides professional management and liquidity to the real estate investor.

In order to contribute an investment property to an UPREIT, the property must meet the REIT's investment criteria which generally include a requirement for institutional-grade property. If the real estate investor's real estate is not institutional-grade, he can convert his real estate to institutional-grade real estate with a sale and exchange through IRC §1031 and replacement with an investment in a syndicated tenancy-in-common (TIC) investment. Then, the TIC investment can be contributed to the UPREIT in exchange for ownership units in the operating partnership of the UPREIT. Some REITs can facilitate the taxpayer with this type of transaction.





## What Realtors Should Know About 1031 Exchanges

**Realtors are Often the First to Recognize the Potential Benefits of a Section 1031 Exchange** to a seller of real estate. When a seller is going to replace qualifying real estate with replacement real estate, a Section 1031 Exchange should be suggested. It is possible for a seller to employ the services of an Exchange Intermediary at any time after a contract is executed up to the day of closing on the contract. It is too late after the closing has occurred.

**Accommodation Language in the Contract.** Accommodation language is usually placed in the Contract to Buy and Sell Real Estate wherein the other party to the contract is informed and agrees to cooperate with the 1031 exchange. Typical accommodation language might read as follows:

**For a Seller** - "A material part of the consideration to the seller for selling is that the seller has the option to qualify this transaction as a tax deferred exchange under Section 1031 of the Internal Revenue Code. Purchaser agrees to cooperate in the exchange provided purchaser incurs no additional liability, cost or expense."

**For a Buyer** - "This offer is conditional upon the seller's cooperation at no cost to allow the purchaser to participate in an exchange under Section 1031 of the Internal Revenue Code at no additional cost or expense. Seller hereby grants buyer permission to assign this Contract to an Intermediary notwithstanding any other language to the contrary in this Contract".

**Accommodation language is not mandatory** and can be omitted if it puts the taxpayer at a disadvantage for other parties to know about his plan to sell and replace property under IRC §1031 and related closing pressures under the exchange 'time clocks.'"

**Assignment of Contracts.** If a Realtor knows that a buyer intends to assign the contract to an Intermediary in connection with an exchange, it is helpful to reference the buyer as "John Doe or Assigns" on the contract.

Paragraph 18 of the standard form Contract to Buy and Sell Real Estate used by Colorado Realtors contains a provision wherein the contract is not assignable by a buyer without the seller's permission unless the seller's permission is so indicated with a check in the "'shall' be assignable" box. The standard form Contract does not limit a seller's right to assign the contract.



Another way to make the contract "assignable" is for an addendum to the contract to be prepared by the Realtor making the contract "assignable." An Exchange Addendum to Contract to Buy and Sell Real Estate issued by the Colorado Real Estate Commission

containing all necessary accommodation language is also available. Use of this Addendum makes contract accommodation language unnecessary and automatically provides for assignability of a contract by the buyer in an exchange transaction.

**Settlement Statements.** Section 1031 of the Internal Revenue Code imposes no requirements and provides no guidance with respect to preparation of settlement statements for an exchange of property. The Colorado Real Estate Commission has no special requirements concerning exchanges involving an Intermediary.

**Intermediaries often instruct closers to name the Intermediary as the seller** of a property on behalf of their client. This is not required by IRC §1031 and creates additional closing burdens since it requires the Intermediary to sign the settlement statements.

**An occasional (but unnecessary) practice** is for the title company closing on the transaction to prepare a second set of settlement statements in which the Intermediary is shown as a buyer and seller. The Intermediary's set of statements "mirror" each other as to debits and credits. The thinking here is that the settlement statements should reflect a "chain of title." This practice is not required by IRC §1031.

**Our recommendation is to prepare one set of settlement statements** in the normal manner which total to zero proceeds due to or from the Exchanger. The settlement statements should be made to total to zero proceeds due to or from the Exchanger by showing a debit or credit for "Exchange Funds - 1031 Corporation" as a transaction item "above the bottom line". The amount of "Exchange Funds" is the amount of funds being transferred to or from the Intermediary in connection with the closing.



# ADDITIONAL READING



## The Capital Gains Tax Rules

(In A Nutshell)

**The American Taxpayer Relief Act of 2012** established the way long-term capital gains are taxed. The top rate for capital gains and dividends is 15% for single taxpayers with incomes of \$400,000 or less (\$450,000 for married taxpayers). The top rate for capital gains and dividends exceeding this level of income is 20%.

**In A Nutshell**, here are the general rules for Federal long-term capital gains tax on the sale of investment real estate commencing with 2013 -

Maximum Tax Rate	Long-Term Capital Gains (Property held 12 months or longer)
20%	High income taxpayers (see above)
15%	Taxpayers in a tax bracket higher than 15%
0%	Taxpayers in the 15% or 10% regular tax brackets

**25% Rate for “Depreciation Recapture”** - Depreciation taken on the real estate which is sold is taxable at a maximum 25% tax rate (15% for taxpayers in 10% and 15% tax bracket). The remainder of the gain from the sale of depreciable real property is taxed at the maximum tax rates referred to above.

**The 3.8% Medicare Tax.** Commencing in 2013, a Medicare tax of 3.8% was imposed on capital gains from the sale of real estate for high-income taxpayers. High-income taxpayers for this tax are taxpayers with gross income of \$200,000 for individuals (\$250,000 for married taxpayers). This tax will only apply to the amount of gain which causes adjusted gross income to exceed this high-income threshold. Exceptions for real estate sales -

- Real estate used in a trade or business will not be subject to this tax.
- Real estate sold by Real Estate Professionals also will not be subject to this tax.  
*A Real Estate Professional is a taxpayer who spends more than half of his time during the year (and at least 750 hours of service) in real property trades or businesses in which he materially participates.*

**A married couple filing jointly in 2016 using the standard deduction is in a 10%/15% tax bracket until adjusted gross income (including capital gains) exceeds \$96,000.00.**

**State Taxes** vary from state to state and should be considered as well when a taxpayer is estimating his total tax from the sale of real estate.



# Capital Gain Worksheet

## Sale of Depreciable Real Estate

### Calculation of Adjusted Basis –

Purchase price	\$ _____	(1)
Improvements added after purchase	_____	(2)
Deferred gain from previous 1031 exchange, if any	( _____ )	(3)
Less depreciation taken during ownership	( _____ )	(4)
 <b>Adjusted Basis</b> (lines 1 + 2 - 3 - 4)	 <b>\$ _____</b>	 <b>(5)</b>

### Calculation of Capital Gain -

Sale price	\$ _____	(6)
Less adjusted basis (line 5 above)	( _____ )	(7)
 <b>Capital Gain</b> (lines 6 minus 7)	 <b>\$ _____</b>	 <b>(8)</b>

### Type of Capital Gain -

Depreciation Recapture (line 4 above)	\$ _____	(9)
15%/20% rate gain (lines 8 minus 9)	_____	(10)
 <b>Total Capital Gain</b> (lines 9 + 10)	 <b>\$ _____</b>	 <b>(11)</b>

Tax rates vary on capital gains depending on the taxpayer's total income. Taxpayers should consult with their tax professional to determine what the tax will be on their capital gains.



## Seller Carrybacks and Dispositions

**A Seller Financed Sale** is usually incompatible with a desire to do a Section 1031 Exchange of real estate. The reason is that a promissory note received by the selling taxpayer is property which is not “like-kind.” If seller financing is necessary due to circumstances and if a delayed exchange with the use of an Intermediary is employed, it is possible to salvage a Section 1031 Exchange treatment by one of the following procedures:

- **The taxpayer can bring cash to the closing table** in exchange for the promissory note. Boot paid offsets boot received. This can be done at either the Relinquished Property closing or the Replacement Property closing. However, do not use acquisition financing to fund the cash at the Replacement Property closing table; the IRS will interpret that as incurring additional debt boot paid to offset cash boot received, which doesn't work. If cash is brought to the Replacement Property closing table, the Intermediary will have to hold the note until the Replacement Property closing occurs.
- **The Intermediary can take and hold the promissory note** as part of the exchange proceeds and hold the note until a disposition occurs, including holding for cash to be brought to the Replacement Property closing table as described above. Or, perhaps the note can be paid while it is being held by the Intermediary and prior to the closing of the Replacement Property. Or, the taxpayer or an investor could buy the note from the intermediary while it is in the Intermediary's possession (see below).
- **The Intermediary could sell the promissory note** to a financial institution or investor and use cash received to acquire qualifying replacement real estate for the taxpayer under the Exchange Agreement.
- **The Intermediary could use the promissory note to pay for the purchase of the Replacement Property.** A problem with this is that in the hands of the seller of the Replacement Property, the note is a third-party note not eligible for installment sale reporting under IRC §453. Accordingly, there is disincentive for the seller of the Replacement Property to take the note as part of the consideration to be received from the sale of his property. This problem is compounded if the seller is also trying to do a 1031 Exchange of his own property.



## The Tax Rules for Sale of a Personal Residence (In A Nutshell)

**Effective for Sales after May 6, 1997, the rules Are -**

- \$250,000 tax-free gain (\$500,000 for married, joint-filing couples).
- **1<sup>st</sup> Two-Year Rule** - Must live in residence for any two out of prior five years.
- **2<sup>nd</sup> Two-Year Rule** - A second home sale within a two-year period is not eligible for this exclusion. Taxpayers can only use this exclusion once in any two-year period.
- **(EXCEPTION) Any depreciation of any kind taken on the property after May 6, 1997 remains taxable at a 25% maximum tax rate** (rental, home office, etc.).
- **(EXCEPTION) A residence which was originally acquired as Replacement Property in a 1031 Exchange** must be owned for five years as well as lived in for two out of those five years to qualify (American Jobs Creation Act of 2004).
- **(EXCEPTION) Non-Qualified Use after January 1, 2009** during which the residence was not used as a primary residence does not qualify as gain eligible for the exclusion. Gain on the sale of a residence which has non-qualified use after January 1, 2009 has to be prorated between qualifying and non-qualifying gain. The fraction which is non-qualifying is the number of months after January 1, 2009 during which the residence was not the taxpayer's principal residence divided by the number of months of ownership of the residence since it was originally purchased (Housing Act of 2008). See an expanded discussion of this rule below.

**A prorata exclusion is available** for taxpayers on sales which are less than two years apart, or for failure to meet either of the two-year rules due to change of employment, health or other reasons specified by Treasury Regulations. For instance, one year of residence or second sale after one year = 50% of the above referenced exclusion if the sale was due to qualifying circumstances.

**Taxpayers with a gain exceeding these exclusion amounts** get no relief and must pay tax on the excess amount.



## 2008 Housing Bill Modifies Rules For Sale of a Personal Residence

**The Housing Assistance Tax Act of 2008** included a modification to the Section 121 exclusion of gain on the sale of a primary residence.

Under Code Section 121 a taxpayer can exclude up to \$250,000 (\$500,000 for married couples filing jointly) of gain realized on the sale of a principal (primary) residence if they have owned and occupied the residence for two years during the five year period preceding the date of sale. That is, except for any depreciation that has ever been taken on the property since May of 1997 which is not excluded.

In order to be eligible for the Code Section 121 exclusion, the residence must have been the primary residence of the taxpayer for periods of time adding up to two years of the preceding five years. Taxpayers often have more than one residence. A second residence which is not the taxpayer's primary residence for the required two years is not eligible for the §121 exclusion. The 2008 Housing Act deals with situations where the taxpayer is selling a residence which was not always the taxpayer's primary residence. For instance –

- The taxpayer moves into a second residence and after residing in it for two years, sells it, or
- The taxpayer moves into a residence which he has previously owned as a rental property and after residing in it for two years, sells it, or
- The taxpayer sells a residence in which he has lived in for two years during the preceding five years but is not currently residing in it. Perhaps he has converted it to a second residence or a rental property.

Effective January 1, 2009 the exclusion that applies to gain from the sale of a primary residence under Code Section 121 will not apply to so much of the gain from the sale as is allocable to periods of "non qualified use."

For instance, if the taxpayer owned the home for four years as a second home or rental property, moved into it, lived in it for two years and then sold it the exclusion would have to be prorated.

- Two thirds of the gain would not be eligible for the \$250,000 exclusion.
- One third of the gain would be eligible for the exclusion.





## **Nonqualified use –**

Nonqualified use of a residence is any use of the residence other than as a primary residence of the taxpayer. For taxpayers with more than one residence, “primary residence” is the residence where the taxpayer lives more of the time than any other residence.

For purposes of application of the 2008 Tax Act, nonqualified use is limited to periods of time commencing with January 1, 2009. Nonqualified use prior to January 1, 2009 is not taken into account for determining the period of time to which the §121 exclusion has to be allocated.

Also, for purposes of application of the 2008 Tax Act, periods of time after which a taxpayer has discontinued use of a residence as his primary residence is also not taken into account.

***Only nonqualified use of a residence which has occurred after January 1, 2009 and before a taxpayer made a residence his primary residence is taken into account for purposes of determining “non qualified use” and the period of time to allocate §121 exclusion to.***

## **Potential 1031 Exchange Issues**

Taxpayers frequently exchange an investment property for a qualifying investment Replacement Property which they intend to convert to a personal residence after one or two years. The game plan has been to eventually qualify the residence under Code Section 121 for a tax-free gain on the sale of the property (except for depreciation taken on the property since May, 1997).

The new law will impact this tax strategy. Any nonqualified use of the property after January 1, 2009 will be subject to the new law limiting the application of the §121 gain exclusion.



## How to Roll-Over Investment Property To a Personal Residence and Cash-Out Under IRC §121 “Tax-Free”

(IRC §1031 and §121)

**Under the rules of IRC §121**, gain on the sale of a personal residence is tax-free up to \$250,000 (\$500,000 for married taxpayers filing a joint return) if the taxpayer has owned and lived in the residence for periods of time adding up to two years out of the previous five years.

**Subject to exceptions (see below) taxpayers have long known that they could cash out of rental properties “tax-free” under the provisions of IRC §121** relating to the tax-free sale of a personal residence (the Section 121 exclusion). All they needed to do was move into a rental property, live there two years and then sell it “tax-free” as a personal residence. Converting a rental property to a personal residence is not a taxable event.

**What if the rental property is not suitable for a taxpayer to want to live in it for two years?** The answer is a 1031 Exchange for a property that will be suitable for the taxpayer. Astute real estate investors have also known that they can roll out of an investment property thru a 1031 Exchange, replace with a qualifying residential real estate investment property, rent it out for a year or so (exchange professionals recommend at least one year), move into it, live in it for two or more years and after owning the property for five years, take the Section 121 exclusion on a subsequent sale.

The five-year ownership requirement became effective October 22, 2004 with the American Jobs Creation Act of 2004 which imposed a new ownership requirement of five years for property received as replacement property in a 1031 Exchange. The two year residency requirement remained unchanged.

### The Exceptions

**Depreciation after May 6, 1997.** Any depreciation taken on the residence after May 6, 1997 is not eligible for the Section 121 exclusion and must be reported as income even if the home otherwise qualifies for the Section 121 exclusion. This exception applies to rental houses converted to a personal residence and also to any part of a personal residence which has been depreciated (i.e. home office).

Any depreciation taken on the residence prior to May 6, 1997 doesn't count and is not taxed under §121. This rule is helpful for rental properties which were substantially depreciated before 1997 and later converted to a personal residence.

It's worth noting here that this “depreciation recapture” rule applies to depreciation taken on the residence which is being sold without reference to depreciation taken on a previous rental property which was exchanged for the current rental property under IRC Section 1031. Depreciation taken on a previous rental property doesn't carry over to the replacement residence for purposes of this “depreciation recapture” rule under IRC §121.



**Non-Qualified Use.** The Housing Assistance Tax Act of 2008 reduced the benefits of the Section 121 exclusion on the sale of a personal residence. In a nutshell, any “disqualified use” of a residence after January 1, 2009 causes a fraction of the §121 gain to be not qualified for the exclusion. Accordingly, any period of time after January 1, 2009 during which the residence was used for rental purposes is “non qualified use” and any exclusion under IRC §121 must be prorated to determine the part of the gain which is not eligible for the 121 Exclusion.

This new rule affects rental properties which are converted to a personal residence after May 1, 2009 and is not helpful for rolling over an investment property to a personal residence for purposes of qualifying the residence for a subsequent sale eligible for the Section 121 exclusion. For a detailed explanation of the 2008 tax act, see [https://www.1031cpas.com/advancedTopics/residenceTopics\\_housingAssistance.htm](https://www.1031cpas.com/advancedTopics/residenceTopics_housingAssistance.htm).

**Conclusion** Taxpayers converting investment property to their personal residence thru a 1031 Exchange with subsequent conversion of the replacement property to a personal residence can still take advantage of the Section 121 exclusion for sale of a personal residence subject to the exceptions listed above. Obviously, this tax-planning possibility is getting more complicated but is still appealing to many taxpayers.

## Vacation Homes and 1031 Exchanges

**Can a vacation home qualify for a 1031 Tax-Deferred Exchange?** Most tax and exchange professionals think so to the extent that the vacation home is used partly for rental purposes. For instance, if the vacation home is used 50% for personal use and 50% for rental or investment purposes, then 50% of the property is qualifying property held for investment purposes under IRC § 1031. The personal use portion of the vacation home will not be eligible for 1031 Exchange treatment. If the vacation home is used 100% for personal use, forget it – it does not qualify under IRC §1031.

**What if the vacation home is used partly for personal use and partly for investment purposes** but is never rented out? In this case, the answer is “it depends.” It depends on the amount of personal use of the property by the taxpayer. Property held for personal use does not qualify as investment property (IRC § 1031(a)). However, mere incidental personal use of property that is otherwise considered investment property does not disqualify the property from 1031 Exchange treatment (PLR 8103117). “Incidental personal use” is not defined by the Code, Regs. or by other guidance issued by the IRS. Personal use of a vacation home for anything other than “incidental personal use” will disqualify a property if it is never rented out by a taxpayer.



**Under what circumstances can all of the vacation home (100%) qualify for a 1031 Exchange?** Code Section 280A(d) provides that a taxpayer's dwelling is a 100% rental property (and not a "residence") if the taxpayer's personal use of the property is less than the greater of -

1. 15-days, or
2. 10% of the number of days during the year for which the dwelling is rented (at fair market value rents).

Personal use includes use by members of the taxpayer's family. Personal use does not include work-days a taxpayer is at the residence. The purpose of IRC §280A is to limit deductions with respect to the rental use of a residence. Does 280A also define a property for purposes of a 1031 Exchange? Most tax and exchange professionals do not think so. However, **compliance with the minimal personal use provisions under IRC §280A could be considered to be a "good bet" for qualification of the property as a 100% eligible property for 1031 Exchange treatment. Also, see (below) the new "safe-harbor" Rev. Proc. Issued by the IRS in March 2008 which uses language similar to IRC §280A.**

**If none of these rules will work** for a taxpayer because of disqualifying personal use of the vacation home, then the taxpayer should consider converting the property to a qualifying investment property by discontinuing all personal use for a year or more to position the property for a 1031 Exchange. At the same time, be sure to report all of expenses related to the property as "investment related expenses." Renting the property will be a definite help for this purpose but is not mandatory.

**The IRS issued Rev. Proc. 2008-16 in March, 2008 (see following article)** for taxpayers who want assurance that their vacation home is a qualifying investment. The Rev Proc applies to any residence owned by the taxpayer in addition to a primary residence so it is broader in its application than to mere "vacation homes." It is effective for exchanges of homes occurring after March 9, 2008.

**Failure to meet the new safe-harbor requirements** does not mean that the exchange automatically does not qualify for §1031 treatment. But it does mean that the IRS could challenge the taxpayer's exchange.



## IRS Issues Safe Harbor for 1031 Exchange of Residences (Including Vacation Homes)

**Rev Proc 2008-16 provides a “safe harbor”** for how dwelling units given and received in an exchange will qualify for §1031 treatment. This Rev Proc is only a safe harbor under which the IRS will not challenge whether a dwelling unit qualifies as property held for use in a trade or business or for investment for purposes of §1031. Failing to meet the safe harbor should not mean that the exchange automatically does not qualify for §1031 treatment.

**A dwelling unit** is real property with a house, apartment, condominium, or similar improvement that provides basic living accommodations, including sleeping space, bathroom and cooking facilities. Therefore, a dwelling unit is a residence.

**Safe-Harbor** – The IRS says they will not challenge whether a dwelling unit qualifies as property held for use in a trade or business or for investment for purposes of §1031, if the following requirements are met:

1. The relinquished residence is owned by the taxpayer during the 24-month period ending on the day before the date of the exchange,
2. The replacement residence is owned by the taxpayer during the 24-month period beginning on the day after the date of the exchange, and
3. Within each of the 24month periods immediately before and after the exchange ,
  - a. the residence is rented to another person or persons at a fair rental for at least 14 days, and
  - b. the period of personal use does not exceed the greater of 14 days or 10% of the days the residence is rented at a fair rental.

**Personal Use** - Rev Proc 2008-16 provides that personal use occurs on any day on which a taxpayer is treated as having used the dwelling unit for personal purposes under IRC §280A(d)(2) (taking into account §280A(d)(3) but not §280A(d)(4)). Therefore, a taxpayer is generally treated as using a residence for personal purposes for a day if the unit is used by:

1. The taxpayer or any other person who has an interest in the dwelling unit or by a member of the family of the taxpayer or the other person;
2. Any individual who uses the unit under a reciprocal use arrangement; or



3. By any individual (other than an employee whose use is excludable from income under §119-Use for the convenience of the employer) unless, for that day, the dwelling unit is rented for a fair rental.

**Failure to meet the safe-harbor requirements of Rev Proc 2008-16** does not mean that the exchange is automatically disqualified for §1031 treatment. But it does mean that the IRS could challenge the taxpayer's exchange.

**Effective Date** - Rev Proc 2008-16 is effective for exchanges of dwelling units occurring after March 9, 2008. In addition, no inference is intended with respect to the federal income tax treatment of exchanges of dwelling units occurring prior to March 10, 2008.

## **How to Report an Exchange of Property Used Partly as a Personal Residence and Partly for Business or Investment Purposes**

**Revenue Procedure 2005-14 provides guidance** on tax reporting issues under IRC §121 and §1031 for exchanges of property that are combination or dual-use residential and business/ investment property.

**Background** - A homeowner can exclude gain from the sale of a personal residence if he owned and used the property as his principal residence for at least two of the five years preceding the date of sale (IRC §121). The maximum amount of gain exclusion is \$250,000 (\$500,000 married filing joint). However, the maximum amount of gain exclusion is reduced by a fraction for any rental use (non-qualified use) of the residence occurring after January 1, 2009 compared to the total years of ownership. And, any depreciation taken on the property since May 6, 1997 is not eligible for the exclusion.

**Treasury Regulation 1.121-1 issued in 2002 made it clear that the IRC §121 exclusion of gain on the sale of a personal residence applies to an entire structure that is used partly as a personal residence and partly for business or investment use.**

**The business/investment portion of a combination or dual-use residential property is also eligible for tax deferral under IRC §1031.** Accordingly, residential property may be eligible for the §121 exclusion and §1031 tax deferral under both provisions of the Internal Revenue Code simultaneously.

**Revenue Procedure 2005-14 gives six examples** of how to report exchanges of property eligible for exclusion under IRC §121 and §1031 in varying circumstances that can be summarized by the following examples. **For purposes of these examples, assume the taxpayer is single and eligible for a gain exclusion of \$250,000 under IRC §121.** In practice, the maximum exclusion will probably have to be reduced for non-qualified use after January 1, 2009.





**Rental Property Converted from a Personal Residence in a Prior Year.** IRC §121 does not require a taxpayer to be residing in a residence at the date of sale in order to qualify for the gain exclusion. If the taxpayer owned and lived in a residence in two out of the past five years, it is eligible for gain exclusion under IRC §121 even if it is presently being used as a rental. The taxpayer can exclude gain up to \$250,000 under IRC §121 except for any depreciation taken on the property since May 6, 1997. Gain resulting from depreciation or gain in excess of the §121 exclusion is eligible for tax-deferral under IRC §1031. Realized gain is first excluded under IRC §121 and then deferred under IRC §1031. Cash boot of up to \$250,000 received on the exchange would be tax-free under §121 even though the residence was used partly for investment/business purposes. Basis in the Replacement Property is increased by any gain excluded under IRC §121 in excess of cash received under IRC §121. This can get tricky, see Rev. Proc. 2005-14 for specifics.

**Combination Property - One Property, Two Structures.** If a taxpayer owns a property with a residence on it and a second structure used for business purposes, the property is a combination property. Part of the property is eligible for gain exclusion under IRC §121 and part of the property is eligible for tax-deferral under §1031. The exchange has to be accounted for as if there were two properties being sold and exchanged. The value of the Replacement Property has to be allocated between personal and business uses and realized gain is measured separately for each property. If the exchange of the business use of the Relinquished Property for business use Replacement Property results in a trade-down, there will be taxable boot on the exchange of the business portion of the Relinquished Property. Gain attributable to the business portion of the Relinquished Property cannot be excluded under IRC §121 or vice versa. Basis in the Replacement Property is measured separately for the personal residence and business portions of the property under the normal rules.

**Dual Use Property - One Structure Used Partly for Residential and Business Uses.** Any gain resulting from cash or debt reduction boot realized on the exchange will be tax-free up to \$250,000 under IRC §121 even if the gain is allocable to or results from a trade-down on the business portion of the Relinquished Property. That is, except for any depreciation taken on the Relinquished Property since May 6, 1997. However, gain resulting from depreciation taken on the property since May 6, 1997 is also eligible for tax-deferral under IRC §1031. Variations on this theme can be summarized as follows:

- All gain on the Relinquished Property up to a maximum of \$250,000 can be excluded under IRC §121 except for depreciation taken on the property since May 6, 1997. Depreciation taken on the property that is allocable to the 1031 portion of the property can be tax-deferred under IRC §1031. Depreciation on the property after May 6, 1997 that is allocable to the personal residence portion of the property cannot be deferred under §1031
- Cash (or debt reduction) boot received on the exchange is tax-free under IRC §121 up to a maximum of \$250,000 even if it relates to the 1031 portion of the property. (Except for post May 6, 1997 depreciation).



- Gain on the exchange allocable to the personal residence portion of the property in excess of \$250,000 is taxable under IRC §121 and cannot be sheltered under IRC §1031.

**Revenue Procedure 2005-14 does not address closing issues** on exchanges of property used partly for residential purposes and partly for investment/business uses. Treasury Department Publication 523 (1998, now replaced by new Pub. 523) instructed taxpayers with Dual-Use Property to treat the sale as two sales. Intermediaries frequently separate an exchange of dual-use property in a similar manner with separate settlement statements so that the taxpayer can cash-out on the personal residence part and roll the 1031 part thru an exchange. As a result of Rev Proc 2005-14, this is no longer necessary for Dual-Use Property. Separate settlement statements remain desirable for sales of Combination Property since all data will have to be prorated for Combination Property.

## **How to Build on Land You Already Own With Leasehold Interests**

(Or How to Build on Land Owned by a Related Party)

The idea here is to establish the transaction as a safe-harbor reverse exchange under the guidelines established by Rev. Proc. 2000-37. This means the taxpayer has to receive title to the improved property within 180-days of the date the Exchange Accommodation Titleholder (“EAT”) took title to the taxpayer’s Replacement Property. However, Rev. Proc. 2004-51 says this won’t work if the taxpayer has been in title on the property in the past 180 days so planning must be done so that this rule can be complied with.

### **The Procedure**

1. Taxpayer conveys his unimproved real estate to a related entity (i.e. corporation, partnership or LLC with more than one owner (“Related Party”).
2. After a month or two, taxpayer sells the Relinquished Property subject to an Exchange Agreement. The Delayed Exchange 180-Day Clock starts ticking.
3. Taxpayer enters into a “safe-harbor” Title holding Agreement with an EAT.
4. Related Party leases property to EAT (30 year lease) at Fair Market Rent. The Reverse Exchange 180-Day Clock starts ticking
5. EAT constructs improvements on the ground lease.





6. EAT conveys ground lease with improvements to taxpayer as Replacement Property for taxpayer's exchange within 180 days of title-holding agreement so as to stay under safe-harbor reverse exchange procedures. Or, ownership of the EAT itself is conveyed.
  - a. But not before 180 days has expired since Related Party received the land in (1) above for purposes of complying with Rev. Proc. 2004-51 which says the taxpayer cannot receive Replacement Property it has previously owned in the past 180-days.
7. Taxpayer continues to pay lease payments to related entity for two years before dissolving the entity and merging the property and improvement to avoid compromising the related-party exchange two-year holding rule.

**PLR 200251008 and PLR 200329021** gave taxpayers their blessing for arrangements similar to this (but, which were a little more complicated than this example). Rev. Proc. 2004-51 promised to study leasehold improvement exchanges such as these. There is no safe-harbor established for leasehold improvement exchanges at the present time.

**Observation** – Taxpayer is not taking title to the fee interest owned by the related party (the LLC). The Leasehold Interest is a new property created by the EAT which is conveyed to the taxpayer by the EAT. So, it can be argued that this is not a “related party exchange” subject to the rules of IRC §1031(f)(4).

## **The “Farm Bill” Makes Ditch Stock Qualified for a Section 1031 Exchange of Real Estate**

**Mutual Irrigation Ditch, Reservoir or Irrigation Company Stock** (referenced in IRC §501(c)(12)(A)) may be like-kind to a fee interest in real estate as a result of Section 15342 of H.R. 2419, the Food and Energy Security Act of 2007 (“the Farm Bill”), which became law on May 22, 2008.

**The Farm Bill amends IRC §1031(a)(2)(B) to exclude mutual irrigation ditch, reservoir or irrigation company stock** from “stocks, bonds, or notes” which are otherwise not eligible for a 1031 exchange. Therefore, mutual ditch, reservoir or irrigation company stock may be (or may not be; see below) eligible for a 1031 exchange of real property.

**Senators Allard and Salazar of Colorado co-sponsored the amendment** to Section 1031. Mutual irrigation ditch, reservoir or irrigation stock (“ditch stock”) is generally considered to be a water right which is used on farm land to irrigate crops. Water rights, as a kind of mineral easement, are generally considered to be an interest in real estate. As an interest in real estate, water rights are generally considered to be like-kind to a fee interest in real estate. Farm land which is sold or exchanged in states such as



Colorado often includes ditch stock. It was the intent of the Colorado senators to qualify ditch stock as like-kind to a fee interest in real estate for exchanges of farm land. Unfortunately, this intent is somewhat unclear in the language of the Farm Bill.

In order to qualify, Section 15342 of the Farm Bill makes it clear that ditch stock has to be recognized as real property, or an interest in real property, in the state in which the corporation is located. Recognition can be by the highest court of the state or by applicable state statute. In Colorado, mutual irrigation ditch companies are organized under separate sections of state statutes and ditch stock has been recognized as an interest in real property by the District Court of Colorado and other court cases. Ditch stock in other states may or may not qualify, depending on circumstances in each state.

Ambiguity in the language of the Farm Bill has caused some experts to be concerned that, perhaps, ditch stock can only be exchanged for other ditch stock. Nevertheless, it is clear that the proponents of this amendment believed that they were making ditch stock like-kind to other interests in real estate.

## **Related Party Solution to a Failed Reverse Exchange**

**In the usual Safe-Harbor Reverse Exchange the taxpayer engages an Exchange Accommodation Titleholder (“EAT” - usually a subsidiary of the QI) to take temporary title to a property** which will be subsequently deeded to the taxpayer as Replacement Property in a §1031 exchange. This is usually done because the taxpayer has to close on the purchase of a Replacement Property before the sale of a Relinquished Property has closed. Under the “safe-harbor” provisions of Revenue Procedure 2000-37 the EAT (Exchange Accommodation Titleholder) can hold the property for no longer than 180 days during which the taxpayer must find a buyer for his Relinquished Property, close on the sale and complete the 1031 exchange by taking title to the parked Replacement Property.

**What should a taxpayer do if a buyer cannot be found for the Relinquished Property within 180 days?** In the past it was common to just end the reverse exchange by transferring title to the Replacement Property to the taxpayer and assume that the reverse exchange had failed. Another option has been to extend the title-holding service of the EAT past the 180-day period in which case the “safe-harbor umbrella folded up” and the arrangement became known as a “non-safe-harbor-reverse exchange.” However, a third option is also a possibility.

**Can a taxpayer sell his Relinquished Property to a related party to hold for resale and complete his exchange by taking title to his Replacement Property?** Using this strategy, the taxpayer would find or create a related party to become the buyer of the Relinquished Property, close on the sale as part of a 1031 exchange, take title to the Replacement Property and complete the exchange. A sale to a related party has always been possible but it has been thought that the related party would be compelled to hold the property for two-years before the property could be re-sold to a third-party buyer.



**The related party exchange rules** - When property is exchanged between related parties, each related party is compelled by the Regulations to hold the property it received for two years. A disposition by either related party would disqualify the exchange and each related party would be required to amend their returns and report the exchange as a taxable sale. A sale to a related party and replacement from an unrelated party has been thought to be subject to this rule as well. It has been the thinking that a related party had to hold the property for at least two years before the property could be resold. However, three private letter rulings issued by the IRS in 2007 say this is not so and that the two-year holding period does not apply (PLRs 200706001, 200712013 and 200728008).

**The taxpayer can sell the Relinquished Property to the related party, take title to the Replacement Property from the EAT and complete the exchange.**

Subsequently, the related party can hold the property for sale to a third party with no 180 day time limit and is not subject to the two-year holding period. The related party has a tax basis equal to the purchase price so when the property is resold there should be little or no taxable gain on the sale. The taxpayer's exchange is completed and everyone is happy.

**Who are related parties?** Related parties include –

- Members of a family, including only brothers, sisters, half-brothers, half-sisters, spouse, ancestors, and lineal descendants).
- An individual and a corporation, partnership or LLC when the individual owns, directly or indirectly with family members, more than 50% of the ownership of each corporation, partnership or LLC.
- Two corporations, partnerships or LLCs when the same person or owners own, directly or indirectly with family members, more than 50% of the ownership of each corporation, partnership or LLC.

**If a related party is used in this fashion, it is preferable, even though not always possible, to use a party or entity which already exists** and is not just a shell entity set up to do this transaction with the entity disappearing after the Relinquished Property is sold. The related party should bear the benefits and burdens of ownership of the Relinquished Property and not merely acting as the taxpayer's agent. The purchase price of the Relinquished Property should be fair market value.

**When the property is resold by the related party, the gain or loss may be short-term** if the property has been held for less than 12 months by the related party. So, care should be taken to price the sale to the related party at the value that the property is expected to ultimately sell at.



## Potential Ordinary Income from Sale to a Related Party

**Sale of depreciable property to any related party.** Under IRC §1239(a) any gain from the sale of depreciable property to a related party is ordinary income rather than capital gain. In the context of a 1031 Exchange, only boot received in the exchange would be taxed as ordinary income.

**Sale of property to a related party partnership or LLC which will not be held as a capital asset by the related partnership or LLC.** Under IRC §707(b)(2) any gain from the sale of property to a related party partnership or LLC reporting as a partnership is ordinary income rather than capital gain if the property will not be a capital asset in the hands of the related party partnership or LLC. Again, in the context of a 1031 Exchange, this would only apply to boot received in the exchange.

**Sale of property to a corporation by a shareholder.** Under case law, if a shareholder sells his property to a related party corporation (51% or more of ownership) and if a subsequent resale by the corporation would be treated as ordinary income by the corporation, then the gain on the sale by the shareholder to his corporation will also be ordinary income (and not capital gain). Only boot received by the taxpayer in the exchange will be taxed as ordinary income.