DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE REGULATIONS: IRC §1031

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1.1031(a)-1 PROPERTY HELD FOR PRODUCTIVE USE IN A TRADE OR BUSINESS OR FOR INVESTMENT.

(a) IN GENERAL --

(1) EXCHANGES OF PROPERTY SOLELY FOR PROPERTY OF A LIKE KIND.

Section 1031(a)(1) provides an exception from the general rule requiring the recognition of gain or loss upon the sale or exchange of property. Under section 1031(a)(1), no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment. Under section 1031(a)(1), property held for productive use in a trade or business may be exchanged for property held for investment. Similarly, under section 1031(a)(1), property held for investment may be exchanged for property held for productive use in a trade or business. However, section 1031(a)(2) provides that section 1031(a)(1) does not apply to any exchange of -

(i) Stock in trade or other property held primarily for sale;
(ii) Stocks, bonds, or notes;
(iii) Other securities or evidences of indebtedness or interest;
(iv) Interests in a partnership;
(v) Certificates of trust or beneficial interests; or
(vi) Choses in action.

Section 1031(a)(1) does not apply to any exchange of interests in a partnership regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or in different partnerships. An interest in a partnership that has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K is treated as an interest in each of the assets of the partnership and not as an interest in a partnership for purposes of section 1031(a)(2)(D) and paragraph (a)(1)(iv) of this section. An exchange of an interest in such a partnership does not qualify for nonrecognition of gain or loss under section 1031 with respect to any asset of the partnership that is described in section 1031(a)(2) or to the extent the exchange of assets of the partnership does not otherwise satisfy the requirements of section 1031(a).

(2) EXCHANGES OF PROPERTY NOT SOLELY FOR PROPERTY OF A LIKE KIND.

A transfer is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or property which does not meet the requirements of section 1031(a), but the transfer, if otherwise qualified, will be within the provisions of either section 1031(b) or (c). Similarly, a transfer is not within the provisions of section 1031(a) if, as part of the consideration, the other party to the exchange assumes a liability of the taxpayer (or acquires property from the taxpayer that is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of either section 1031(b) or (c). A transfer of property meeting the requirements of section 1031(a) may be within the provisions of section 1031(a) even though the taxpayer transfers in addition property not meeting the requirements of section 1031(a) or money. However, the nonrecognition treatment provided by section 1031(a) does not apply to the property transferred which does not meet the requirements of section 1031(a).

(b) DEFINITION OF "LIKE KIND."

As used in section 1031(a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale. For additional rules for exchanges of personal property, see section 1.1031(a)-2.

(c) EXAMPLES OF EXCHANGES OF PROPERTY OF A "LIKE KIND."

No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

(d) EXAMPLES OF EXCHANGES NOT SOLELY IN KIND.

Gain or loss is recognized if, for instance, a taxpayer exchanges (1) Treasury bonds maturing March 15, 1958, for Treasury bonds maturing December 15, 1968, unless section 1037(a) (or so much of section 1031 as relates to section 1037(a)) applies to such exchange, or (2) a real estate mortgage for consolidated farm loan bonds.

(e) EFFECTIVE DATE RELATING TO EXCHANGES OF PARTNERSHIP INTERESTS.

The provisions of paragraph (a)(1) of this section relating to exchanges of partnership interests apply to transfers of property made by taxpayers on or after July 12, 1986.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15822, Nov. 17, 1967; T.D. 8343, 56 FR 14854, Apr. 12, 1991; T.D. 8346, 56 FR 19938, May 3, 1991]

PREAMBLE TO DEPARTMENT OF TREASURY INTERNAL REVENUE SERVICE REGULATIONS: IRC §1031

EXCHANGES OF PERSONAL PROPERTY AND EXCHANGES OF MULTIPLE PROPERTIES

Like-kind Exchange: Additional Rules for Exchanges of Personal Property and for Exchanges of Multiple Properties

SUMMARY: This document contained final regulations relating to exchanges of personal property and multiple properties under section 1031 of the Internal Revenue Code. The regulations affect persons who exchange personal property or multiple properties. The regulations are necessary to provide persons who exchange these properties with the guidance necessary to comply with the law.

EFFECTIVE DATE: The final regulations are effective for exchanges occurring on or after April 11, 1991.

SUPPLEMENTARY INFORMATION:

Background

On April 26, 1990, the Federal Register published a Notice of Proposed Rulemaking (55 FR 17635) under section 1031 of the Internal Revenue Code of 1986, relating to exchanges of personal and multiple properties. Those regulations proposed to amend §1.1031 (a)-1 and 1.1031 (b)-1(c) of the Income Tax Regulations and to add new §1.1031 (a)-2 and 1.1031 (f)-1.

After issuance of the proposed regulations, the Internal Revenue Service received public comments on the proposed regulations and held a public hearing on September 6, 1990. Six commentators spoke at the hearing. After fully considering the comments and the statements made at the hearing, the Service adopts the proposed regulations as revised by this Treasury decision. Descriptions of the revisions to the proposed regulations are included in the discussion of the public comments below. Proposed regulation §1.1031 (f)-1 has been renumbered §1.1031 (j)-1 in the final regulations.

Product class coding system

Under the proposed and final regulations, depreciable tangible personal property held for productive use in a business is exchanged for property of a "like-kind" under section 1031 if the property is exchanged for property that is either of a like kind or of a like class. An exchange of properties of a like kind may qualify under section 1031 regardless of whether the properties are also of a like class. In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class.

Under the proposed regulations, depreciable tangible personal property held by the taxpayer for productive use in its business is of a like class to other depreciable tangible personal property to be held by the taxpayer for productive use in its business if the exchanged properties are within either the same "General Business Asset Class" or the same "Product Class." A General Business Asset Class consists of depreciable tangible personal property described in one of asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87-56, 1987-2 C.B. 674. Under the final regulations, the term "General Business Asset Class" has been changed to "General Asset Class."

Under the proposed regulations, Product Classes consist of depreciable tangible personal property listed in a Product Code. A property's Product Code is its 5-digit product class under the product coding system of the U.S. Department of Commerce, Bureau of the Census, 1987 Census of Manufactures and Census of Mineral Industries, 1989 Reference Series: Numerical List of Manufactured and Mineral Products (Issued February 1989) ("Numerical List").

Under the proposed regulations, in the case of depreciable tangible personal property that is not listed in a Product Code, or that is listed in a Product Code ending in a "9" (i.e., a miscellaneous category), the determination of whether the exchanged properties are of a like class is made based on all the facts and circumstances.

Several commentators suggested that the regulations provide a different approach to determine whether property is of a like class. The two most commonly suggested approaches were (1) expanding the use of categories contained in Rev. Proc. 87-56, and (2) using the 4-digit product coding system of the Numerical List.

The final regulations adopt a 4-digit coding system for classifying depreciable tangible personal property. Specifically, the regulations adopt the 4-digit product coding system within Division D of the Standard Industrial Classification codes, set forth in Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (1987) ("SIC Manual"). Division D contains a listing of manufactured products and equipment. The SIC Manual provides the framework for the Numerical List.

Adoption of the 4-digit SIC Manual coding system approach improves the administrability and certainty of these regulations in several ways. As a practical matter, the SIC Manual is much more readily available (e.g., at many public libraries) than the alternative Numerical List. In addition, the SIC Manual is referenced by other federal regulations. With respect to section 1031 exchanges, use of the 4-digit SIC Manual coding system will likely result in fewer categories (and fewer exchange groups), thus simplifying the administration of this provision in transactions involving a number of items of depreciable tangible *personal property. Furthermore, properties will more often be of a like class and thus fewer taxpayers will have to demonstrate that depreciable tangible personal properties exchanged are of a like kind. For example, under the 5-digit Numerical List, dairy equipment is in Product Code 35232 and haying machinery is in Product Code 35236. Thus, under the Numerical List these properties would not be of a like class. Under the 4-digit SIC Manual, however, dairy equipment and haying machinery are both within the same Product Classes (SIC Cod 3523), and are of a like class.*

Under the final regulations, property that is listed in a 4-digit product class ending in a "9" (i.e., a miscellaneous category) is not considered property within a Product Class. Accordingly, that property, and property that is not listed in a 4-digit product class, cannot be of a like class based on the 4-digit SIC Manual classification. Taxpayers may still demonstrate that these properties are of a like kind.

The final regulations provide that the Commissioner may, by guidance published in the Internal Revenue Bulletin, supplement the guidance provided in the final regulations relating to classification of properties. For example, the Commissioner may determine that two properties that are listed in separate product classes each ending in a "9" are of a like class, or that property that is not listed in any product class is of a like class to property that is listed in a product class.

Personal property held for investment

The proposed regulations did not provide like classes for personal property that is held for investment rather than for productive use in a business. Under the proposed regulations, therefore, an exchange of personal property held for investment could qualify for nonrecognition under section 1031 only if the exchanged properties were of a like kind. Many commentators pointed out that certain types of depreciable tangible personal property are held for investment. Examples of depreciable tangible personal property held for investment are the lamps, carpets and other furnishings in a building that is held for investment. The commentators stated that it would facilitate compliance with and administration of the regulations not to restrict taxpayers holding such property for investment to the less objective like-kind standard.

Upon further consideration, the Service has concluded that it is appropriate to extend the like-class provisions of the proposed regulations to depreciable tangible personal property held for investment, and the final regulations so provide. As under the proposed regulations, no like classes are provided for intangible personal property or for nondepreciable personal property. Exchanges of these types of properties qualify under section 1031 only if the properties are of a like kind. Nondepreciable personal property held for investment generally includes items considered to be collectibles, for example, works of art, antiques, gems, stamps, precious metals, coins, and historical objects.

Goodwill

Under the proposed regulations, neither the goodwill nor going concern value of dissimilar businesses is of a like kind. The proposed regulations also proposed treating goodwill or going concern value of similar businesses as being of a like kind only in rare and unusual circumstances.

After considering comments received on this issue, the Internal Revenue Service has concluded that the nature and character of goodwill and going concern value of a business are so inherently unique and inseparable from the business that goodwill or going concern value of one business can never be of a like kind to goodwill or going concern value of another business.

Accordingly, under the final regulations, goodwill or going concern value of a business activity are not of a like kind to goodwill or going concern value of another business activity.

Several commentators suggested that this rule would be inappropriate because section 1031 (a) (2), which provides exceptions to property eligible for nonrecognition treatment under section 1031 (a) (1), does not list goodwill or going concern value. The legislative history of section 1031 (a) (2) demonstrates, however, that these exceptions were provided for reasons unrelated to whether the enumerated properties could be of a like kind to any other property. The fact that goodwill or going concern value is not listed in section 1031 (a) (2) therefore does not establish that goodwill or going concern value can be of a like kind.

De Minimus exception

Several commentators suggested that the regulations provide an exception from the multiple property rules for items of personal property that have de minimus value. The suggestions generally were premised on the argument that the exception would eliminate small dollar exchange groups, thus simplifying the application of the regulations. The commentators suggesting a section 1031 de minimus rule did not address the application of section 1245 to section 1031 exchanges. In cases in which a section 1031 de minimus rule typically would apply, section 1245 (a) (1) and (b) (4) would also apply. Section 1245 (a) (1) generally requires the "recapture" of prior depreciation or amortization deductions as ordinary income. Although section 1245 (b) (4) provides an exception from the recapture requirements of like-kind exchanges, this exception is limited; a taxpayer who transfers section 1245 property in a section 1031 exchange must recognize recapture gain to the extent of (i) any gain recognized on the exchange (determined without regard to section 1245) plus (ii) the fair market value of property acquired which is like-kind property under section 1031 but which is not section 1245 property. See §1.1245-4(d). Thus, a de minimus rule under section 1031 generally would neither relieve taxpayers from gain recognition nor simplify the application of the regulations. Accordingly, the final regulations do not contain a de minimus exception.

Netting of liabilities--debt in anticipation

Section 1.1031 (b)-1(c) of the existing regulations provides that consideration received in the form of an assumption of a liability (or a transfer of property subject to a liability) is to be treated as "other property or money" for purposes of section 1031 (b). Further, in determining the amount of "other property or money" for purposes of section 1031 (b), consideration given in the form of an assumption of a liability (or a receipt of property subject to a liability) is offset against consideration received in the form of an assumption of a liability (or a *transfer of property subject to a liability). Section 1.1031 (d)-2, examples (1) and (2), provides additional rules.*

The proposed regulations would have amended §1.1031 (b)-1 (c) to clarify that, in determining the amount of "other property or money" for purposes of section 1031 (b), consideration received by the taxpayer in the form of an assumption of a liability (or a transfer of property subject to a liability) may not be offset by consideration given by the taxpayer in the form of an assumption of a liability (or a receipt of property subject to a liability) with respect to a liability incurred by the taxpayer in anticipation of an exchange under section 1031.

Commentators demonstrated that the proposed rule could create substantial uncertainty in the tax results of exchange transactions involving liabilities on both relinquished and replacement properties. The final regulations do not include this proposed amendment.

<u>Other liabilities issues</u>

Under the proposed regulations, all liabilities of which the taxpayer is relieved are offset against all liabilities assumed by the taxpayer in the exchange, regardless of whether the liabilities are recourse or nonrecourse and regardless of whether the liabilities are secured by or otherwise relate to specific property transferred or received as part of the exchange. If the taxpayer assumes excess liabilities as part of the exchange (i.e., the amount of liabilities the taxpayer assumes exceeds the amount of the liabilities of which the taxpayer is relieved), the excess is allocated to the properties received in all the exchange groups, based on their fair market value and to the extent of their fair market values.

Several commentators suggested that the proposed rules not be adopted. In general, these commentators suggested that excess liabilities be allocated instead to property, if any, securing the indebtedness. This rule could be manipulated, however, in any case in which the lender permitted substitution of, or additions to, loan security in contemplation of the exchange transaction. It would put a premium on sophisticated tax planning and would not improve the administrability of the regulations. The final regulations do not change either §1.1031(d)-2 of the existing regulations or the proposed regulations on allocating excess liabilities.

<u>Effective date</u>

The regulations contained in this Treasury decision are effective for exchanges occurring on or after April 11, 1991. For exchanges occurring prior to April 11, 1991 the Internal Revenue Service will take into account whether the properties exchanged would be of a like class under these regulations in determining whether those properties are of a like kind.

<u>Special analyses</u>

It has been determined that these final rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. Although this Treasury decision was preceded by a notice of proposed rulemaking that solicited public comments, the notice was not required by 5 U.S.C. § 553 because the regulations proposed in that notice and adopted by this Treasury decision are interpretive. Therefore, a final Regulatory Flexibility Analysis is not required by the Regulatory Flexibility Act (5 U.S.C. Chapter 6). In accordance with section 7805 (f) of the Internal Revenue Code, the proposed regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

<u>Drafting information</u>

The principal authors of these final regulation are Debra L. Fischer and Arthur E. Davis III of the Office of Assistant Chief Counsel, Income Tax & Accounting. However, personnel from other offices of the Treasury Department and from the Internal Revenue Service participated in developing the regulations on matters of both substance and style.

1.1031(a)-2 ADDITIONAL RULES FOR EXCHANGES OF PERSONAL PROPERTY.

(a) INTRODUCTION.

Section 1.1031(a)-1(b) provides that the nonrecognition rules of section 1031 do not apply to an exchange of one kind or class of property for property of a different kind or class. This section contains additional rules for determining whether personal property has been exchanged for property of a like kind or like class. Personal properties of a like class are considered to be of a "like kind" for purposes of section 1031. In addition, an exchange of properties of a like kind may qualify under section 1031 regardless of whether the properties are also of a like class. In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class. Under paragraph (b) of this section, depreciable tangible personal properties are of a like class if they are either within the same General Asset Class (as defined in paragraph (b)(2) of this section) or within the same Product Class (as defined in paragraph (b)(3) of this section). Paragraph (c) of this section provides rules for exchanges of intangible personal property and non depreciable personal property.

(b) DEPRECIABLE TANGIBLE PERSONAL PROPERTY

(1) GENERAL RULE.

Depreciable tangible personal property is exchanged for property of a "like kind" under section 1031 if the property is exchanged for property of a like kind or like class. Depreciable tangible personal property is of a like class to other depreciable tangible personal property if the exchanged properties are either within the same General Asset Class or within the same Product Class. A single property may not be classified within more than one General Asset Class or within more than one Product Class. In addition, property classified within any General Asset Class may not be classified within a Product Class. A property's General Asset Class or Product Class is determined as of the date of the exchange.

(2) GENERAL ASSET CLASSES.

Except as provided in paragraphs (b)(4) and (b)(5) of this section, property within a General Asset Class consists of depreciable tangible personal property described in one of asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87- 56, 1987-2 C.B. 674. These General Asset Classes describe types of depreciable tangible personal property that frequently are used in many businesses. The General Asset Classes are as follows:

(i) Office furniture, fixtures, and equipment (asset class 00.11),
(ii) Information systems (computers and peripheral equipment) (asset class 00.12),
(iii) Data handling equipment, except computers (asset class 00.13),

(iv) Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21),
(v) Automobiles, taxis (asset class 00.22),
(vi) Buses (asset class 00.23),
(vii) Light general purpose trucks (asset class 00.241),
(viii) Heavy general purpose trucks (asset class 00.242),
(ix) Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25),
(x) Tractor units for use over-the-road (asset class 00.26),
(xi) Trailers and trailer-mounted containers (asset class 00.27),
(xii) Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28), and
(xiii) Industrial steam and electric generation and/or distribution systems (asset class 00.4).

(3) PRODUCT CLASSES.

Except as provided in paragraphs (b)(4) and (b)(5) of this section, property within a Product Class consists of depreciable tangible personal property that is listed in a 4-digit product class within Division D of the Standard Industrial Classification codes, set forth in Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (1987) ("SIC Manual"). Copies of the SIC Manual may be obtained from the National Technical Information Service, an agency of the U.S. Department of Commerce. Division D of the SIC Manual contains a listing of manufactured products and equipment. For this purpose, any 4-digit product class ending in a "9" (i.e., a miscellaneous category) will not be considered a Product Class. If a property is listed in more than one product class, the property is treated as listed in any one of those product classes. A property's 4-digit product classification is referred to as the property's "SIC Code."

(4) MODIFICATIONS OF REV. PROC. 87-56 AND SIC MANUAL.

The asset classes of Rev. Proc. 87-56 and the product classes of the SIC Manual may be updated or otherwise modified from time to time. In the event Rev. Proc. 87-56 is modified, the General Asset Classes will follow the modification, and the modification will be effective for exchanges occurring on or after the date the modification is published in the Internal Revenue Bulletin, unless otherwise provided. Similarly, in the event the SIC Manual is modified, the Product Classes will follow the modification, and the modification will be effective for exchanges occurring on or after the effective date of the modification. However, taxpayers may rely on the unmodified SIC Manual for exchanges occurring during the one-year period following the effective date of the modification. The SIC Manual generally is modified every five years, in years ending in a 2 or 7 (e.g., 1987 and 1992). The effective date of the modified SIC Manual is announced in the Federal Register and generally is January 1 of the year the SIC Manual is modified.

(5) MODIFIED CLASSIFICATION THROUGH PUBLISHED GUIDANCE.

The Commissioner may, by guidance published in the Internal Revenue Bulletin, supplement the guidance provided in this section relating to classification of properties. For example, the Commissioner may determine not to follow, in whole or in part, any modification of Rev. Proc. 87-56 of the SIC Manual. The Commissioner may also determine that two types of property that are listed in separate product classes each ending in a "9" are of a like class, or that a type of property that has a SIC Code is of a like class to a type of property that does not have a SIC Code.

(6) NO INFERENCE OUTSIDE OF SECTION 1031.

The rules provided in this section concerning the use of Rev. Proc. 87-56 and the SIC Manual are limited to exchanges under section 1031. No inference is intended with respect to the classification of property for other purposes, such as depreciation.

(7) EXAMPLES.

The application of this paragraph (b) may be illustrated by the following examples:

EXAMPLE 1. Taxpayer A transfers a personal computer (asset class 00.12) to B in exchange for a printer (asset class 00.12). With respect to A, the properties exchanged are within the same General Asset Class and therefore are of a like class.

EXAMPLE 2. Taxpayer C transfers an airplane (asset class 00.21) to D in exchange for a heavy general purpose truck (asset class 00.242). The properties exchanged are not of a like class because they are within different General Asset Classes. Because each of the properties is within a General Asset Class, the properties may not be classified within a Product Class. The airplane and heavy general purpose truck are also not of a like kind. Therefore, the exchange does not qualify for nonrecognition of gain or loss under section 1031.

EXAMPLE 3. Taxpayer E transfers a grader to F in exchange for a scraper. Neither property is within any of the General Asset Classes, and both properties are within the same Product Class (SIC Code 3533). With respect to E, therefore, the properties exchanged are of a like class.

EXAMPLE 4. Taxpayer G transfers a personal computer (asset class 00.12), an airplane (asset class 00.21) and a sanding machine (SIC Code 3553), to H in exchange for a printer (asset class 00.12), a heavy general purpose truck (asset class 00.242) and a lathe (SIC Code 3553). The personal computer and the printer are of a like class because they are within the same General Asset Class; the sanding machine and the lathe are of a like class because neither property is within any of the General Asset Classes and they are within the same Product Class. The airplane and the heavy general purpose truck are neither within the same General Asset Class nor within the same Product Class, and are not of a like kind.

(c) INTANGIBLE PERSONAL PROPERTY AND NONDEPRECIABLE PERSONAL PROPERTY --

(1) GENERAL RULE.

An exchange of intangible personal property or non depreciable personal property qualifies for nonrecognition of gain or loss under section 1031 only if the exchanged properties are of a like kind. No like classes are provided for these properties. Whether intangible personal property is of a like kind to other intangible personal property generally depends on the nature or character of the rights involved (e.g., a patent or a copyright) and also on the nature or character of the underlying property to which the intangible personal property relates.

(2) GOODWILL AND GOING CONCERN VALUE.

The goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business.

(3) EXAMPLES.

The application of this paragraph (c) may be illustrated by the following examples:

EXAMPLE (1). Taxpayer K exchanges a copyright on a novel for a copyright on a different novel. The properties exchanged are of a like kind.

EXAMPLE (2). Taxpayer J exchanges a copyright on a novel for a copyright on a song. The properties exchanged are not of a like kind.

(d) EFFECTIVE DATE.

Section 1.1031(a)-2 is effective for exchanges occurring on or after April 11, 1991.
[T.D. 8343, 56 FR 14854, Apr. 12, 1991, as amended by T.D. 8346, 56 FR 19938, May 3, 1991]

1.1031(b)-1 RECEIPT OF OTHER PROPERTY OR MONEY IN TAX-FREE EXCHANGE.

(a) If the taxpayer receives other property (in addition to property permitted to be received without recognition of gain) or money-

(1) In an exchange described in section 1031(a) of property held for investment or productive use in trade or business for property of like kind to be held either for productive use or for investment,

(2) In an exchange described in section 1035(a) of insurance policies or annuity contracts,

(3) In an exchange described in section 1036(a) of common stock for common stock, or preferred stock for preferred stock, in the same corporation and not in connection with a corporate reorganization, or

(4) In an exchange described in section 1037(a) of obligations of the United States, issued under the Second Liberty Bond Act (31 U.S.C. 774 (2)), solely for other obligations issued under such Act, the gain, if any, to the taxpayer will be recognized under section 1031(b) in an amount not in excess of the sum of the money and the fair market value of the other property, but the loss, if any, to the taxpayer from such an exchange will not be recognized under section 1031(c) to any extent.

(b) The application of this section may be illustrated by the following examples:

Example (1). A, who is not a dealer in real estate, in 1954 exchanges real estate held for investment, which he purchased in 1940 for $5,000, for other real estate (to be held for productive use in trade or business) which has a fair market value of $6,000, and $2,000 in cash. The gain from the transaction is $3,000, but is recognized only to the extent of the cash received of $2,000.

Example (2). (a) B, who uses the cash receipts and disbursements method of accounting and the calendar year as his taxable year, has never elected under section 454(a) to include in gross income currently the annual increase in the redemption price of non-interest-bearing obligations issued at a discount. In 1943, for $750 each, B purchased four $1,000 series E U.S. savings bonds bearing an issue date of March 1, 1943.

(b) On October 1, 1963, the redemption value of each such bond was $1,396, and the total redemption value of the four bonds was $5,584. On that date B submitted the four $1,000 series E bonds to the United States in a transaction in which one of such $1,000 bonds was reissued by issuing four $100 series E U.S. savings bonds bearing an issue date of March 1, 1943, and by considering six $100 series E bonds bearing an issue date of March 1, 1943, to have been issued. The redemption value of each such $100 series E bond was $139.60 on October 1, 1963. Then, as part of the transaction, the six $100 series E bonds so considered to have been issued and the three $1,000 series E bonds were exchanged, in an exchange qualifying under section 1037(a), for five $1,000 series H U.S. savings bonds plus $25.60 in cash.

(c) The gain realized on the exchange qualifying under section 1037(a) is $2,325.60, determined as follows:

Amount realized:	
Par value of five series H bonds:	$5,000.00

Cash received:	$25.60
	________
Total realized:	$5,025.60
Less: Adjusted basis of series E bonds surrendered in the exchange:	
Three $1,000 series E bonds:	$2,250.00
Six $100 series E bonds at $75 each:	$450.00
	________
	$2,700.00
Gain realized:	$2,325.60

(d) Pursuant to section 1031(b), only $25.60 (the money received) of the total gain of $2,325.60 realized on the exchange is recognized at the time of exchange and must be included in B's gross income for 1963. The $2,300 balance of the gain ($2,325.60 less $25.60) must be included in B's gross income for the taxable year in which the series H bonds are redeemed or disposed of, or reach final maturity, whichever is earlier, as provided in paragraph (c) of 1.454-1.

(e) The gain on the four $100 series E bonds, determined by using $75 as a basis for each such bond, must be included in B's gross income for the taxable year in which such bonds are redeemed or disposed of, or reach final maturity, whichever is earlier.

Example (3). (a) The facts are the same as in example (2), except that, as part of the transaction, the $1,000 series E bond is reissued by considering ten $100 series E bonds bearing an issue date of March 1, 1943, to have been issued. Six of the $100 series E bonds so considered to have been issued are surrendered to the United States as part of the exchange qualifying under section 1037(a) and the other four are immediately redeemed.

(b) Pursuant to section 1031(b), only $25.60 (the money received) of the total gain of $2,325.60 realized on the exchange qualifying under section 1037(a) is recognized at the time of the exchange and must be included in B's gross income for 1963. The $2,300 balance of the gain ($2,325.60 less $25.60) realized on such exchange must be included in B's gross income for the taxable year in which the series H bonds are redeemed or disposed of, or reach final maturity, whichever is earlier, as provided in paragraph (c) of 1.454-1.

(c) The redemption on October 1, 1963, of the four $100 series E bonds considered to have been issued at such time results in gain of $258.40, which is then recognized and must be included in B's gross income for 1963. This gain of $258.40 is the difference between the $558.40 redemption value of such bonds on the date of the exchange and the $300 (4 x $75) paid for such series E bonds in 1943.

Example (4). On November 1, 1963, C purchased for $91 a marketable U.S. bond which was originally issued at its par value of $100 under the Second Liberty Bond Act. On February 1, 1964, in an exchange qualifying under section 1037(a), C surrendered the bond to the United States for another marketable U.S. bond, which then had a fair market value of $92, and $1.85 in cash, $0.85 of which was interest. The $0.85 interest received is includable in gross income for the taxable year of the exchange, but the $2 gain ($93 less $91) realized on the exchange is recognized for such year under section 1031(b) to the extent of $1 (the money received). Under section 1031(d), C's basis in the bond received in exchange is $91 (his basis of $91 in the bond surrendered, reduced by the $1 money received and increased by the $1 gain recognized).

(c) Consideration received in the form of an assumption of liabilities (or a transfer subject to a liability) is to be treated as "other property or money" for the purposes of section 1031(b). Where, on an exchange described in section 1031(b), each party to the exchange either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of "other property or money" for purposes of section 1031(b), consideration given in the form of an assumption of liabilities (or a receipt of property subject to a liability) shall be offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability). See 1.1031(d)-2, examples (1) and (2).
[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15822, Nov. 17, 1967]

1.1031(b)-2 SAFE HARBOR FOR QUALIFIED INTERMEDIARIES.

(a) In the case of simultaneous transfers of like-kind properties involving a qualified intermediary (as defined in section 1.1031(k)-1(g)(4)(iii)), the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the transfer and receipt of property by the taxpayer is treated as an exchange.

(b) In the case of simultaneous exchanges of like-kind properties involving a qualified intermediary (as defined in §1.1031(k)-1(g)(4)(iii)), the receipt by the taxpayer of an evidence of indebtedness of the transferee of the qualified intermediary is treated as the receipt of an evidence of indebtedness of the person acquiring property from the taxpayer for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter.

(c) Paragraph (a) of this section applies to transfers of property made by taxpayers on or after June 10, 1991.

(d) Paragraph (b) of this section applies to transfers of property made by taxpayers on or after April 19, 1994. A taxpayer may choose to apply paragraph (b) of this section to transfers of property made on or after June 10, 1991.

1.1031(c)-1 NONRECOGNITION OF LOSS.

Section 1031(c) provides that a loss shall not be recognized from an exchange of property described in section 1031(a), 1035(a), 1036(a), or 1037(a) where there is received in the exchange other property or money in addition to property permitted to be received without recognition of gain or loss. See example (4) of paragraph (a)(3) of 1.1037-1 for an illustration of the application of this section in the case of an exchange of U.S. obligations described in section 1037(a).
[T.D. 6935, 32 FR 15822, Nov. 17, 1967]
1.1031(d)-1 PROPERTY ACQUIRED UPON A TAX-FREE EXCHANGE.

(a) If, in an exchange of property solely of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), no part of the gain or loss was recognized under the law applicable to the year in which the exchange was made, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange. If additional consideration is given by the taxpayer in the exchange, the basis of the property acquired shall be the same as the property transferred increased by the amount of additional consideration given (see section 1016 and the regulations thereunder).

(b) If, in an exchange of properties of the type indicated in section 1031, section 1035(a), section 1036(a), or section 1037(a), gain to the taxpayer was recognized under the provisions of section 1031(b) or a similar provision of a prior revenue law, on account of the receipt of money in the transaction, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized on the exchange. The application of this paragraph may be illustrated by the following example:

Example. A, an individual in the moving and storage business, in 1954 transfers one of his moving trucks with an adjusted basis in his hands of $2,500 to B in exchange for a truck (to be used in A's business) with a fair market value of $2,400 and $200 in cash. A realizes a gain of $100 upon the exchange, all of which is recognized under section 1031(b). The basis of the truck acquired by A is determined as follows:

Adjusted basis of A's former truck:	$2,500
Less: Amount of money received:	$200
	______
Difference:	$2,300
Plus: Amount of gain recognized:	$100
Basis of truck acquired by A:	$2,400

(c) If, upon an exchange of properties of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), the taxpayer received other property (not permitted to be received without the recognition of gain) and gain from the transaction was recognized as required under section 1031(b), or a similar provision of a prior revenue law, the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of any money received and increased by the amount of gain recognized, must be allocated to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of the basis of the properties received, there must be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. The application of this paragraph may be illustrated by the following example:
Example. A, who is not a dealer in real estate, in 1954 transfers real estate held for investment which he purchased in 1940 for $10,000 in exchange for other real estate (to be held for investment) which has a fair market value of $9,000, an automobile which has a fair market value of $2,000, and $1,500 in cash. A realizes a gain of $2,500, all of which is recognized under section 1031(b). The basis of the property received in exchange is the basis of the real estate A transfers ($10,000) decreased by the amount of money received ($1,500) and increased in the amount of gain that was recognized ($2,500), which results in a basis for the property received of $11,000. This basis of $11,000 is allocated between the automobile and the real estate received by A, the basis of the automobile being its fair market value at the date of the exchange, $2,000, and the basis of the real estate received being the remainder, $9,000.

(d) Section 1031(c) and, with respect to section 1031 and section 1036(a), similar provisions of prior revenue laws provide that no loss may be recognized on an exchange of properties of a type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), although the taxpayer receives other property or money from the transaction. However, the basis of the property or properties (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be allocated to the properties received, and for this purpose there must be allocated to such other property an amount of such basis equivalent to its fair market value at the date of the exchange.

(e) If, upon an exchange of properties of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), the taxpayer also exchanged other property (not permitted to be transferred without the recognition of gain or loss) and gain or loss from the transaction is recognized under section 1002 or a similar provision of a prior revenue law, the basis of the property acquired is the total basis of the properties transferred (adjusted to the date of the exchange) increased by the amount of gain and decreased by the amount of loss recognized on the other property. For purposes of this rule, the taxpayer is deemed to have received in exchange for such other property an amount equal to its fair market value on the date of the exchange. The application of this paragraph may be illustrated by the following example:

Example. A exchanges real estate held for investment plus stock for real estate to be held for investment. The real estate transferred has an adjusted basis of $10,000 and a fair market value of $11,000. The stock transferred has an adjusted basis of $4,000 and a fair market value of $2,000. The real estate acquired has a fair market value of $13,000. A is deemed to have received a $2,000 portion of the acquired real estate in exchange for the stock, since $2,000 is the fair market value of the stock at the time of the exchange. A $2,000 loss is recognized under section 1002 on the exchange of the stock for real estate. No gain or loss is recognized on the exchange of the real estate since the property received is of the type permitted to be received without recognition of gain or loss. The basis of the real estate acquired by A is determined as follows:

Adjusted basis of real estate transferred:	$10,000
Adjusted basis of stock transferred:	$4,000
	$14,000
Less: Loss recognized on transfer of stock:	$2,000
Basis of real estate acquired upon the exchange:	$12,000

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15823, Nov. 17, 1967]

1.1031(d)-1T COORDINATION OF SECTION 1060 WITH SECTION 1031 (TEMPORARY).

If the properties exchanged under section 1031 are part of a group of assets which constitute a trade or business under section 1060, the like-kind property and other property or money which are treated as transferred in exchange for the like-kind property shall be excluded from the allocation rules of section 1060. However, section 1060 shall apply to property which is not like-kind property or other property or money which is treated as transferred in exchange for the like-kind property. For application of the section 1060 allocation rules to property which is not part of the like-kind exchange, see 1.1060-1T (b), (d), and (g) Example (3).

[T.D. 8215, 53 FR 27044, July 18, 1988]

1.1031(d)-2 TREATMENT OF ASSUMPTION OF LIABILITIES.

For the purposes of section 1031(d), the amount of any liabilities of the taxpayer assumed by the other party to the exchange (or of any liabilities to which the property exchanged by the taxpayer is subject) is to be treated as money received by the taxpayer upon the exchange, whether or not the assumption resulted in a recognition of gain or loss to the taxpayer under the law applicable to the year in which the exchange was made. The application of this section may be illustrated by the following examples:

Example (1). B, an individual, owns an apartment house which has an adjusted basis in his hands of $500,000, but which is subject to a mortgage of $150,000. On September 1, 1954, he transfers the apartment house to C, receiving in exchange therefor $50,000 in cash and another apartment house with a fair market value on that date of $600,000. The transfer to C is made subject to the $150,000 mortgage. B realizes a gain of $300,000 on the exchange, computed as follows:

Value of property received:	$600,000
Cash:	$50,000
Liabilities subject to which old property was transferred:	$150,000
Total consideration received:	$800,000
Less: Adjusted basis of property transferred:	$500,000
Gain realized:	$300,000

Under section 1031(b), $200,000 of the $300,000 gain is recognized. The basis of the apartment house acquired by B upon the exchange is $500,000, computed as follows:

Adjusted basis of property transferred:	$500,000
Less: Amount of money received: Cash:	$50,000
Amount of liabilities subject to which property was transferred:	$150,000
	$200,000
Difference:	$300,000
Plus: Amount of gain recognized upon the exchange:	$200,000
Basis of property acquired upon the exchange	$500,000

Example (2). (a) D, an individual, owns an apartment house. On December 1, 1955, the apartment house owned by D has an adjusted basis in his hands of $100,000, a fair market value of $220,000, but is subject to a mortgage of $80,000. E, an individual, also owns an apartment house. On December 1, 1955, the apartment house owned by E has an adjusted basis of $175,000, a fair market value of $250,000, but is subject to a mortgage of $150,000. On December 1, 1955, D transfers his apartment house to E, receiving in exchange therefore $40,000 in cash and the apartment house owned by E. Each apartment house is transferred subject to the mortgage on it.

(b) D realizes a gain of $120,000 on the exchange, computed as follows:

Value of property received:	$250,000
Cash:	$40,000
Liabilities subject to which old property was transferred:	$80,000
Total consideration received:	$370,000
Less: Adjusted basis of property transferred:	$100,000
Liabilities to which new property is subject:	$150,000
_	$250,000
Gain realized:	$120,000

For purposes of section 1031(b), the amount of "other property or money" received by D is $40,000. (Consideration received by D in the form of a transfer subject to a liability of $80,000 is offset by consideration given in the form of a receipt of property subject to a $150,000 liability. Thus, only the consideration received in the form of cash, $40,000, is treated as "other property or money" for purposes of section 1031(b).) Accordingly, under section 1031(b), $40,000 of the $120,000 gain is recognized. The basis of the apartment house acquired by D is $170,000, computed as follows:

Adjusted basis of property transferred:	$100,000
Liabilities to which new property is subject:	$150,000
_	
Total:	$250,000
Less: Amount of money received:	
Cash:	$40,000
Amount of liabilities subject to which property was transferred:	$80,000
	$120,000
Difference:	$130,000
Plus: Amount of gain recognized upon the exchange:	$40,000
Basis of property acquired upon the exchange:	$170,000

(c) E realizes a gain of $75,000 on the exchange, computed as follows:

Value of property received:	$220,000
Liabilities subject to which old property was transferred:	$150,000
Total consideration received:	$370,000
Less:	
Adjusted basis of property transferred:	$175,000
Cash:	$40,000
Liabilities to which new property is subject:	$80,000
_	$295,000
Gain realized:	$75,000

For purposes of section 1031(b), the amount of "other property or money" received by E is $30,000. (Consideration received by E in the form of a transfer subject to a liability of $150,000 is offset by consideration given in the form of a receipt of property subject to an $80,000 liability and by the $40,000 cash paid by E. Although consideration received in the form of cash or other property is not offset by consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability, consideration given in the form of cash or other property is offset against consideration received in the form of an assumption of liabilities or a transfer of property subject to a liability.) Accordingly, under section 1031(b), $30,000 of the $75,000 gain is recognized. The basis of the apartment house acquired by E is $175,000, computed as follows:

Adjusted basis of property transferred:	$175,000
Cash:	$40,000
Liabilities to which new property is subject:	$80,000

Total:	$295,000
Less: Amount of money received:	$0
Amount of liabilities subject to which property was transferred:	$150,000
	$150,000
Difference:	$145,000
Plus: Amount of gain recognized upon the exchange:	$30,000
Basis of property acquired upon the exchange:	$175,000

1.1031(e)-1 EXCHANGE OF LIVESTOCK OF DIFFERENT SEXES.

Section 1031(e) provides that livestock of different sexes are not property of like kind. Section 1031(e) and this section are applicable to taxable years to which the Internal Revenue Code of 1954 applies.

[T.D. 7141, 36 FR 18792, Sept. 22, 1971]

1.1031(j)-1 EXCHANGES OF MULTIPLE PROPERTIES.

(a) INTRODUCTION --

(1) OVERVIEW.

As a general rule, the application of section 1031 requires a property-by-property comparison for computing the gain recognized and basis of property received in a like-kind exchange. This section provides an exception to this general rule in the case of an exchange of multiple properties. An exchange is an exchange of multiple properties if, under paragraph (b)(2) of this section, more than one exchange group is created. In addition, an exchange is an exchange of multiple properties if only one exchange group is created but there is more than one property being transferred or received within that exchange group. Paragraph (b) of this section provides rules for computing the amount of gain recognized in an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031. Paragraph (c) of this section provides rules for computing the basis of properties received in an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031.

(2) GENERAL APPROACH.

(i) IN GENERAL, the amount of gain recognized in an exchange of multiple properties is computed by first separating the properties transferred and the properties received by the taxpayer in the exchange into exchange groups in the manner described in paragraph (b)(2) of this section. The separation of the properties transferred and the properties received in the exchange into exchange groups involves matching up properties of a like kind or like class to the extent possible. Next, all liabilities assumed by the taxpayer as part of the transaction are offset by all liabilities of which the taxpayer is relieved as part of the transaction, with the excess liabilities assumed or relieved allocated in accordance with paragraph (b)(2)(ii) of this section. Then, the rules of section 1031 and the regulations thereunder are applied separately to each exchange group to determine the amount of gain recognized in the exchange. See sections 1.1031(b)-1 and 1.1031(c)-1. Finally, the rules of section 1031 and the regulations thereunder are applied separately to each exchange group to determine the basis of the properties received in the exchange. See sections 1.1031(d)-1 and 1.1031(d)-2.

(ii) For purposes of this section, the exchanges are assumed to be made at arms' length, so that the aggregate fair market value of the property received in the exchange equals the aggregate fair market value of the property transferred. Thus, the amount realized with respect to the properties transferred in each exchange group is assumed to equal their aggregate fair market value.

(b) COMPUTATION OF GAIN RECOGNIZED --

(1) IN GENERAL.

In computing the amount of gain recognized in an exchange of multiple properties, the fair market value must be determined for each property transferred and for each property received by the taxpayer in the exchange. In addition, the adjusted basis must be determined for each property transferred by the taxpayer in the exchange.

(2) EXCHANGE GROUPS AND RESIDUAL GROUP.

The properties transferred and the properties received by the taxpayer in the exchange are separated into exchange groups and a residual group to the extent provided in this paragraph (b)(2).

(i) EXCHANGE GROUPS.

Each exchange group consists of the properties transferred and received in the exchange, all of which are of a like kind or like class. If a property could be included in more than one exchange group, the taxpayer may include the property in any of those exchange groups. Property eligible for inclusion within an exchange group does not include money or property described in section 1031(a)(2) (i.e., stock in trade or other property held primarily for sale, stocks, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action). For example, an exchange group may consist of all exchanged properties that are within the same General Asset Class or within the same Product Class (as defined in section 1.1031(a)-2(b)). Each exchange group must consist of at least one property transferred and at least one property received in the exchange.

(ii) TREATMENT OF LIABILITIES.

(A) All liabilities assumed by the taxpayer as part of the exchange are offset against all liabilities of which the taxpayer is relieved as part of the exchange, regardless of whether the liabilities are recourse or nonrecourse and regardless of whether the liabilities are secured by or otherwise relate to specific property transferred or received as part of the exchange. See sections 1.1031(b)-1(c) and 1.1031(d)-2. For purposes of this section, liabilities assumed by the taxpayer as part of the exchange consist of liabilities of the other party to the exchange assumed by the taxpayer and liabilities subject to which the other party's property is transferred in the exchange. Similarly, liabilities of which the taxpayer is relieved as part of the exchange consist of liabilities of the taxpayer assumed by the other party to the exchange and liabilities subject to which the taxpayer's property is transferred.

(B) If there are excess liabilities assumed by the taxpayer as part of the exchange (i.e., the amount of liabilities assumed by the taxpayer exceeds the amount of liabilities of which the taxpayer is relieved), the excess is allocated among the exchange groups (but not to the residual group) in proportion to the aggregate fair market value of the properties received by the taxpayer in the exchange groups. The amount of excess liabilities assumed by the taxpayer that are allocated to each exchange group may not exceed the aggregate fair market value of the properties received in the exchange group.

(C) If there are excess liabilities of which the taxpayer is relieved as part of the exchange (i.e., the amount of liabilities of which the taxpayer is relieved exceeds the amount of liabilities assumed by the taxpayer), the excess is treated as a Class I asset for purposes of making allocations to the residual group under paragraph (b)(2)(iii) of this section.

(D) Paragraphs (b)(2)(ii)(A), (B), and (C) of this section are applied in the same manner even if section 1031 and this section apply to only a portion of a larger transaction (such as a transaction described in section 1060(c) and section 1.1060-1T(b)). In that event, the amount of excess liabilities assumed by the taxpayer or the amount of excess liabilities of which the taxpayer is relieved is determined based on all liabilities assumed by the taxpayer and all liabilities of which the taxpayer is relieved as part of the larger transaction.

(iii) RESIDUAL GROUP.

If the aggregate fair market value of the properties transferred in all of the exchange groups differs from the aggregate fair market value of the properties received in all of the exchange groups (taking liabilities into account in the manner described in paragraph (b)(2)(ii) of this section), a residual group is created. The residual group consists of an amount of money or other property having an aggregate fair market value equal to that difference. The residual group consists of either money or other property transferred in the exchange or money or other property received in the exchange, but not both. For this purpose, other property includes property described in section 1031(a)(2) (i.e., stock in trade or other property held primarily for sale, stocks, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action), property transferred that is not of a like kind or like class with any property received, and property received that is not of a like kind or like class with any property transferred. The money and properties that are allocated to the residual group are considered to come from the following assets in the following order: first from Class I assets, then from Class II assets, then from Class III assets, and then from Class IV assets. The terms Class I assets, Class II assets, Class III assets, and Class IV assets have the same meanings as in section 1.1060-1T(d). Within each Class, taxpayers may choose which properties are allocated to the residual group.

(iv) EXCHANGE GROUP SURPLUS AND DEFICIENCY.

For each of the exchange groups described in this section, an "exchange group surplus" or "exchange group deficiency," if any, must be determined. An exchange group surplus is the excess of the aggregate fair market value of the properties received (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group) in an exchange group over the aggregate fair market value of the properties transferred in that exchange group. An exchange group deficiency is the excess of the aggregate fair market value of the properties transferred in an exchange group over the aggregate fair market value of the properties received (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group) in that exchange group.

(3) AMOUNT OF GAIN RECOGNIZED. --

(i) For purposes of this section, the amount of gain or loss realized with respect to each exchange group and the residual group is the difference between the aggregate fair market value of the properties transferred in that exchange group or residual group and the properties' aggregate adjusted basis. The gain realized with respect to each exchange group is recognized to the extent of the lesser of the gain realized and the amount of the exchange group deficiency, if any. Losses realized with respect to an exchange group are not recognized. See section 1031 (a) and (c). The total amount of gain recognized under section 1031 in the exchange is the sum of the amount of gain recognized with respect to each exchange group. With respect to the residual group, the gain or loss realized (as determined under this section) is recognized as provided in section 1001 or other applicable provision of the Code.

(ii) The amount of gain or loss realized and recognized with respect to properties transferred by the taxpayer that are not within any exchange group or the residual group is determined under section 1001 and other applicable provisions of the Code, with proper adjustments made for all liabilities not allocated to the exchange groups or the residual group.

(c) COMPUTATION OF BASIS OF PROPERTIES RECEIVED.

In an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031 and this section, the aggregate basis of properties received in each of the exchange groups is the aggregate adjusted basis of the properties transferred by the taxpayer within that exchange group, increased by the amount of gain recognized by the taxpayer with respect to that exchange group, increased by the amount of the exchange group surplus or decreased by the amount of the exchange group deficiency, and increased by the amount, if any, of excess liabilities assumed by the taxpayer that are allocated to that exchange group. The resulting aggregate basis of each exchange group is allocated proportionately to each property received in the exchange group in accordance with its fair market value. The basis of each property received within the residual group (other than money) is equal to its fair market value.

(d) EXAMPLES.

The application of this section may be illustrated by the following examples:

EXAMPLE 1. (i) K exchanges computer A (asset class 00.12) and automobile A (asset class 00.22), both of which were held by K for productive use in its business, with W for printer B (asset class 00.12) and automobile B (asset class 00.22), both of which will be held by K for productive use in its business. K's adjusted basis and the fair market value of the exchanged properties are as follows:

	Adjusted Basis	Fair Market Value
Computer A	$375	$1000
Automobile A	$1500	$4000
Printer B		$2050
Automobile B		$2950

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A and printer B (both are within the same General Asset Class) and, as to K, has an exchange group surplus of $1050 because the fair market value of printer B ($2050) exceeds the fair market value of computer A ($1000) by that amount.

(B) The second exchange group consists of automobile A and automobile B (both are within the same General Asset Class) and, as to K, has an exchange group deficiency of $1050 because the fair market value of automobile A ($4000) exceeds the fair market value of automobile B ($2950) by that amount.

(iii) K recognizes gain on the exchange as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A ($1000) over its adjusted basis ($375), or $625. The amount of gain recognized is the lesser of the gain realized ($625) and the exchange group deficiency ($0), or $0.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A ($4000) over its adjusted basis ($1500), or $2500. The amount of gain recognized is the lesser of the gain realized ($2500) and the exchange group deficiency ($1050), or $1050.

(iv) The total amount of gain recognized by K in the exchange is the sum of the gains recognized with respect to both exchange groups ($0 + $1050), or $1050.

(v) The bases of the property received by K in the exchange, printer B and automobile B, are determined in the following manner:

(A) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($375), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($1050), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $1425. Because printer B was the only property received within the first exchange group, the entire basis of $1425 is allocated to printer B.

(B) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($1500), increased by the amount of gain recognized with respect to that exchange group ($1050), decreased by the amount of the exchange group deficiency ($1050), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $1500. Because automobile B was the only property received within the second exchange group, the entire basis of $1500 is allocated to automobile B.

EXAMPLE 2. (i) F exchanges computer A (asset class 00.12) and automobile A (asset class 00.22), both of which were held by F for productive use in its business, with G for printer B (asset class 00.12) and automobile B (asset class 00.22), both of which will be held by F for productive use in its business, and corporate stock and $500 cash. The adjusted basis and fair market value of the properties are as follows:

	Adjusted Basis	Fair Market Value
Computer A	$ 375	$1000
Automobile A	$3500	$4000
Printer B		$800
Automobile B		$2950
Corporate Stock		$750
Cash		$500

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A and printer B (both are within the same General Asset Class) and, as to F, has an exchange group deficiency of $200 because the fair market value of computer A ($1000) exceeds the fair market value of printer B ($800) by that amount.

(B) The second exchange group consists of automobile A and automobile B (both are within the same General Asset Class) and, as to F, has an exchange group deficiency of $1050 because the fair market value of automobile A ($4000) exceeds the fair market value of automobile B ($2950) by that amount.

(C) Because the aggregate fair market value of the properties transferred by F in the exchange groups ($5,000) exceeds the aggregate fair market value of the properties received by F in the exchange groups ($3750) by $1250, there is a residual group in that amount consisting of the $500 cash and the $750 worth of corporate stock.

(iii) F recognizes gain on the exchange as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A ($1000) over its adjusted basis ($375), or $625. The amount of gain recognized is the lesser of the gain realized ($625) and the exchange group deficiency ($200), or $200.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A ($4000) over its adjusted basis ($3500), or $500. The amount of gain recognized is the lesser of the gain realized ($500) and the exchange group deficiency ($1050), or $500.

(C) No property transferred by F was allocated to the residual group. Therefore, F does not recognize gain or loss with respect to the residual group.

(iv) The total amount of gain recognized by F in the exchange is the sum of the gains recognized with respect to both exchange groups ($200 + $500), or $700.

(v) The bases of the properties received by F in the exchange (printer B, automobile B, and the corporate stock) are determined in the following manner:

(A) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($375), increased by the amount of gain recognized with respect to that exchange group ($200), decreased by the amount of the exchange group deficiency ($200), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $375. Because printer B was the only property received within the first exchange group, the entire basis of $375 is allocated to printer B.

(B) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($3500), increased by the amount of gain recognized with respect to that exchange group ($500), decreased by the amount of the exchange group deficiency ($1050), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $2950. Because automobile B was the only property received within the second exchange group, the entire basis of $2950 is allocated to automobile B.

(C) The basis of the property received within the residual group (the corporate stock) is equal to its fair market value or $750. Cash of $500 is also received within the residual group.

EXAMPLE 3. (i) J and H enter into an exchange of the following properties. All of the property (except for the inventory) transferred by J was held for productive use in J's business. All of the property received by J will be held by J for productive use in its business.

J Transfers:				H Transfers:
Property	Adj. Basis	Fair Market Value	Property	Fair Market Value
Computer A	$1500	$5000	Computer Z	$4500
Computer B	500	3000	Printer Y	2500
Printer C	2000	1500	Real Estate X	1000
Real Estate D	1200	2000	Real Estate W	4000
Real Estate E	0	1800	Grader V	2000
Scraper F	3300	2500	Truck T	1700
Inventory	1000	1700	Cash	1800
Total	$9500	$17,500		$17,500

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A, computer B, printer C, computer Z, and printer Y (all are within the same General Asset Class) and, as to J, has an exchange group deficiency of $2500 [($5000 + $3000 + $1500) - ($4500 + $2500)].

(B) The second exchange group consists of real estate D, E, X and W (all are of a like kind) and, as to J, has an exchange group surplus of $1200 [($1000 + $4000) - ($2000 + $1800)].

(C) The third exchange group consists of scraper F and grader V (both are within the same Product Class (SIC Code 3531)) and, as to J, has an exchange group deficiency of $500 ($2500 - $2000).

(D) Because the aggregate fair market value of the properties transferred by J in the exchange groups ($15,800) exceeds the aggregate fair market value of the properties received by J in the exchange groups ($14,000) by $1800, there is a residual group in that amount consisting of the $1800 cash (a Class I asset).

(E) The transaction also includes a taxable exchange of inventory (which is property described in section 1031(a)(2)) for truck T (which is not of a like kind or like class to any property transferred in the exchange).

(iii) J recognizes gain on the transaction as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the aggregate fair market value of the properties transferred in the exchange group ($9500) over the aggregate adjusted basis ($4000), or $5500. The amount of gain recognized is the lesser of the gain realized ($5500) and the exchange group deficiency ($2500), or $2500.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the aggregate fair market value of the properties transferred in the exchange group ($3800) over the aggregate adjusted basis ($1200), or $2600. The amount of gain recognized is the lesser of the gain realized ($2600) and the exchange group deficiency ($0), or $0.

(C) With respect to the third exchange group, a loss is realized in the amount of $800 because the fair market value of the property transferred in the exchange group ($2500) is less than its adjusted basis ($3300). Although a loss of $800 was realized, under section 1031 (a) and (c) losses are not recognized.

(D) No property transferred by J was allocated to the residual group. Therefore, J does not recognize gain or loss with respect to the residual group.

(E) With respect to the taxable exchange of inventory for truck T, gain of $700 is realized and recognized by J (amount realized of $1700 (the fair market value of truck T) less the adjusted basis of the inventory ($1000)).

(iv) The total amount of gain recognized by J in the transaction is the sum of the gains recognized under section 1031 with respect to each exchange group ($2500 + $0 + $0) and any gain recognized outside of section 1031 ($700), or $3200.

(v) The bases of the property received by J in the exchange are determined in the following manner:

(A) The aggregate basis of the properties received in the first exchange group is the adjusted basis of the properties transferred within that exchange group ($4000), increased by the amount of gain recognized with respect to that exchange group ($2500), decreased by the amount of the exchange group deficiency ($2500), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $4000. This $4000 of basis is allocated proportionately among the assets received within the first exchange group in accordance with their fair market values: computer Z's basis is $2571 ($4000 x $4500/$7000); printer Y's basis is $1429 ($4000 x $2500/$7000).

(B) The aggregate basis of the properties received in the second exchange group is the adjusted basis of the properties transferred within that exchange group ($1200), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($1200), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $2400. This $2400 of basis is allocated proportionately among the assets received within the second exchange group in accordance with their fair market values: real estate X's basis is $480 ($2400 x $1000/$5000); real estate W's basis is $1920 ($2400 x $4000/$5000).

(C) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group ($3300), increased by the amount of gain recognized with respect to that exchange group ($0), decreased by the amount of the exchange group deficiency ($500), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $2800. Because grader V was the only property received within the third exchange group, the entire basis of $2800 is allocated to grader V.

(D) Cash of $1800 is received within the residual group.

(E) The basis of the property received in the taxable exchange (truck T) is equal to its cost of $1700.

EXAMPLE 4. (i) B exchanges computer A (asset class 00.12), automobile A (asset class 00.22) and truck A (asset class 00.241), with C for computer R (asset class 00.12), automobile R (asset class 00.22), truck R (asset class 00.241) and $400 cash. All properties transferred by either B or C were held for productive use in the respective transferor's business. Similarly, all properties to be received by either B or C will be held for productive use in the respective recipient's business. Automobile A, automobile R and truck R are each secured by a nonrecourse liability and are transferred subject to such liability. The adjusted basis, fair market value, and liability secured by each property, if any, are as follows:

	Adjusted Basis	Fair Market Value	Liability
B Transfers:			
Computer A	$800	$1500	$ 0
Automobile A	900	2500	500
Truck A	700	2000	0
C Transfers:			
Computer R	$1100	$1600	$ 0
Automobile R	2100	3100	750
Truck R	600	1400	250
Cash		400	

(ii) The tax treatment to B is as follows:

(A)(1) The first exchange group consists of computers A and R (both are within the same General Asset Class).

(2) The second exchange group consists of automobiles A and R (both are within the same General Asset Class).

(3) The third exchange group consists of trucks A and R (both are in the same General Asset Class).

(B) Under paragraph (b)(2)(ii) of this section, all liabilities assumed by B ($1000) are offset by all liabilities of which B is relieved ($500), resulting in excess liabilities assumed of $500. The excess liabilities assumed of $500 is allocated among the exchange groups in proportion to the fair market value of the properties received by B in the exchange groups as follows:

(1) $131 of excess liabilities assumed ($500 x $1600/$6100) is allocated to the first exchange group. The first exchange group has an exchange group deficiency of $31 because the fair market value of computer A ($1500) exceeds the fair market value of computer R less the excess liabilities assumed allocated to the exchange group ($1600 - $131) by that amount.

(2) $254 of excess liabilities assumed ($500 x $3100/$6100) is allocated to the second exchange group. The second exchange group has an exchange group surplus of $346 because the fair market value of automobile R less the excess liabilities assumed allocated to the exchange group ($3100 - $254) exceeds the fair market value of automobile A ($2500) by that amount.

(3) $115 of excess liabilities assumed ($500 x $1400/$6100) is allocated to the third exchange group. The third exchange group has an exchange group deficiency of $715 because the fair market value of truck A ($2000) exceeds the fair market value of truck R less the excess liabilities assumed allocated to the exchange group ($1400 $115) by that amount.

(4) The difference between the aggregate fair market value of the properties transferred in all of the exchange groups, $6000, and the aggregate fair market value of the properties received in all of the exchange groups (taking excess liabilities assumed into account), $5600, is $400. Therefore there is a residual group in that amount consisting of $400 cash received.

(C) B recognizes gain on the exchange as follows:

(1) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A ($1500) over its adjusted basis ($800), or $700. The amount of gain recognized is the lesser of the gain realized ($700) and the exchange group deficiency ($31), or $31.

(2) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A ($2500) over its adjusted basis ($900), or $1600. The amount of gain recognized is the lesser of the gain realized ($1600) and the exchange group deficiency ($0), or $0.

(3) With respect to the third exchange group, the amount of gain realized is the excess of the fair market value of truck A ($2000) over its adjusted basis ($700), or $1300. The amount of gain recognized is the lesser of gain realized ($1300) and the exchange group deficiency ($715), or $715.

(4) No property transferred by B was allocated to the residual group. Therefore, B does not recognize gain or loss with respect to the residual group.

(D) The total amount of gain recognized by B in the exchange is the sum of the gains recognized under section 1031 with respect to each exchange group ($31 + $0 + $715), or $746.

(E) The bases of the property received by B in the exchange (computer R, automobile R, and truck R) are determined in the following manner:

(1) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($800), increased by the amount of gain recognized with respect to that exchange group ($31), decreased by the amount of the exchange group deficiency ($31), and increased by the amount of excess liabilities assumed allocated to that exchange group ($131), or $931. Because computer R was the only property received within the first exchange group, the entire basis of $931 is allocated to computer R.

(2) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($900), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($346), and increased by the amount of excess liabilities assumed allocated to that exchange group ($254), or $1500. Because automobile R was the only property received within the second exchange group, the entire basis of $1500 is allocated to automobile R.

(3) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group ($700), increased by the amount of gain recognized with respect to that exchange group ($715), decreased by the amount of the exchange group deficiency ($715), and increased by the amount of excess liabilities assumed allocated to that exchange group ($115), or $815. Because truck R was the only property received within the third exchange group, the entire basis of $815 is allocated to truck R.

(F) Cash of $400 is also received by B.

(iii) The tax treatment to C is as follows:

(A)(1) The first exchange group consists of computers R and A (both are within the same General Asset Class).

(2) The second exchange group consists of automobiles R and A (both are within the same General Asset Class).

(3) The third exchange group consists of trucks R and A (both are in the same General Asset Class).

(B) Under paragraph (b)(2)(ii) of this section, all liabilities of which C is relieved ($1000) are offset by all liabilities assumed by C ($500), resulting in excess liabilities relieved of $500. This excess liabilities relieved is treated as cash received by C.

(1) The first exchange group has an exchange group deficiency of $100 because the fair market value of computer R ($1600) exceeds the fair market value of computer A ($1500) by that amount.

(2) The second exchange group has an exchange group deficiency of $600 because the fair market value of automobile R ($3100) exceeds the fair market value of automobile A ($2500) by that amount.

(3) The third exchange group has an exchange group surplus of $600 because the fair market value of truck A ($2000) exceeds the fair market value of truck R ($1400) by that amount.

(4) The difference between the aggregate fair market value of the properties transferred by C in all of the exchange groups, $6100, and the aggregate fair market value of the properties received by C in all of the exchange groups, $6000, is $100. Therefore, there is a residual group in that amount, consisting of excess liabilities relieved of $100, which is treated as cash received by C.

(5) The $400 cash paid by C and $400 of the excess liabilities relieved which is treated as cash received by C are not within the exchange groups or the residual group.

(C) C recognizes gain on the exchange as follows:

(1) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer R ($1600) over its adjusted basis ($1100), or $500. The amount of gain recognized is the lesser of the gain realized ($500) and the exchange group deficiency ($100), or $100.

(2) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile R ($3100) over its adjusted basis ($2100), or $1000. The amount of gain recognized is the lesser of the gain realized ($1000) and the exchange group deficiency ($600), or $600.

(3) With respect to the third exchange group, the amount of gain realized is the excess of the fair market value of truck R ($1400) over its adjusted basis ($600), or $800. The amount of gain recognized is the lesser of gain realized ($800) and the exchange group deficiency ($0), or $0.

(4) No property transferred by C was allocated to the residual group. Therefore, C does not recognize any gain with respect to the residual group.

(D) The total amount of gain recognized by C in the exchange is the sum of the gains recognized under section 1031 with respect to each exchange group ($100 + $600 + $0), or $700.
(E) The bases of the properties received by C in the exchange (computer A, automobile A, and truck A) are determined in the following manner:

(1) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($1100), increased by the amount of gain recognized with respect to that exchange group ($100), decreased by the amount of the exchange group deficiency ($100), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $1100. Because computer A was the only property received within the first exchange group, the entire basis of $1100 is allocated to computer A.

(2) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($2100), increased by the amount of gain recognized with respect to that exchange group ($600), decreased by the amount of the exchange group deficiency ($600), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $2100. Because automobile A was the only property received within the second exchange group, the entire basis of $2100 is allocated to automobile A.

(3) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group ($600), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($600), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $1200. Because truck A was the only property received within the third exchange group, the entire basis of $1200 is allocated to truck A.

EXAMPLE 5. (i) U exchanges real estate A, real estate B, and grader A (SIC Code 3531) with V for real estate R and railroad car R (General Asset Class 00.25). All properties transferred by either U or V were held for productive use in the respective transferor's business. Similarly, all properties to be received by either U or V will be held for productive use in the respective recipient's business. Real estate R is secured by a recourse liability and is transferred subject to that liability. The adjusted basis, fair market value, and liability secured by each property, if any, are as follows:

	Adjusted Basis	Fair Market Value	Liability
<u>U Transfers:</u>			
Real Estate A	$2000	$5000	
Real Estate B	8000	13,500	
Grader A	500	2000	
<u>V Transfers:</u>			
Real Estate R	$20,000	$26,500	$7000
Railroad car R	1200	1000	

(ii) The tax treatment to U is as follows:

(A) The exchange group consists of real estate A, real estate B, and real estate R.

(B) Under paragraph (b)(2)(ii) of this section, all liabilities assumed by U ($7000) are excess liabilities assumed. The excess liabilities assumed of $7000 is allocated to the exchange group.

(1) The exchange group has an exchange group surplus of $1000 because the fair market value of real estate R less the excess liabilities assumed allocated to the exchange group ($26,500 - $7000) exceeds the aggregate fair market value of real estate A and B ($18,500) by that amount.

(2) The difference between the aggregate fair market value of the properties received in the exchange group (taking excess liabilities assumed into account), $19,500, and the aggregate fair market value of the properties transferred in the exchange group, $18,500, is $1000. Therefore, there is a residual group in that amount consisting of $1000 (or 50 percent of the fair market value) of grader A.

(3) The transaction also includes a taxable exchange of the 50 percent portion of grader A not allocated to the residual group (which is not of a like kind or like class to any property received by U in the exchange) for railroad car R (which is not of a like kind or like class to any property transferred by U in the exchange).

(C) U recognizes gain on the exchange as follows:

(1) With respect to the exchange group, the amount of the gain realized is the excess of the aggregate fair market value of real estate A and B ($18,500) over the aggregate adjusted basis ($10,000), or $8500. The amount of the gain recognized is the lesser of the gain realized ($8500) and the exchange group deficiency ($0), or $0.

(2) With respect to the residual group, the amount of gain realized and recognized is the excess of the fair market value of

the 50 percent portion of grader A that is allocated to the residual group ($1000) over its adjusted basis ($250), or $750.

(3) With respect to the taxable exchange of the 50 percent portion of grader A not allocated to the residual group for railroad car R, gain of $750 is realized and recognized by U (amount realized of $1000 (the fair market value of railroad car R) less the adjusted basis of the 50 percent portion of grader A not allocated to the residual group ($250)).

(D) The total amount of gain recognized by U in the transaction is the sum of the gain recognized under section 1031 with respect to the exchange group ($0), any gain recognized with respect to the residual group ($750), and any gain recognized with respect to property transferred that is not in the exchange group or the residual group ($750), or $1500.

(E) The bases of the property received by U in the exchange (real estate R and railroad car R) are determined in the following manner:

(1) The basis of the property received in the exchange group is the aggregate adjusted basis of the property transferred within that exchange group ($10,000), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($1000), and increased by the amount of excess liabilities assumed allocated to that exchange group ($7000), or $18,000. Because real estate R is the only property received within the exchange group, the entire basis of $18,000 is allocated to real estate R.

(2) The basis of railroad car R is equal to its cost of $1000.

(iii) The tax treatment to V is as follows:

(A) The exchange group consists of real estate R, real estate A, and real estate B.
(B) Under paragraph (b)(2)(ii) of this section, the liabilities of which V is relieved ($7000) results in excess liabilities relieved of $7000 and is treated as cash received by V.

(1) The exchange group has an exchange group deficiency of $8000 because the fair market value of real estate R ($26,500) exceeds the aggregate fair market value of real estate A and B ($18,500) by that amount.

(2) The difference between the aggregate fair market value of the properties transferred by V in the exchange group, $26,500, and the aggregate fair market value of the properties received by V in the exchange group, $18,500, is $8000. Therefore, there is a residual group in that amount, consisting of the excess liabilities relieved of $7000, which is treated as cash received by V, and $1000 (or 50 percent of the fair market value) of grader A.

(3) The transaction also includes a taxable exchange of railroad car R (which is not of a like kind or like class to any property received by V in the exchange) for the 50 percent portion of grader A (which is not of a like kind or like class to any property transferred by V in the exchange) not allocated to the residual group.

(C) V recognizes gain on the exchange as follows:

(1) With respect to the exchange group, the amount of the gain realized is the excess of the fair market value of real estate R ($26,500) over its adjusted basis ($20,000), or $6500. The amount of the gain recognized is the lesser of the gain realized ($6500) and the exchange group deficiency ($8000), or $6500 .

(2) No property transferred by V was allocated to the residual group. Therefore, V does not recognize gain or loss with respect to the residual group.

(3) With respect to the taxable exchange of railroad car R for the 50 percent portion of grader A not allocated to the exchange group or the residual group, a loss is realized and recognized in the amount of $200 (the excess of the $1200 adjusted basis of railroad car R over the amount realized of $1000 (fair market value of the 50 percent portion of grader A)).

(D) The bases of the property received by V in the exchange (real estate A, real estate B, and grader A) are determined in the following manner:

(1) The basis of the property received in the exchange group is the adjusted basis of the property transferred within that exchange group ($20,000), increased by the amount of gain recognized with respect to that exchange group ($6500), and decreased by the amount of the exchange group deficiency ($8000), or $18,500. This $18,500 of basis is allocated proportionately among the assets received within the exchange group in accordance with their fair market values: real estate A's basis is $5000 ($18,500 x $5000/$18,500); real estate B's basis is $13,500 ($18,500 x $13,500/$18,500).

(2) The basis of grader A is $2000.

(e) EFFECTIVE DATE.

Section 1.1031(j)-1 is effective for exchanges occurring on or after April 11, 1991.

[T.D. 8343, 56 FR 14854, Apr. 12, 1991]

PREAMBLE TO DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE REGULATIONS: IRC §1031
DEFERRED EXCHANGES

Like-kind Exchanges--Limitations of Deferred Exchanges; and Inapplicability of Section 1031 to Exchanges of Partnership Interests

SUMMARY: This document contains final regulations relating to limitations on deferred exchanges under section 1031 (a) (3) Internal Revenue Code of 1986 and to the inapplicability of section 1031 to exchanges of interests in a partnership under section 1031 (a) (2) (D). The regulations provide the public with the guidance needed to comply with the Tax Reform Act of 1984 and 1986.

EFFECTIVE DATES: Sections 1.1031-0, 1.1031 (b)-2 and 1.1031 (k)-1 are effective for transfers of property made by taxpayers on or after June 10, 1991. The amendments to §1.1031 (a)-1 are effective for transfers of property made by taxpayers on or after April 25, 1991.

SUPPLEMENTARY INFORMATION:

Background

On May 16, 1990, the Federal Register published a notice of proposed rulemaking (IA-237-84) under section 1031 of the Internal Revenue Code. The notice proposed to add regulations relating to deferred exchanges and exchanges of partnership interests. Pursuant to section 7805 (f) of the Code, these regulations were submitted to the Administrator of the Small Business Administration for comment of their impact on small business. The Internal Revenue Service received public comments on the proposed regulations and held a public hearing on September 5, 1990. After full consideration of the public comments and statements regarding the proposed regulations, the Service adopts the proposed regulations as revised by this Treasury decision. Descriptions of the revisions to the proposed regulations are included in the discussion of the public comments below. A more complete explanation of the provisions common to the proposed and final regulations, and of the policy reasons underlying those provisions, is set forth in the preamble to the proposed regulations.

DEFERRED EXCHANGES

Exchanges in which receipt of replacement property precedes transfer of relinquished property

Section 1031 (a) (3) of the Code and §1.1031 (a)-3 of the proposed regulations apply to deferred exchanges. The proposed regulations define a deferred exchange as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property"). The proposed regulations do not apply to transactions in which the taxpayer receives the replacement property prior to the date on which the taxpayer transfers the relinquished property (so-called "reverse-Starker" transaction). See Starker v. United States, 602 F.2d 1341 (9th Cir. 1979).

The Service requested comments on whether reverse-Starker transactions should qualify for tax-free exchange treatment under any provision of section 1031. The comments received ranged from advocating the application of the deferred exchange provisions of section 1031 (a) (3) to these transactions to advising that these transactions should not qualify for tax-free exchange treatment under either the general rule set forth in section 1031 (a) (1) or section 1031 (a) (3). After reviewing the comments and applicable law, the Service has determined that the deferred exchange rules of section 1031 (a) (3) do not apply to reverse-Starker transactions. Therefore, the final regulations, like the proposed regulations, do not apply to reverse-Starker transactions. However, the Service will continue to study the applicability of the general rule of section 1031 (a) (1) to these transactions.

Identification and receipt requirements

In general

Section 1031 (a) (3) provides that any property received by the taxpayer in a deferred exchange is treated as property that is not like-kind property if (a) the property is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange (the "identification period"), or (b) the property is received after the earlier of (1) the day that is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (2) the due date (including extensions) of the taxpayer's tax return for the taxable year in which the transfer of the relinquished property occurs (the "exchange period"). The proposed and final regulations provide additional guidance with respect to these requirements.

Application of section 7503

The proposed regulations provide that in determining the dates on which the identification and exchange periods end, section 7503 does not apply. Section 7503 provides that where the last day for performance falls on a Saturday, Sunday, or legal holiday, performance on the next succeeding day that is not a Saturday, Sunday or legal holiday will be considered timely.

Some commentators suggested that the proposed regulations should be revised to provide that section 7503 does apply in determining the dates *on which the identification and exchange periods end. However, Rev. Rul. 83-116, 1983-2 C.B. 264, provides that section 7503 is limited to procedural acts required to be performed in connection with the determination, collection, or refund of taxes. Because it is unnecessary to state a special rule for the application of section 7503 to deferred exchanges, the provision regarding application of section 7503 to section 1031 deferred exchanges has been deleted from the final regulations. In addition, because the timing requirements relating to the identification and exchange periods are statutory, requests for extension of the identification period or the exchange period through administrative relief under §1.9100 will not be granted.*

Identification of alternative properties

When section 1031(a)(3) was added to the Code in 1984, Congress was concerned that the greater the discretion a taxpayer has to vary the replacement property that will ultimately be received in a transaction, the more the transaction appears to be a sale rather than an exchange. See H.R. Rep. No. 432, 98th Cong., 2d Sess., pt. 2, at 1232; Staff of Committee on Finance, 98th Cong., 2d Sess., Explanation of the Deficit Reduction Act of 1984 (Comm. Print 1984) at 242. On the other hand, a taxpayer may encounter practical difficulties in trying to identify with precision the replacement property that the taxpayer will ultimately receive. The identification rules provided by the proposed regulations balance these competing concerns in several ways. Under these rules, the maximum number of replacement properties that a taxpayer may identify is (a) three properties of any fair market value (the "3-property rule"), or (b) any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties (the "200-percent rule"). The proposed regulations also provide that the fair market value of property for purposes of the deferred exchange rules is the property's fair market value without regard to liabilities secured by the property.

Commentators suggested that both the 3-property rule and the 200-percent rule be expanded to give taxpayers more discretion in identifying replacement property in deferred exchanges. To do so, however, would give these transactions more of the character of sales rather than exchanges and therefore would be less consistent with congressional intent. Accordingly, these rules have not been changed in the final regulations.

Commentators also suggested that the fair market value of property for purposes of the 200-percent rule should be its fair market value less liabilities secured by the property (i.e., its net equity value). Use of net equity value would create practical problems, however, because the 200-percent rule is applied at the end of the identification period. At that time, a taxpayer may not know or be able to control unilaterally the amount of the liabilities to which the replacement property will be subject when that property is ultimately received. For this reason, the final regulations, like the proposed regulations, provide that for purposes of the deferred exchange rules the fair market value of property is determined without regard to liabilities secured by the property.

Rules regarding safe harbors

In general

Because taxpayers typically are unwilling to rely on a transferee's unsecured promise to transfer the like-kind replacement property, the use of various guarantee or security arrangements is common in deferred exchanges. In addition, because persons who want to purchase the relinquished property may be unwilling or unable to acquire the replacement property, taxpayers often retain an intermediary to facilitate the exchange. Use of these arrangements, however, raises issues concerning actual receipt, constructive receipt, and agency.

Section 1031 (a) (3) leaves unclear the application of the rules of actual and constructive receipt and the implications of the taxpayer's possible agency relationship with an intermediary in deferred exchange transactions. Therefore, the proposed regulations provide taxpayers with four safe harbors based on commonly used security, guarantee, and intermediary arrangements. The first safe harbor permits certain security arrangements. The second permits the use of a qualified escrow account or a qualified trust. The third permits the use of a qualified intermediary, and the fourth permits the taxpayer to receive interest or a growth factor to compensate for the time value of money during the period between transfer of the relinquished property and receipt of the replacement property. Use of these safe harbors will result in a determination that the taxpayer is not, either directly or through an intermediary that may be an agent, in actual or constructive receipt of money or other property for purposes of these regulations. The final regulations retain these four safe harbors, but with certain modifications and clarifications.

Rights to money or other property outside of safe harbors

Under the proposed regulations, the safe harbors generally apply only if the taxpayer has no right to receive, pledge, borrow, or otherwise obtain the benefits of the funds or interest in escrow or trust or held by an intermediary before the occurrence of certain enumerated circumstances. The final regulations clarify that the limitations on a taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the funds apply only to the money or other property in a qualified escrow account or qualified trust, or held by the qualified intermediary. Under the final regulations, a taxpayer may receive money or other property directly from another party to the transaction, but not from a qualified escrow account, a qualified trust, or a qualified intermediary, without affecting the application of a safe harbor.

Rights under state law to money or other property

Some commentators expressed concern that, as a result of certain rights under state law, a taxpayer may be treated as having the immediate right to receive money or other property in an escrow or trust or held by a qualified intermediary. For example, commentators questioned whether a taxpayer would be treated as having the immediate right to receive money or other property held by an intermediary if, under state agency law, the intermediary is the agent of the taxpayer and the taxpayer has the right to dismiss an agent and thereby obtain property held for the taxpayer by the agent.

To assure taxpayers who use the safe harbors that the federal tax treatment of deferred exchanges is not intended to be dependent in this respect upon state law, the final regulations clarify that the terms of the *applicable agreement, rather than state law, will determine whether the limitations imposed by a safe harbor with respect to a taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefit of money or other property are satisfied. Thus, the safe harbors require that the applicable agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property before the end of the exchange period. The applicable agreement may, but need not, give a taxpayer rights to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property before the end of the exchange period if the exchange is completed or the requirements of section 1031 (a) (3) can no longer by met.*

The final regulations also provide that rights conferred upon a taxpayer under state agency law to dismiss an escrow holder, trustee, or intermediary will be disregarded in determining whether the taxpayer has the ability to receive or otherwise obtain the benefits of money or other property held by the escrow holder, trustee or intermediary. Actual or constructive receipt necessarily will occur at the time the taxpayer exercises these rights.

Special rule for certain acquisition and closing costs

Commentators pointed out that funds in a qualified escrow account or qualified trust, or held by a qualified intermediary, may be needed to pay closing costs for which the taxpayer is responsible. The taxpayer is in receipt of the funds to the extent the funds are used to pay the taxpayer's closing costs. Commentators questioned whether paying closing costs out of theses funds also results in actual or constructive receipt of the remaining funds. The final regulations provide that the use of money or other property in a qualified escrow account or qualified trust, or held by a qualified intermediary, to pay certain specified items will not result in actual or constructive receipt of the remaining funds and, furthermore, will be disregarded in determining whether the applicable agreement properly limits the taxpayer's rights to receive, borrow, pledge, or otherwise obtain the benefits of money or other property. The specified items are transactional items that (a) relate to the disposition of the relinquished property or to the acquisition of the replacement property and (b) are listed as the responsibility of a buyer or seller in the typical closing statement under local standards. Examples of these transactional items include commissions, prorated taxes, recording or transfer taxes, and title company fees. In addition, under the final regulations, a taxpayer's rights to receive items (such as prorated rents) that a seller may receive as a consequence of the disposition of property and that are not included in the amount realized from the disposition of property are disregarded.

Definition of qualified intermediary

Under the proposed regulations, a qualified intermediary is defined as a person who is not the taxpayer or a related party and who acts to facilitate a deferred exchange by entering into an agreement with the taxpayer for the exchange of properties. The proposed regulations also require that the qualified intermediary acquire the relinquished property from the taxpayer, acquire the replacement property, and transfer the replacement property to the taxpayer. The final regulations provide that the qualified intermediary must also transfer the relinquished property.

Commentators requested clarification as to what an intermediary must do to acquire property. In response, the final regulations described limited circumstances under which an intermediary is treated as acquiring and transferring property regardless of whether, under general tax principles, the intermediary actually acquires and transfers the property. First, an intermediary us treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property. In addition, an intermediary is treated as acquiring and transferring the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person. Finally, an intermediary is treated as acquiring and transferring replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer. Solely for these purposes, an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property.

Definition of "related party"

Under the proposed regulations, a party that is related to the taxpayer cannot be the escrow holder of a qualified escrow account, the trustee of a qualified trust, or a qualified intermediary. The proposed regulations define a person as a related party if: (i) the person and the taxpayer bear a relationship described in section 267 (b) or section 707 (b) (applied by substituting in each section "10 percent" for "50 percent" each place it appears); (ii) the person acts as the taxpayer's agent (including, for example, by performing services as the taxpayer's employee, attorney, or broker); or (iii) the person and a person who acts as the taxpayer's agent bear a relationship described in section 267 (b) or 707 (b) (again, substituting in each section "10 percent" for "50 percent" each place it appears). The proposed regulations further provide that, in determining whether a person acts as the taxpayer's agent, the performance of services with respect to exchanges intended to qualify under section 1031 and the performance of routine financial services by a financial institution are not taken into account.

Commentators suggested several changes to the above definition of related party. They pointed out that the term "related party" as used in the proposed regulations is defined differently than the term "related person" as used in section 1031 (f). To avoid confusion, they suggested using the section 1031 (f) definition. The Service believes that the section 1031 (f) related person definition is too narrow for purposes of the safe harbors contained in the deferred exchange regulations. To alleviate any potential confusion, the final regulations substitute the term "disqualified person" for the term "related party."

Commentators also asked for clarification regarding when certain persons, such as attorneys, would be treated as acting as a taxpayer's agent. In this regard, commentators suggested that a person who has not recently acted as the taxpayer's agent should not be disqualified from performing exchange-related services for the taxpayer. Finally, *commentators requested that the status of title insurance companies, escrow companies, and certain other persons be clarified.*

The final regulations have been revised to address these concerns. Under the final regulations, a person is a disqualified person if (i) the person is an agent of the taxpayer at the time of the transaction; (ii) the person and the taxpayer bear a relationship described in section 267 (b) or section 707 (b) (applied by substituting "10 percent " for "50 percent" each time it appears in those sections); or (iii) the person and a person who is an agent of the taxpayer at the time of the transaction bear a relationship described in section 267 (b) or 707 (b) (again, substituting "10 percent" for "50 percent" in applying those sections). A person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction.

In addition, the final regulations broaden somewhat the services that are disregarded for purposes of determining if an agency relationship exists. In determining whether a person is an agent of the taxpayer or has acted within the preceding 2-year period as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker, the performance of services with respect to exchanges intended to qualify under section 1031 is not taken into account. Furthermore, for these purposes, the performance of routine financial, title insurance, escrow, or trust services by a financial institution, title insurance company, or escrow company is not taken into account.

Extension of safe harbor rules to simultaneous exchanges

The rules in the proposed regulations, including the safe harbors, apply only to deferred exchanges. Commentators noted that the concerns relating to actual or constructive receipt and agency also exist in the case of simultaneous exchanges. They requested that the safe harbors be made available for simultaneous-exchanges. Upon review, the Service has determined it necessary to make only the qualified intermediary safe harbor available for simultaneous exchanges.

The final regulations provide, therefore, that in the case of simultaneous transfers of like-kind properties involving a qualified intermediary, the qualified intermediary will not be considered the agent of the taxpayer for purposes of section 1031 (a). Thus, in such a case the transfer and receipt of property by the taxpayer will be treated as an exchange. This provision is set forth in new §1.1031 (b)-2 of the final regulations and is effective for transfers of property made by taxpayers on or effective for transfers of property made by taxpayers on or after June 10, 1991.

Application of section 468B (g) rules regarding interest

Section 468B (g) provides that nothing in any provision of law will be construed as providing than an escrow account, settlement fund, or similar fund is not subject to current income tax. It also directs the Secretary to prescribe regulations relating to the taxation of these accounts or funds whether as a grantor trust or otherwise.

The forth safe harbor provided by the proposed regulations permits taxpayers to receive interest or a growth factor with respect to the deferred exchange, provided that the taxpayer's rights to receive the interest or growth factor are limited to certain specified circumstances. Although the proposed regulations require the interest or growth factor to be treated as interest, regardless of whether it is paid in cash or in property, they do not address the proper manner for reporting interest income earned on money held in an escrow account or trust. Comments were requested concerning whether the Service should exercise its regulatory authority under section 468B (g) with respect to interest earned on escrow accounts and trusts used in deferred exchanges.

[Unfortunately, final regulations effective December 31, 1992 did not address this issue.]

Coordination with section 453 installment sale rules

The section of the proposed regulations that coordinates the deferred exchange rules and the installment sale rules is reserved. Commentators suggested that this issue should be addressed in the near future because the two sets of rules often apply to the same transactions. The Service agrees this issue merits prompt attention. The issue remains reserved in the final regulations but will be addressed in forthcoming proposed regulations.

Effective date relating to deferred exchange provisions

Section 1.1031 (k)-1 of the final regulations applies to transfers of property made by taxpayers on or after June 10, 1991. Transfers of property made by taxpayers after May 16, 1990, but before June 10, 1991, will be treated as complying with section 1031 (a) (3) and this section if either the provisions of this section or the provisions of the notice of proposed rulemaking published in the Federal Register on May 16, 1990 (55 F.R. 20278) are satisfied.

EXCHANGES OF PARTNERSHIP INTEREST

<u>In general</u>
Section 1031 (a) (2) (D) provides that section 1031 (a) does not apply to any exchange of interests in a partnership. The Service requested comments on whether an exchange of an interest in an organization which has elected under section 761 (a) to be excluded from the application of subchapter K is eligible for nonrecognition of gain or loss under section 1031 (a).

Section 11703 (d) of the Omnibus Budget Reconciliation Act of 1990, P.L. 101-503, amended section 1031 (a) (2) to provide that an interest in a partnership that has in effect a valid election under section 761 (a) to be excluded from the application of all of subchapter K is treated for purpose of section 1031 as an interest in each of the assets of the partnership and not as an interest in a partnership. The final regulations have been revised to reflect the amendment to section 1031 (a) (2).

The final regulations otherwise retain the provisions of the proposed regulations regarding exchanges of interests in a partnership. Under the proposed and final regulations, an exchange of partnership interests will not qualify for nonrecognition of gain or loss under section 1031 (a) regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership of different partnerships. No inference is to be drawn from these regulations, however, with respect to the application of other Code sections that allow nonrecognition of gain or loss in an exchange of interests in a partnership. For example, as stated in the preamble to the proposed regulations, these regulations are not intended to affect the applicability of Rev. Rul. 84-53, 1984-1 C.B. 157, concerning conversions of partnership interests. More generally, the regulations are not intended to restrict in any way the application of the rules of subchapter K of the Code to exchanges of partnership interests.

<u>Effective date relating to exchanges of partnership interests</u>

The amendments to §1.1031 (a)-1 made in the final regulations with respect to exchanges of partnership interest are effective for transfers of property made by taxpayers on or after April 25, 1991.

<u>Special Analyses</u>

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553 (b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and therefore an initial Regulatory Flexibility Analysis is not required.

<u>Drafting Information</u>

The principal author of these regulations is D. Lindsay Russell of the Office of Assistant Chief Counsel (Income Tax & Accounting), Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing these regulations, on matters of both substance and style.

1.1031(k)-1 TREATMENT OF DEFERRED EXCHANGES.

(a) OVERVIEW.

This section provides rules for the application of section 1031 and the regulations thereunder in the case of a "deferred exchange." For purposes of section 1031 and this section, a deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property"). In the case of a deferred exchange, if the requirements set forth in paragraphs (b), (c), and (d) of this section (relating to identification and receipt of replacement property) are not satisfied, the replacement property received by the taxpayer will be treated as property which is not of a like kind to the relinquished property. In order to constitute a deferred exchange, the transaction must be an exchange (i.e., a transfer of property for property, as distinguished from a transfer of property for money). For example, a sale of property followed by a purchase of property of a like kind does not qualify for nonrecognition of gain or loss under section 1031 regardless of whether the identification and receipt requirements of section 1031(a)(3) and paragraphs (b), (c), and (d) of this section are satisfied. The transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or property which does not meet the requirements of section 1031(a), but the transfer, if otherwise qualified, will be within the provisions of either section 1031(b) or (c). See section 1.1031(a)- l(a)(2). In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or property which does not meet the requirements of section 1031(a) before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or property which does not meet the requirements of section 1031(a) in the full amount of the consideration for the relinquished property, the transaction will constitute a sale, and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property. For purposes of this section, property which does not meet the requirements of section 1031(a)(whether by being described in section 1031(a)(2) or otherwise) is referred to as "other property." For rules regarding actual and constructive receipt, and safe harbors therefrom, see paragraphs (f) and (g), respectively, of this section. For rules regarding the determination of gain or loss recognized and the basis of property received in a deferred exchange, see paragraph (j) of this section.

(b) IDENTIFICATION & RECEIPT REQUIREMENTS

(1) IN GENERAL.

In the case of a deferred exchange, any replacement property received by the taxpayer will be treated as property which is not of a like kind to the relinquished property if -

(i) The replacement property is not "identified" before the end of the "identification period," or

(ii) The identified replacement property is not received before the end of the "exchange period."

(2) IDENTIFICATION PERIOD AND EXCHANGE PERIOD.

(i) The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th day thereafter.

(ii) The exchange period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the earlier of the 180th day thereafter or the due date (including extensions) for the taxpayer's return of the tax imposed by chapter 1 of subtitle A of the Code for the taxable year in which the transfer of the relinquished property occurs.

(iii) If, as part of the same deferred exchange, the taxpayer transfers more than one relinquished property and the relinquished properties are transferred on different dates, the identification period and the exchange period are determined by reference to the earliest date on which any of the properties are transferred.

(iv) For purposes of this paragraph (b)(2), property is transferred when the property is disposed of within the meaning of section 1001(a).

(3) EXAMPLE.

This paragraph (b) may be illustrated by the following example.

EXAMPLE. (i) M is a corporation that files its Federal income tax return on a calendar year basis. M and C enter into an agreement for an exchange of property that requires M to transfer property X to C. Under the agreement, M is to identify like-kind replacement property which C is required to purchase and to transfer to M. M transfers property X to C on November 16, 1992.

(ii) The identification period ends at midnight on December 31, 1992, the day which is 45 days after the date of transfer of property X. The exchange period ends at midnight on March 15, 1993, the due date for M's Federal income tax return for the taxable year in which M transferred property X. However, if M is allowed the automatic six-month extension for filing its tax return, the exchange period ends at midnight on May 15, 1993, the day which is 180 days after the date of transfer of property X.

(c) IDENTIFICATION OF REPLACEMENT PROPERTY BEFORE THE END OF THE IDENTIFICATION PERIOD

(1) IN GENERAL.

For purposes of paragraph (b)(1)(i) of this section (relating to the identification requirement), replacement property is identified before the end of the identification period only if the requirements of this paragraph (c) are satisfied with respect to the replacement property. However, any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

(2) MANNER OF IDENTIFYING REPLACEMENT PROPERTY.

Replacement property is identified only if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either -

(i) The person obligated to transfer the replacement property to the taxpayer (regardless of whether that person is a disqualified person as defined in paragraph (k) of this section); or

(ii) Any other person involved in the exchange other than the taxpayer or a disqualified person (as defined in paragraph (k) of this section).

Examples of persons involved in the exchange include any of the parties to the exchange, an intermediary, an escrow agent, and a title company. An identification of replacement property made in a written agreement for the exchange of properties signed by all parties thereto before the end of the identification period will be treated as satisfying the requirements of this paragraph (c)(2).

(3) DESCRIPTION OF REPLACEMENT PROPERTY.

Replacement property is identified only if it is unambiguously described in the written document or agreement. Real property generally is unambiguously described if it is described by a legal description, street address, or distinguishable name (e.g., the Mayfair Apartment Building). Personal property generally is unambiguously described if it is described by a specific description of the particular type of property. For example, a truck generally is unambiguously described if it is described by a specific make, model, and year.

(4) ALTERNATIVE AND MULTIPLE PROPERTIES.

(i) The taxpayer may identify more than one replacement property. Regardless of the number of relinquished properties transferred by the taxpayer as part of the same deferred exchange, the maximum number of replacement properties that the taxpayer may identify is --

(A) Three properties without regard to the fair market values of the properties (the "3-property rule"), or

(B) Any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer (the "200-percent rule").

(ii) If, as of the end of the identification period, the taxpayer has identified more properties as replacement properties than permitted by paragraph (c)(4)(i) of this section, the taxpayer is treated as if no replacement property had been identified. The preceding sentence will not apply, however, and an identification satisfying the requirements of paragraph (c)(4)(i) of this section will be considered made, with respect to -

(A) Any replacement property received by the taxpayer before the end of the identification period, and

(B) Any replacement property identified before the end of the identification period and received before the end of the exchange period, but only if the taxpayer receives before the end of the exchange period identified replacement property the fair market value of which is at least 95 percent of the aggregate fair market value of all identified replacement properties (the "95-percent rule").

For this purpose, the fair market value of each identified replacement property is determined as of the earlier of the date the property is received by the taxpayer or the last day of the exchange period.

(iii) For purposes of applying the 3-property rule, the 200-percent rule, and the 95-percent rule, all identifications of replacement property, other than identifications of replacement property that have been revoked in the manner provided in paragraph (c)(6) of this section, are taken into account. For example, if, in a deferred exchange, B transfers property X with a fair market value of $100,000 to C and B receives like-kind property Y with a fair market value of $50,000 before the end of the identification period, under paragraph (c)(1) of this section, property Y is treated as identified by reason of being received before the end of the identification period. Thus, under paragraph (c)(4)(i) of this section, B may identify either two additional replacement properties of any fair market value or any number of additional replacement properties as long as the aggregate fair market value of the additional replacement properties does not exceed $150,000.

(5) INCIDENTAL PROPERTY DISREGARDED

(i) Solely for purposes of applying this paragraph (c), property that is incidental to a larger item of property is not treated as property that is separate from the larger item of property. Property is incidental to a larger item of property if -

(A) In standard commercial transactions, the property is typically transferred together with the larger item of property, and

(B) The aggregate fair market value of all of the incidental property does not exceed 15 percent of the aggregate fair market value of the larger item of property.

(ii) This paragraph (c)(5) may be illustrated by the following examples.

EXAMPLE 1. For purposes of paragraph (c) of this section, a spare tire and tool kit will not be treated as separate property from a truck with a fair market value of $10,000, if the aggregate fair market value of the spare tire and tool kit does not exceed $1,500. For purposes of the 3-property rule, the truck, spare tire, and tool kit are treated as 1 property. Moreover, for purposes of paragraph (c)(3) of this section (relating to the description of replacement property), the truck, spare tire, and tool kit are all considered to be unambiguously described if the make, model, and year of the truck are specified, even if no reference is made to the spare tire and tool kit.

EXAMPLE 2. For purposes of paragraph (c) of this section, furniture, laundry machines, and other miscellaneous items of personal property will not be treated as separate property from an apartment building with a fair market value of $1,000,000 if the aggregate fair market value of the furniture, laundry machines, and other personal property does not exceed $150,000. For purposes of the 3-property rule, the apartment building, furniture, laundry machines, and other personal property are treated as 1 property. Moreover, for purposes of paragraph (c)(3) of this section (relating to the description of replacement property), the apartment building, furniture, laundry machines, and other personal property are all considered to be unambiguously described if the legal description, street address, or distinguishable name of the apartment building is specified, even if no reference is made to the furniture, laundry machines, and other personal property.

(6) REVOCATION OF IDENTIFICATION.

An identification of replacement property may be revoked at any time before the end of the identification period. An identification of replacement property is revoked only if the revocation is made in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to the person to whom the identification of the replacement property was sent. An identification of replacement property that is made in a written agreement for the exchange of properties is treated as revoked only if the revocation is made in a written amendment to the agreement or in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to all of the parties to the agreement.

(7) EXAMPLES.

This paragraph (c) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. No replacement property is identified in the agreement. When subsequently identified, the replacement property is described by legal description and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold the replacement property received for investment.

EXAMPLE 1. (i) On July 2, 1991, B identifies real property E as replacement property by designating real property E as replacement property in a written document signed by B and personally delivered to C.

(ii) Because the identification was made after the end of the identification period, pursuant to paragraph (b)(1)(i) of this section (relating to the identification requirement), real property E is treated as property which is not of a like kind to real property X.

EXAMPLE 2. (i) C is a corporation of which 20 percent of the outstanding stock is owned by B. On July 1, 1991, B identifies real property F as replacement property by designating real property F as replacement property in a written document signed by B and mailed to C.

(ii) Because C is the person obligated to transfer the replacement property to B, real property F is identified before the end of the identification period. The fact that C is a "disqualified person" as defined in paragraph (k) of this section does not change this result.

(iii) Real property F would also have been treated as identified before the end of the identification period if, instead of sending the identification to C, B had designated real property F as replacement property in a written agreement for the exchange of properties signed by all parties thereto on or before July 1, 1991.

EXAMPLE 3. (i) On June 3, 1991, B identifies the replacement property as "unimproved land located in Hood County with a fair market value not to exceed $100,000." The designation is made in a written document signed by B and personally delivered to C. On July 8, 1991, B and C agree that real property G is the property described in the June 3, 1991 document.

(ii) Because real property G was not unambiguously described before the end of the identification period, no replacement property is identified before the end of the identification period.

EXAMPLE 4. (i) On June 28, 1991, B identifies real properties H, J, and K as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. The written document provides that by August 1, 1991, B will orally inform C which of the identified properties C is to transfer to B. As of July 1, 1991, the fair market values of real properties H, J, and K are $75,000, $100,000, and $125,000, respectively.

(ii) Because B did not identify more than three properties as replacement properties, the requirements of the 3-property rule are satisfied, and real properties H, J, and K are all identified before the end of the identification period.

EXAMPLE 5. (i) On May 17, 1991, B identifies real properties L, M, N, and P as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. The written document provides that by July 2, 1991, B will orally inform C which of the identified properties C is to transfer to B. As of July 1, 1991, the fair market values of real properties L, M, N, and P are $30,000, $40,000, $50,000, and $60,000, respectively.

(ii) Although B identified more than three properties as replacement properties, the aggregate fair market value of the identified properties as of the end of the identification period ($180,000) did not exceed 200 percent of the aggregate fair market value of real property X (200% x $100,000 = $200,000). Therefore, the requirements of the 200-percent rule are satisfied, and real properties L, M, N, and P are all identified before the end of the identification period.

EXAMPLE 6. (i) On June 21, 1991, B identifies real properties Q, R, and S as replacement properties by designating these properties as replacement properties in a written document signed by B and mailed to C. On June 24, 1991, B identifies real properties T and U as replacement properties in a written document signed by B and mailed to C. On June 28, 1991, B revokes the identification of real properties Q and R in a written document signed by B and personally delivered to C.

(ii) B has revoked the identification of real properties Q and R in the manner provided by paragraph (c)(6) of this section. Identifications of replacement property that have been revoked in the manner provided by paragraph (c)(6) of this section are not taken into account for purposes of applying the 3-property rule. Thus, as of June 28, 1991, B has identified only replacement properties S, T, and U for purposes of the 3--property rule. Because B did not identify more than three properties as replacement properties for purposes of the 3-property rule, the requirements of that rule are satisfied, and real properties S, T, and U are all identified before the end of the identification period.

EXAMPLE 7. (i) On May 20, 1991, B identifies real properties V and W as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. On June 4, 1991, B identifies real properties Y and Z as replacement properties in the same manner. On June 5, 1991, B telephones C and orally revokes the identification of real properties V and W. As of July 1, 1991, the fair market values of real properties V, W, Y, and Z are $50,000, $70,000, $90,000, and $100,000, respectively. On July 31, 1991, C purchases real property Y and Z and transfers them to B.

(ii) Pursuant to paragraph (c)(6) of this section (relating to revocation of identification), the oral revocation of the identification of real properties V and W is invalid. Thus, the identification of real properties V and W is taken into account for purposes of determining whether the requirements of paragraph (c)(4) of this section (relating to the identification of alternative and multiple properties) are satisfied. Because B identified more than three properties and the aggregate fair market value of the identified properties as of the end of the identification period ($310,000) exceeds 200 percent of the fair market value of real property X (200% x $100,000 = $200,000), the requirements of paragraph (c)(4) of this section are not satisfied, and B is treated as if B did not identify any replacement property.

(d) RECEIPT OF IDENTIFIED REPLACEMENT PROPERTY

(1) IN GENERAL.

For purposes of paragraph (b)(1)(ii) of this section (relating to the receipt requirement), the identified replacement property is received before the end of the exchange period only if the requirements of this paragraph (d) are satisfied with respect to the replacement property. In the case of a deferred exchange, the identified replacement property is received before the end of the exchange period if -

(i) The taxpayer receives the replacement property before the end of the exchange period, and

(ii) The replacement property received is substantially the same property as identified.

If the taxpayer has identified more than one replacement property, section 1031(a)(3)(B) and this paragraph (d) are applied separately to each replacement property.

(2) EXAMPLES.

This paragraph (d) may be illustrated by the following examples. The following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. The replacement property is identified in a manner that satisfies paragraph (c) of this section (relating to identification of replacement property) and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

EXAMPLE 1. (i) In the agreement, B identifies real properties J, K, and L as replacement properties. The agreement provides that by July 26, 1991, B will orally inform C which of the properties C is to transfer to B.

(ii) As of July 1, 1991, the fair market values of real properties J, K, and L are $75,000, $100,000, and $125,000, respectively. On July 26, 1991, B instructs C to acquire real property K. On October 31, 1991, C purchases real property K for $100,000 and transfers the property to B.

(iii) Because real property K was identified before the end of the identification period and was received before the end of the exchange period, the identification and receipt requirements of section 1031(a)(3) and this section are satisfied with respect to real property K.

EXAMPLE 2. (i) In the agreement, B identifies real property P as replacement property. Real property P consists of two acres of unimproved land. On October 15, 1991, the owner of real property P erects a fence on the property. On November 1, 1991, C purchases real property P and transfers it to B.

(ii) The erection of the fence on real property P subsequent to its identification did not alter the basic nature or character of real property P as unimproved land. B is considered to have received substantially the same property as identified.

EXAMPLE 3. (i) In the agreement, B identifies real property Q as replacement property. Real property Q consists of a barn on two acres of land and has a fair market value of $250,000 ($187,500 for the barn and underlying land and $87,500 for the remaining land). As of July 26, 1991, real property Q remains unchanged and has a fair market value of $250,000. On that date, at B's direction, C purchases the barn and underlying land for $187,500 and transfers it to B, and B pays $87,500 to C.

(ii) The barn and underlying land differ in basic nature or character from real property Q as a whole. B is not considered to have received substantially the same property as identified.

EXAMPLE 4. (i) In the agreement, B identifies real property R as replacement property. Real property R consists of two acres of unimproved land and has a fair market value of $250,000. As of October 3, 1991, real property R remains unimproved and has a fair market value of $250,000. On that date, at B's direction, C purchases 1 1/2 acres of real property R for $187,500 and transfers it to B, and B pays $87,500 to C.

(ii) The portion of real property R that B received does not differ from the basic nature or character of real property R as a whole. Moreover, the fair market value of the portion of real property R that B received ($187,500) is 75 percent of the fair market value of real property R as of the date of receipt. Accordingly, B is considered to have received substantially the same property as identified.

(e) SPECIAL RULES FOR IDENTIFICATION AND RECEIPT OF REPLACEMENT PROPERTY TO BE PRODUCED.

(1) IN GENERAL.

A transfer of relinquished property in a deferred exchange will not fail to qualify for nonrecognition of gain or loss under section 1031 merely because the replacement property is not in existence or is being produced at the time the property is identified as replacement property. For purposes of this paragraph (e), the terms "produced" and "production" have the same meanings as provided in section 263A(g)(1) and the regulations thereunder.

(2) IDENTIFICATION OF REPLACEMENT PROPERTY TO BE PRODUCED.

(i) In the case of replacement property that is to be produced, the replacement property must be identified as provided in paragraph (c) of this section (relating to identification of replacement property). For example, if the identified replacement property consists of improved real property where the improvements are to be constructed, the description of the replacement property satisfies the requirements of paragraph (c)(3) of this section (relating to description of replacement property) if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time the identification is made.

(ii) For purposes of paragraphs (c)(4)(i)(B) and (c)(5) of this section (relating to the 200-percent rule and incidental property), the fair market value of replacement property that is to be produced is its estimated fair market value as of the date it is expected to be received by the taxpayer.

(3) RECEIPT OF REPLACEMENT PROPERTY TO BE PRODUCED.

(i) For purposes of paragraph (d)(1)(ii) of this section (relating to receipt of the identified replacement property), in determining whether the replacement property received by the taxpayer is substantially the same property as identified where the identified replacement property is property to be produced, variations due to usual or typical production changes are not taken into account. However, if substantial changes are made in the property to be produced, the replacement property received will not be considered to be substantially the same property as identified.

(ii) If the identified replacement property is personal property to be produced, the replacement property received will not be considered to be substantially the same property as identified unless production of the replacement property received is completed on or before the date the property is received by the taxpayer.

(iii) If the identified replacement property is real property to be produced and the production of the property is not completed on or before the date the taxpayer receives the property, the property received will be considered to be substantially the same property as identified only if, had production been completed on or before the date the taxpayer receives the replacement property, the property received would have been considered to be substantially the same property as identified. Even so, the property received is considered to be substantially the same property as identified only to the extent the property received constitutes real property under local law.

(4) ADDITIONAL RULES.

The transfer of relinquished property is not within the provisions of section 1031 (a) if the relinquished property is transferred in exchange for services (including production services). Thus, any additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of a like kind.

(5) EXAMPLE.

This paragraph (e) may be illustrated by the following example.

EXAMPLE. (i) B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers improved real property X and personal property Y to C on May 17, 1991. On or before November 13, 1991 (the end of the exchange period), C is required to transfer to B real property M, on which C is constructing improvements, and personal property N, which C is producing. C is obligated to complete the improvements and production regardless of when properties M and N are transferred to B. Properties M and N are identified in a manner that satisfies paragraphs (c) (relating to identification of replacement property) and (e)(2) of this section. In addition, properties M and N are of a like kind, respectively, to real property X and personal property Y (determined without regard to section 1031(a)(3) and this section). On November 13, 1991, when construction of the improvements to property M is 20 percent completed and the production of property N is 90 percent completed, C transfers to B property M and property N. If construction of : the improvements had been completed, property M would have been considered to be substantially the same property as identified. Under local law, property M constitutes real property to the extent of the underlying land and the 20 percent of the construction that is completed.

(ii) Because property N is personal property to be produced and production of property N is not completed before the date the property is received by B, property N is not considered to be substantially the same property as identified and is treated as property which is not of a like kind to property Y.

(iii) Property M is considered to be substantially the same property as identified to the extent of the underlying land and the 20 percent of the construction that is completed when property M is received by B. However, any additional construction performed by C with respect to property M after November 13, 1991, is not treated as the receipt of property of a like kind.

(f) RECEIPT OF MONEY OR OTHER PROPERTY

(1) IN GENERAL.

A transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or other property. However, such a transfer, if otherwise qualified, will be within the provisions of either section 1031(b) or (c). See section 1.1031(a)- l(a)(2). In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

(2) ACTUAL AND CONSTRUCTIVE RECEIPT.

Except as provided in paragraph (9) of this section (relating to safe harbors), for purposes of section 1031 and this section, the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. The taxpayer is in actual receipt of money or property at the time the taxpayer actually receives the money or property or receives the economic benefit of the money or property. The taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given. Although the taxpayer is not in constructive receipt of money or property if the taxpayer's control of its receipt is subject to substantial limitations or restrictions, the taxpayer is in constructive receipt of the money or property at the time the limitations or restrictions lapse, expire, or are waived. In addition, actual or constructive receipt of money or property by an agent of the taxpayer (determined without regard to paragraph (k) of this section) is actual or constructive receipt by the taxpayer.

(3) EXAMPLE.

This paragraph (f) may be illustrated by the following example.

EXAMPLE. (i) B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to the agreement, on May 17, 1991, B transfers real property X to C. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. At any time after May 17, 1991, and before C has purchased the replacement property, B has the right, upon notice, to demand that C pay $100,000 in lieu of acquiring and transferring the replacement property. Pursuant to the agreement, B identifies replacement property, and C purchases the replacement property and transfers it to B.

(ii) Under the agreement, B has the unrestricted right to demand the payment of $100,000 as of May 17, 1991. B is therefore in constructive receipt of $100,000 on that date. Because B is in constructive receipt of money in the full amount of the consideration for the relinquished property before B actually receives the like-kind replacement property, the transaction constitutes a sale, and the transfer of real property X does not qualify for nonrecognition of gain or loss under section 1031. B is treated as if B received the $100,000 in consideration for the sale of real property X and then purchased the like-kind replacement property.

(iii) If B's right to demand payment of the $100,000 were subject to a substantial limitation or restriction (e.g., the agreement provided that B had no right to demand payment before November 14, 1991 (the end of the exchange period)), then, for purposes of this section, B would not be in actual or constructive receipt of the money unless (or until) the limitation or restriction lapsed, expired, or was waived.

(g) SAFE HARBORS

(1) IN GENERAL.

Paragraphs (g)(2c through (g)(5) of this section set forth four safe harbors the use of which will result in a determination that the taxpayer is not in actual or constructive receipt of money or other property for purposes of section 1031 and this section. More than one safe harbor can be used in the same deferred exchange, but the terms and conditions of each must be separately satisfied. For purposes of the safe harbor rules, the term "taxpayer" does not include a person or entity utilized in a safe harbor (e.g., a qualified intermediary). See paragraph (g)(8), Example 3 (v), of this section.

(2) SECURITY OR GUARANTEE ARRANGEMENTS.

(i) In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured or guaranteed by one or more of the following -

(A) A mortgage, deed of trust, or other security interest in property (other than cash or a cash equivalent),

(B) A standby letter of credit which satisfies all of the requirements of section 15A.453-l(b)(3)(iii) and which may not be drawn upon in the absence of a default of the transferee's obligation to transfer like-kind replacement property to the taxpayer, or

(C) A guarantee of a third party.

(ii) Paragraph (g)(2)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive money or other property pursuant to the security or guarantee arrangement.

(3) QUALIFIED ESCROW ACCOUNTS AND QUALIFIED TRUSTS.

(i) In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured by cash or a cash equivalent if the cash or cash equivalent is held in a qualified escrow account or in a qualified trust.

(ii) A qualified escrow account is an escrow account wherein -

(A) The escrow holder is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and

(B) The escrow agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account as provided in paragraph (g)(6) of this section.

(iii) A qualified trust is a trust wherein -

(A) The trustee is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section, except that for this purpose the relationship between the taxpayer and the trustee created by the qualified trust will not be considered a relationship under section 267(b)), and

(B) The trust agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held by the trustee as provided in paragraph (g)(6) of this section.

(iv) Paragraph (g)(3)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the qualified escrow account or qualified trust. Rights conferred upon the taxpayer under state law to terminate or dismiss the escrow holder of a qualified escrow account or the trustee of a qualified trust are disregarded for this purpose.

(v) A taxpayer may receive money or other property directly from a party to the exchange, but not from a qualified escrow account or a qualified trust, without affecting the application of paragraph (g)(3)(i) of this section.

(4) QUALIFIED INTERMEDIARIES.

(i) In the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer.

(ii) Paragraph (g)(4)(i) of this section applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in paragraph (g)(6) of this section.

(iii) A qualified intermediary is a person who

(A) Is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and

(B) Enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

(iv) Regardless of whether an intermediary acquires and transfers property under general tax principals, solely for purposes of paragraph (g)(4)(iii)(B) of this section -

(A) An intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property,

(B) An intermediary is treated as acquiring and transferring the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person, and

(C) An Intermediary is treated as acquiring and transferring replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer.

(v) Solely for purposes of paragraphs (g)(4)(iii) and (g)(4)(iv) of this section, an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. For example, if a taxpayer enters into an agreement for the transfer of relinquished property and thereafter assigns its rights in that agreement to an intermediary and all parties to that 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 entering into that agreement. If the relinquished property is transferred pursuant to that agreement, the intermediary is treated as having acquired and transferred the relinquished property.

(vi) Paragraph (g)(4)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. Rights conferred upon the taxpayer under state law to terminate or dismiss the qualified intermediary are disregarded for this purpose.

(vii) A taxpayer may receive money or other property directly from a party to the transaction other than the qualified intermediary without affecting the application of paragraph (g)(4)(i) of this section.

(5) INTEREST AND GROWTH FACTORS.

In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives the like-kind replacement property will be made without regard to the fact that the taxpayer is or may be entitled to receive any interest or growth factor with respect to the deferred exchange. The preceding sentence applies only if the agreement pursuant to which the taxpayer is or may be entitled to the interest or growth factor expressly limits the taxpayer's rights to receive the interest or growth factor as provided in paragraph (g)(6) of this section. For additional rules concerning interest or growth factors, see paragraph (h) of this section.

(6) ADDITIONAL RESTRICTIONS ON SAFE HARBORS UNDER PARAGRAPHS (g)(3) THROUGH (g)(5).

(i) An agreement limits a taxpayer's rights as provided in this paragraph (g)(6) only if the agreement provides that the taxpayer has no rights, except as provided in paragraphs (g)(6)(ii) and (g)(6)(iii) of this section, to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period.

(ii) The agreement may provide that if the taxpayer has not identified replacement property by the end of the identification period, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property at any time after the end of the identification period.

(iii) The agreement may provide that if the taxpayer has identified replacement property, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property upon or after

(A) The receipt by the taxpayer of all of the replacement property to which the taxpayer is entitled under the exchange agreement, or

(B) The occurrence after the end of the identification period of a material and substantial contingency that -

(1) Relates to the deferred exchange,

(2) Is provided for in writing, and

(3) Is beyond the control of the taxpayer and of any disqualified person (as defined in paragraph (k) of this section), other than the person obligated to transfer the replacement property to the taxpayer.

(7) ITEMS DISREGARDED IN APPLYING SAFE HARBORS UNDER PARAGRAPHS (g)(3) THROUGH (g)(5).

In determining whether a safe harbor under paragraphs (g)(3) through (g)(5) of this section ceases to apply and whether the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property are expressly limited as provided in paragraph (g)(6) of this section, the taxpayer's receipt of or right to receive any of the following items will be disregarded

(i) Items that a seller may receive as a consequence of the disposition of property and that are not included in the amount realized from the disposition of property (e.g., prorated rents), and

(ii) Transactional items that relate to the disposition of the relinquished property or to the acquisition of the replacement property and appear under local standards in the typical closing statement as the responsibility of a buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees).

(8) EXAMPLES.

This paragraph (g) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B is to transfer real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. The replacement property is identified as provided in paragraph (c) of this section (relating to identification of replacement property) and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

EXAMPLE 1. (i) On May 17, 1991, B transfers real property X to C. On the same day, C pays $10,000 to B and deposits $90,000 in escrow as security for C's obligation to perform under the agreement. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow before November 14, 1991, except that:

(A) if B fails to identify replacement property on or before July 1, 1991, B may demand the funds in escrow at any time after July 1, 1991; and

(B) if B identifies and receives replacement property, then B may demand the balance of the remaining funds in escrow at any time after B has received the replacement property. The funds in escrow may be used to purchase the replacement property. The escrow holder is not a disqualified person as defined in paragraph (k) of this section. Pursuant to the terms of the agreement, B identifies replacement property, and C purchases the replacement property using the funds in escrow and transfers the replacement property to B.

(ii) C's obligation to transfer the replacement property to B was secured by cash held in a qualified escrow account because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow as provided in paragraph (g)(6) of this section. In addition, B did not have the immediate ability or unrestricted right to receive money or other property in escrow before B actually received the like-kind replacement property. Therefore, for purposes of section 1031 and this section, B is determined not to be in actual or constructive receipt of the $90,000 held in escrow before B received the like-kind replacement property. The transfer of real property X by B and B's acquisition of the replacement property qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

EXAMPLE 2. (i) On May 17, 1991, B transfers real property X to C, and C deposits $100,000 in escrow as security for C's obligation to perform under the agreement. Also on May 17, B identifies real property J as replacement property. The escrow agreement provides that no funds may be paid out without prior written approval of both B and C. The escrow agreement also provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow before November 14, 1991, except that:

(A) B may demand the funds in escrow at any time after the later of July 1, 1991, and the occurrence of any of the following events -

(1) real property J is destroyed, seized, requisitioned, or condemned, or

(2) a determination is made that the regulatory approval necessary for the transfer of real property J cannot be obtained in time for real property J to be transferred to B before the end of the exchange period;

(B) B may demand the funds in escrow at any time after August 14, 1991, if real property J has not been rezoned from residential to commercial use by that date; and

(C) B may demand the funds in escrow at the time B receives real property J or any time thereafter. Otherwise, B is entitled to all funds in escrow after November 13, 1991. The funds in escrow may be used to purchase the replacement property. The escrow holder is not a disqualified person as described in paragraph (k) of this section. Real property J is not rezoned from residential to commercial use on or before August 14, 1991.

(ii) C's obligation to transfer the replacement property to B was secured by cash held in a qualified escrow account because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow as provided in paragraph (g)(6) of this section. From May 17, 1991, until August 15, 1991, B did not have the immediate ability or unrestricted right to receive money or other property before B actually received the like-kind replacement property. Therefore, for purposes of section 1031 and this section, B is determined not to be in actual or constructive receipt of the $100,000 in escrow from May 17, 1991, until August 15, 1991. However, on August 15, 1991, B had the unrestricted right, upon notice, to draw upon the $100,000 held in escrow. Thus, the safe harbor ceased to apply and B was in constructive receipt of the funds held in escrow. Because B constructively received the full amount of the consideration ($100,000) before B actually received the like-kind replacement property, the transaction is treated as a sale and not as a deferred exchange. The result does not change even if B chose not to demand the funds in escrow and continued to attempt to have real property J rezoned and to receive the property on or before November 13, 1991.

(iii) If real property J had been rezoned on or before August 14, 1991, and C had purchased real property J and transferred it to B on or before November 13, 1991, the transaction would have qualified for nonrecognition of gain or loss under section 1031 (a).

EXAMPLE 3. (i) On May 1, 1991, D offers to purchase real property X for $100,000. However, D is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is not a disqualified person as described in paragraph (k) of this section. The exchange agreement between B and C provides that B is to execute and deliver a deed conveying real property X to C who, in turn, is to execute and deliver a deed conveying real property X to D. The exchange agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g)(6) of this section. On May 3, 1991, C enters into an agreement with B to transfer real property X to D for $100,000. On May 17, 1991, B executes and delivers to C a deed conveying real property X to C. On the same date, C executes and delivers to D a deed conveying real property X to D, and D deposits $100,000 in escrow. The escrow holder is not a disqualified person as defined in paragraph (k) of this section and the escrow agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section. However, the escrow agreement provides that the money in escrow may be used to purchase replacement property. On June 3, 1991, B identifies real property K as replacement property. On August 9, 1991, E executes and delivers to C a deed conveying real property K to C and $80,000 is released from the escrow and paid to E. On the same date, C executes and delivers to B a deed conveying real property K to B, and the escrow holder pays B $20,000, the balance of the $100,000 sale price of real property X remaining after the purchase of real property K for $80,000.

(ii) B and C entered into an exchange agreement that satisfied the requirements of paragraph (g)(4)(iii)(B) of this section. Regardless of whether C may have acquired and transferred real property X under general tax principles, C is treated as having acquired and transferred real property X because C acquired and transferred legal title to real property X. Similarly, C is treated as having acquired and transferred real property X because C acquired and transferred legal title to real property K. Thus, C was a qualified intermediary. This result is reached for purposes of this section regardless of whether C was B's agent under state law.

(iii) Because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section, the escrow account was a qualified escrow account. For purposes of section 1031 and this section, therefore, B is determined not to be in actual or constructive receipt of the funds in escrow before B received real property K.

(iv) The exchange agreement between B and C expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of any money held by C as provided in paragraph (g)(6) of this section. Because C was a qualified intermediary, for purposes of section 1031 and this section B is determined not to be in actual or constructive receipt of any funds held by C before B received real property K. In addition, B's transfer of real property X and acquisition of real property K qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

(v) If the escrow agreement had expressly limited C's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section, but had not expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of that money or other property, the escrow account would not have been a qualified escrow account. Consequently, paragraph (g)(3)(i) of this section would not have been applicable in determining whether B was in actual or constructive receipt of that money or other property before B received real property K.

EXAMPLE 4. (i) On May 1, 1991, B enters into an agreement to sell real property X to D for $100,000 on May 17, 1991. However, D is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is not a disqualified person as described in paragraph (k) of this section. In the exchange agreement between B and C, B assigns to C all of B's rights in the agreement with D. The exchange agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g) (6) of this section. On May 17, 1991, B notifies D in writing of the assignment. On the same date, B executes and delivers to D a deed conveying real property X to D. D pays $10,000 to B and $90,000 to C. On June 1, 1991, B identifies real property L as replacement property. On July 5, 1991, B enters into an agreement to purchase real property L from E for $90,000, assigns its rights in that agreement to C, and notifies E in writing of the assignment. On August 9, 1991, C pays $90,000 to E, and E executes and delivers to B a deed conveying real property L to B.

(ii) The exchange agreement entered into by B and C satisfied the requirements of paragraph (g)(4)(iii)(B) of this section. Because B's rights in its agreements with D and E were assigned to C, and D and E were notified in writing of the assignment on or before the transfer of real properties X and L, respectively, C is treated as entering into those agreements. Because C is treated as entering into an agreement with D for the transfer of real property X and, pursuant to that agreement, real property X was transferred to D, C is treated as acquiring and transferring real property X. Similarly, because C is treated as entering into an agreement with E for the transfer of real property K and, pursuant to that agreement, real property K was transferred to B, C is treated as acquiring and transferring real property K. This result is reached for purposes of this section regardless of whether C was B's agent under state law and regardless of whether C is considered, under general tax principles, to have acquired title or beneficial ownership of the properties. Thus, C was a qualified intermediary.

(iii) The exchange agreement between B and C expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by C as provided in paragraph (g)(6) of this section. Thus, B did not have the immediate ability or unrestricted right to receive money or other property held by C before B received real property L. For purposes of section 1031 and this section, therefore, B is determined not to be in actual or constructive receipt of the $90,000 held by C before B received real property L. In addition, the transfer of real property X by B and B's acquisition of real property L qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

EXAMPLE 5. (i) On May 1, 1991, B enters into an agreement to sell real property X to D for $100,000. However, D is unwilling to participate in a like-kind exchange. B thus enters into an agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is not a disqualified person as described in paragraph (k) of this section. The agreement between B and C expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g)(6) of this section. C neither enters into an agreement with D to transfer real property X to D nor is assigned B's rights in B's agreement to sell real property X to D. On May 17, 1991, B transfers real property X to D and instructs D to transfer the $100,000 to C. On June 1, 1991, B identifies real property M as replacement property. On August 9, 1991, C purchases real property L from E for $100,000, and E executes and delivers to C a deed conveying real property M to C. On the same date, C executes and delivers to B a deed conveying real property M to B.

(ii) Because B transferred real property X directly to D under B's agreement with B, C did not acquire real property X from B and transfer real property X to D. Moreover, because C did not acquire legal title to real property X, did not enter into an agreement with D to transfer real property X to D, and was not assigned B's rights in B's agreement to sell real property X to D, C is not treated as acquiring and transferring real property X. Thus, C was not a qualified intermediary and paragraph (g)(4)(i) of this section does not apply.

(iii) B did not exchange real property X for real property M. Rather, B sold real property X to D and purchased, through C, real property M. Therefore, the transfer of real property X does not qualify for nonrecognition of gain or loss under section 1031.

(h) INTEREST AND GROWTH FACTORS

(1) IN GENERAL.

For purposes of this section, the taxpayer is treated as being entitled to receive interest or a growth factor with respect to a deferred exchange if the amount of money or property the taxpayer is entitled to receive depends upon the length of time elapsed between transfer of the relinquished property and receipt of the replacement property.

(2) TREATMENT AS INTEREST.

If, as part of a deferred exchange, the taxpayer receives interest or a growth factor, the interest or growth factor will be treated as interest, regardless of whether it is paid to the taxpayer in cash or in property (including property of a like kind). The taxpayer must include the interest or growth factor in income according to the taxpayer's method of accounting.

(i) [Reserved]

(j) DETERMINATION OF A GAIN OR LOSS RECOGNIZED AND THE BASIS OF PROPERTY RECEIVED IN A DEFERRED EXCHANGE

(1) IN GENERAL.

Except as otherwise provided, the amount of gain or loss recognized and the basis of property received in a deferred exchange is determined by applying the rules of section 1031 and the regulations thereunder. See sections 1.1031(b)-1, 1.1031(c)-1, 1.1031(d)-1, 1.1031(d)-1T, 1.1031(d)-2, and 1.1031(j)-1.

PREAMBLE TO DEPARTMENT OF TREASURY INTERNAL REVENUE SERVICE REGULATIONS: IRC §1031

Like-Kind Exchange of Property
Coordination with §453

SUMMARY

This document contains final income tax regulations under section 1031(a)(3) of the Internal Revenue Code of 1986 relating to the coordination of deferred like-kind exchanges described in section 1031(a)(3) with the installment sale rules of section 453. The final regulations affect taxpayers who engage in certain like-kind exchanges of property under section 1031. These regulations are effective June 10, 1991. For dates of applicability, see §§1.1031(b)-2(d) and 1.1031(k)-1(j)(2) of the regulations.

SUPPLEMENTARY INFORMATION

Background

On May 1, 1991, the IRS published in the Federal Register (56 FR 19933) final regulations under section 1031(a)(3) of the Internal Revenue Code relating to deferred like-kind exchanges. Section 1.1031(k)-1(j)(2) of the regulations, relating to the coordination of section 1031(a)(3) with the installment sale provisions of section 453, is reserved. On November 2, 1992, the IRS published a notice of proposed rulemaking in the Federal Register (57 FR 49432) coordinating section 1031(a)(3) with the installment sale provisions of section 453. After consideration of the written comments received regarding the proposed regulations, the regulations are adopted as amended by this Treasury decision. This Treasury decision amends §1.1031(b)-2 of 26 CFR part 1, Income Tax Regulations, adds the text of §1.1031(k)-1(j)(2), and amends §15a.453-1(b)(3)(i) of 26 CFR part 15a.

Technical Background

In a typical deferred exchange, the taxpayer may require the transferee to secure its promise to acquire replacement property in a cash funded escrow account or trust. Alternatively, the taxpayer may retain an intermediary to arrange for the transfer of replacement property to the taxpayer. Section 1.1031(k)-1(g) provides certain safe harbors that, if followed, ensure that these arrangements do not cause the transaction to be treated as a taxable sale rather than a deferred exchange for purposes of section 1031. Section 453(a) generally provides that income from an installment sale is taken into account under the installment method as payments are made. Section 15a.453-1(b)(3)(i) of the regulations provides that the receipt of an evidence of indebtedness that is secured directly or indirectly by cash or a cash equivalent is treated as the receipt of a payment. That section also provides that a payment includes amounts actually or constructively received under an installment obligation.

These final regulations provide rules that coordinate the safe harbor provisions of §1.1031(k)-1(g) with the installment sale rules that determine when a taxpayer is in receipt of a payment under section 453 and §15a.453-1(b)(3)(i).

Description of Provisions

The final regulations under §1.1031(k)-1(g)(3) and (4) provide certain safe harbors under which taxpayers are treated as not being in actual or constructive receipt of money or other property held in a qualified escrow account, qualified trust, or by a qualified intermediary. These final regulations generally adopt the same safe harbors for the purpose of determining whether a taxpayer is in receipt of payment under section 453 and §15a.453-1(b)(3)(i) if, at the beginning of the exchange period, the taxpayer has a bona fide intent to enter into a deferred exchange. The qualified escrow account, qualified trust, or qualified intermediary is disregarded for purpose of section 453 and §15a.453-1(b)(3)(i) until the earlier of (a) the time the safe harbor would otherwise cease to apply for purposes of section 1031 (e.g., when the taxpayer has the immediate right to receive the funds held in the qualified escrow account), or (b) the end of the exchange period. Thus, subject to the other requirements of sections 453 and 453A and the related regulations, taxpayers who use the safe harbors of the existing 1031 regulations and meet the requirements of these final regulations will be entitled to report gain recognized on the deferred exchange under the installment method.

Several commentators requested that the bona fide intent requirement be clarified by providing either examples or presumptions. Whether a particular taxpayer has a bona fide intent to enter into a deferred exchange is determined on the basis of all relevant facts and circumstances. Because the presumptions suggested by commentators would emphasize certain factors that in many cases should not be determinative, the final regulations do not contain rules setting forth presumptions. However, the final regulations clarify that a taxpayer will be treated as having a bona fide intent only if it is reasonable to believe, based on all the facts and circumstances as of the beginning of the exchange period, that like-kind replacement property will be acquired before the end of the exchange period. In addition, two examples have been added to the final regulations in which the bona fide intent requirement is determined to have been satisfied. These examples are intended to be illustrative only, and do not represent either the minimum steps required to establish bona fide intent or safe harbors pursuant to which a bona fide intent will in other contexts be assumed to exist.

The regulations provide a special rule for deferred exchanges involving qualified intermediaries. Under this rule, a taxpayer in receipt of an evidence of indebtedness of the qualified intermediary's transferee is treated as receiving an evidence of indebtedness of the transferee of the relinquished property, even though these regulations generally treat the qualified intermediary as having acquired and transferred the relinquished property for other purposes. Therefore, for purposes of section 453 and §15a.453-1(b)(3)(i), the receipt by the taxpayer of such an evidence of indebtedness is treated as the receipt of an evidence of indebtedness of the person acquiring the relinquished property from the taxpayer and is not considered a payment under section 453.

One commentator was concerned that the treatment provided by the special rule terminates at the end of the exchange period even is the note remains outstanding. The final regulations make clear that this rule applies beyond the end of the exchange period. Another commentator suggested that the special rule that treats indebtedness of the qualified intermediary's transferee as indebtedness of the person acquiring relinquished property from the taxpayer for purposes of section 453 and

§15a.453-1(b)(3)(i) should also apply to simultaneous exchanges under §1.1031(b)-2. This comment has been adopted, as reflected in amendments to §1.1031(b)-2.

Another commentator recommended that the regulations provide that the distribution of an installment note to the taxpayer at any time by the qualified intermediary would not terminate the applicability of the qualified intermediary safe harbor. The Internal Revenue Service and the Treasury do not believe a special exception to the limitations contained in 1.1031(k)-1(g)(4)(ii) and (vi) (relating to the taxpayer's right to receive or otherwise obtain the benefits of money or other property held by a qualified intermediary) should be provided for installment notes. Rather, §1.1031(k)-1(g)(4)(vii) provides sufficient flexibility by permitting the receipt of money or other property (including an installment note) by the taxpayer directly from a transferee without affecting the applicability of the qualified intermediary safe harbor. Therefore, this comment has not been adopted.

Another commentator suggested that certain interest payments made on the installment note during the exchange period be treated as fee income to the qualified intermediary and not as interest income to the taxpayer. Section 1.1031(k)-1(h)(2) specifies that interest payments received by the taxpayer, whether received in cash or property (including like-kind property), are to be treated as income to the taxpayer. The determination of whether interest payments retained by a qualified intermediary should be treated as received by the taxpayer, and thereby represent income to the taxpayer, is beyond the scope of this regulation and may be the subject of future guidance.

One commentator requested that the regulations address the timing of gain recognition in deferred exchanges involving assumptions of liabilities. The Internal Revenue Service and the Treasury are currently studying the circumstances under which, and the extent to which, gain attributable to assumptions of liabilities in like-kind exchanges (including simultaneous exchanges) should be eligible for deferral under the installment method. Among other things, this process will include an examination of the rules proposed under section 453(f)(6) in 1984. Accordingly, this final regulation does not address these issues.

Two Commentators requested that the regulations consider issues relating to the timing of receipt of income after the end of the exchange period in cases where the delivery of money or other property is delayed due to events such as breach of contract or bankruptcy. Because section 1031(a)(3) requires deferred exchanges to be completed by the end of the exchange period, the safe harbors from the constructive receipt rules provided by §1.1031(k)-1(g)(3) and (4) have no application after that period. Whether a taxpayer is in receipt of money or other property held in a qualified escrow account or qualified trust or by a qualified intermediary after the end of the exchange period is determined under general principles of federal income tax law. Therefore, the final regulations do not provide specific guidance regarding the timing of receipt of income where delivery of the money or other property held in a qualified escrow account or a qualified trust, or by a qualified intermediary is delayed beyond the end of the exchange period.

Several additional comments were received pertaining to issues that may arise when an installment note is used in a deferred like-kind exchange. Commentators suggested that guidance be provided on the tax consequences of making the installment note payable to a qualified intermediary. Commentators also wanted to know the consequences of a qualified intermediary's disposition of a note to a third party during the exchange period. Commentators requested guidance on the treatment of principal payments made on an installment note during the exchange period. One commentator requested guidance on the tax consequences of a reversion to the transferee of cash held in a qualified escrow account or qualified trust followed by the transferee's issuance of an installment note to the taxpayer at the end of the exchange period. Commentators also suggested that the final regulations address the treatment of issues arising from deferred exchanges of multiple assets.

The issues raised by these comments are broader than the scope of these regulations. Resolution of these issues would affect not only deferred like-kind exchanges spanning more than one tax year, but also such exchanges taking place within one tax year. In addition, these issues may also involve the character of income rather than the timing of the receipt of income. Therefore, the final regulations do not address these comments. However, the Internal Revenue Service will take these issues into consideration in issuing further guidance in this area.

Finally, under these regulations, taxpayers may choose to apply the safe harbors retroactively to transfers of property occurring on or after May 16, 1990. However, if taxpayers reported gain that qualifies for installment method reporting under these regulations in the year they transferred the relinquished property, they in effect elected out of the installment method. In the preamble to the proposed regulations, the Internal Revenue Service requested comments on whether the Service should publish a revenue procedure providing simplified procedures under which those taxpayers who elected out of the installment method could use the installment method in reporting gain on those transactions. Because commentators expressed only minimal interest in this revenue procedure, the Service will not issue such a revenue procedure or similar guidance.

Special Analyses
It has been determined that these regulations are not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking published in the Federal Register on November 2, 1992 (57 FR 49432) was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Drafting Information
The principal author of these regulations is Christopher F. Kane of the Office of Assistant Chief Counsel (Income Tax and Accounting), Internal Revenue Service. However, other personnel from the IRS and Treasury Department participated in their development.

(2) COORDINATION WITH SECTION 453.
(effective 6/10/91)

(i) Qualified escrow accounts and qualified trusts. Subject to the limitations of paragraphs (j)(2)(iv) and (j)(2)(v) of this section, in the case of a taxpayer's transfer of relinquished property in which the obligation of the taxpayer's transferee to transfer replacement property to the taxpayer is or may be secured by cash or a cash equivalent, the determination of whether the taxpayer has received a payment for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter will be made without regard to the fact that the obligation is or may be so secured if the cash or cash equivalent is held in a qualified escrow account or a qualified trust. This paragraph (j)(2)(i) ceases to apply at the earlier of -

(A) The time described in paragraph (g)(3)(iv) of this section; or

(B) The end of the exchange period.

(ii) Qualified intermediaries. Subject to the limitations of paragraphs (j)(2)(iv) and (j)(2)(iv) of this section, in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the determination of whether the taxpayer has received a payment for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter is made as if the qualified intermediary is not the agent of the taxpayer. For purposes of this paragraph (j)(2)(ii), a person who otherwise satisfies the definition of a qualified intermediary is treated as a qualified intermediary even though that person ultimately fails to acquire identified replacement property and transfer it to the taxpayer. This paragraph (j)(2)(ii) ceases to apply at the earlier of -

(A) The time described in paragraph (g)(4)(vi) of this section; or

(B) The end of the exchange period.

(iii) Transferee indebtedness. In the case of a transaction described in paragraph (j)(2)(ii) of this section, the receipt by the taxpayer of an evidence of indebtedness of the transferee of the qualified intermediary is treated as the receipt of an evidence of indebtedness of the person acquiring property from the taxpayer for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter.

(iv) Bona fide intent requirement. The provisions of paragraphs (j)(2)(i) and (ii) of this section do not apply unless the taxpayer has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period. A taxpayer will be treated as having a bona fide intent only if it is reasonable to believe, based on all the facts and circumstances as of the beginning of the exchange period, that like-kind replacement property will be acquired before the end of the exchange period.

(v) Disqualified property. The provisions of paragraphs (j)(2)(i) and (ii) of this section do not apply if the relinquished property is disqualified property. For purposes of this paragraph (j)(2), "disqualified property" means property that is not held for productive use in a trade or business or for investment or is property described in section 1031(a)(2).

(vi) Examples. This paragraph (j)(2) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B is a calendar year taxpayer who agrees to enter into a deferred exchange. Pursuant to the agreement, B is to transfer real property X. Real property X, which has been held by B for investment, is unencumbered and has a fair market value of $100,000 at the time of transfer. B's adjusted basis in real property X at that time is $60,000. B identifies a single like-kind replacement property before the end of the identification period, and B receives the replacement property before the end of the exchange period. The transaction qualifies as a like-kind exchange under section 1031.

Example 1. (i) On September 22, 1994, B transfers real property X to C and C agrees to acquire like-kind property and deliver it to B. On that date B has a bona fide intent to enter into a deferred exchange. C's obligation, which is not payable on demand or readily tradable, is secured by $100,000 in cash. The $100,000 is deposited by C in an escrow account that is a qualified escrow account under paragraph (g)(3) of this section. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash deposited in the escrow account until the earlier of the date the replacement property is delivered to B or the end of the exchange period. On March 11, 1995, C acquires replacement property having a fair market value of $80,000 and delivers the replacement property to B. The $20,000 in cash remaining in the qualified escrow account is distributed to B at that time.

(ii) Under section 1031(b), B recognizes gain to the extent of the $20,000 in cash that B receives in the exchange. Under paragraph (j)(2)(i) of this section, the qualified escrow account is disregarded for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B's receipt of C's obligation on September 22, 1994, does not constitute a payment. Instead, B is treated as receiving payment on March 11, 1995, on receipt of the $20,000 in cash from the qualified escrow account. Subject to the other requirements of sections 453 and 453A, B may report the $20,000 gain in 1995 under the installment method. See section 453(f)(6) for special rules for determining total contract price and gross profit in the case of an exchange described in section 1031(b).

Example 2. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. On September 22, 1994, pursuant to the agreement, B transfers real property X to C who transfers it to D for $100,000 in cash. On that date B has a bona fide intent to enter into a deferred exchange. C is a qualified intermediary under paragraph (g)(4) of this section. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by C until the earlier of the date the replacement property is delivered to B or the end of the exchange period. On March 11, 1995, C acquires replacement property having a fair market value of $80,000 and delivers it, along with the remaining $20,000 from the transfer of real property X, to B.

(ii) Under section 1031(b), B recognizes gain to the extent of the $20,000 cash B receives in the exchange. Under paragraph (j)(2)(ii) of this section, any agency relationship between B and C is disregarded for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on September 22, 1994, on C's receipt of payment from D for the relinquished property. Instead, B is treated as receiving payment on March 11, 1995 on receipt of the $20,000 in cash from C. Subject to the other requirements of section 453 and 453A, B may report the $20,000 gain in 1995 under the installment method.

Example 3. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B enters into an exchange agreement with C whereby B retains C as a qualified intermediary to facilitate an exchange with respect to real property X. On December 1, 1994, pursuant to the agreement, B transfers real property X to C who transfers it to D for $100,000 in cash. On that date B has a bona fide intent to enter into a deferred exchange. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash held by C until the earliest of the end of the identification period if B has not identified replacement property, the date the replacement property is delivered to B, or the end of the exchange period. Although B has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period, B does not identify or acquire any replacement property. In 1995, at the end of the identification period, C delivers the entire $100,000 from the sale of real property X to B.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis in real property X ($60,000), or $40,000. Because B has a bona fide intent at the beginning of the exchange period to enter into a deferred exchange, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(ii) of this section inapplicable even though B fails to acquire replacement property. Further, under paragraph (j)(2)(ii) of this section, C is a qualified intermediary even though C does not acquire and transfer replacement property to B. Thus, any agency relationship between B and C is disregarded for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on December 1, 1994, on C's receipt of payment from D for the relinquished property. Instead, B is treated as receiving payment at the end of the identification period in 1995 on receipt of the $100,000 in cash from C. Subject to the other requirements of sections 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

Example 4. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is a qualified intermediary under paragraph (g)(4) of this section. On September 22, 1994, pursuant to the agreement, B transfers real property X to C who then transfers it to D for $80,000 in cash and D's 10-year installment obligation for $20,000. On that date B has a bona fide intent to enter into a deferred exchange. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property held by C until the earlier of the date the replacement property is delivered to B or the end of the exchange period. D's obligation bears adequate stated interest and is not payable on demand or readily tradable. On March 11, 1995, C acquires replacement property having a fair market value of $80,000 and delivers it, along with the $20,000 installment obligation, to B.

(ii) Under section 1031(b), $20,000 of B's gain (i.e., the amount of the installment obligation B receives in the exchange) does not qualify for nonrecognition under section 1031(a). Under paragraphs (j)(2)(ii) and (iii) of this section, B's receipt of D's obligation is treated as the receipt of an obligation of the person acquiring the property for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B's receipt of the obligation is not treated as a payment. Subject to the other requirements of sections 453 and 453A, B may report the $20,000 gain under the installment method on receiving payments from D on the obligation.

Example 5. (i) B is a corporation that has held real property X to expand its manufacturing operations. However, at a meeting in November 1994, B's directors decide that real property X is not suitable for the planned expansion, and authorize a like-kind exchange of this property for property that would be suitable for the planned expansion. B enters into an exchange agreement with C whereby B retains C as a qualified intermediary to facilitate an exchange with respect to real property X. On November 28, 1994, pursuant to the agreement, B transfers real property X to C, who then transfers it to D for $100,000 in cash. The exchange agreement does not include any limitations or conditions that make it unreasonable to believe that like-kind replacement property will be acquired before the end of the exchange period. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash held by C until the earliest of the end of the identification period, if B has not identified replacement property, the date the replacement property is delivered to B, or the end of the exchange period. In early January 1995, B's directors meet and decide that it is not feasible to proceed with the planned expansion due to a business downturn reflected in B's preliminary financial reports for the last quarter of 1994. Thus, B's directors instruct C to stop seeking replacement property. C delivers the $100,000 cash to B on January 12, 1995, at the end of the identification period. Both the decision to exchange real property X for other property and the decision to cease seeking replacement property because of B's business downturn are recorded in the minutes of the directors' meetings. There are no other facts or circumstances that would indicate whether, on November 28, 1994, B had a bona fide intent to enter into a deferred like-kind exchange.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis of real property X ($60,000), or $40,000. The directors' authorization of a like-kind exchange, the terms of the exchange agreement with C, and the absence of other relevant facts, indicate that B had a bona fide intent at the beginning of the exchange period to enter into a deferred like-kind exchange. Thus, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(ii) of this section inapplicable, even though B fails to acquire replacement property. Further, under paragraph (j)(2)(ii) of this section, C is a qualified intermediary, even though C does not transfer replacement property to B. Thus, any agency relationship between B and C is disregarded for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment until January 12, 1995, on receipt of the $100,000 cash from C. Subject to the other requirements of sections 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

Example 6. (i) B has held real property X for use in its trade of business, but decides to transfer that property because it is no longer suitable for B's planned expansion of its commercial enterprise. B and D agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to D on September 22, 1994, and D deposits $100,000 cash in a qualified escrow account as security for D's obligations under the agreement to transfer replacement property to B before the end of the exchange period. D's obligation is not payable on demand or readily tradable. The agreement provides that B is not required to accept any property that is not zoned for commercial use. Before the end of the identification period, B identifies real properties J, K, and L, all zoned for residential use, as replacement properties. Any one of these properties, rezoned for commercial use, would be suitable for B's planned expansion. In recent years, the zoning board with jurisdiction over properties J, K, and L has rezoned similar properties for commercial use. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in the escrow account until the earlier of the time that the zoning board determines, after the end of the identification period, that it will not rezone the properties for commercial use or the end of the exchange period. On January 5, 1995, the zoning board decides that none of the properties will be rezoned for commercial use. Pursuant to the exchange agreement, B receives the $100,000 cash from the escrow on January 5, 1995. There are no other facts or circumstances that would indicate whether, on September 22, 1994, B had a bona fide intent to enter into a deferred like-kind exchange.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis of real property X ($60,000), or $40,000. The terms of the exchange agreement with D, the identification of properties J, K, and L, the efforts to have those properties rezoned for commercial purposes, and the absence of other relevant facts, indicate that B had a bona fide intent at the beginning of the exchange period to enter into a deferred exchange. Moreover, the limitations imposed in the exchange agreement on acceptable replacement property do not make in unreasonable to believe that like-kind replacement property would be acquired before the end of the exchange period. Therefore, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(i) of this section inapplicable even though B fails to acquire replacement property. Thus, for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter, the qualified escrow account is disregarded in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on September 22, 1994, on D's deposit of the $100,000 cash into the qualified escrow account. Instead, B is treated as receiving payment on January 5, 1995. Subject to the other requirements of sections 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

(vii) Effective date. This paragraph (j)(2) is effective for transfers of property occurring on or after April 19, 1994. Taxpayers may apply this paragraph (j)(2) to transfers of property occurring before April 19, 1994 but on or after June 10, 1991, if those transfers otherwise meet the requirements of §1.1031(k)-1. In addition, taxpayers may apply this paragraph (j)(2) to transfers of property occurring before June 10, 1991, but on or after May 16, 1990, if those transfers otherwise meet the requirements of §1.1031(k)-1 or follow the guidance of IA-237-84 published in 1990-1, C.B. See §601.601(d)(2)(ii)(b) of this chapter.

(3) EXAMPLES.

This paragraph (j) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B is to transfer real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. B's adjusted basis in real property X is $40,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received. The replacement property is identified as provided in paragraph (c) of this section and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

EXAMPLE 1 (i) On May 17, 1991, B transfers real property X to C and identifies real property R as replacement property. On June 3, 1991, C transfers $10,000 to B. On September 4, 1991, C purchases real property R for $90,000 and transfers real property R to B.

(ii) The $10,000 received by B is "money or other property" for purposes of section 1031 and the regulations thereunder. Under section 1031(b), B recognizes gain in the amount of $10,000. Under section 1031(d), B's basis in real property R is $40,000 (i.e., B's basis in real property X ($40,000), decreased in the amount of money received ($10,000), and increased in the amount of gain recognized ($10,000) in the deferred exchange).

EXAMPLE 2. (i) On May 17, 1991, B transfers real property X to C and identifies real property S as replacement property, and C transfers $10,000 to B. On September 4, 1991, C purchases real property S for $100,000 and transfers real property S to B On the same day, B transfers $10,000 to C.

(ii) The $10,000 received by B is "money or other property" for purposes of section 1031 and the regulations thereunder. Under section 1031 (b), B recognizes gain in the amount of $10,000. Under section 1031 (d), B's basis in real property S is $50,000 (i.e., B's basis in real property X ($40,000), decreased in the amount of money received ($10,000), increased in the amount of gain recognized ($10,000), and increased in the amount of the additional consideration paid by B ($10,000) in the deferred exchange).

EXAMPLE 3. (i) Under the exchange agreement, B has the right at all times to demand $100,000 in cash in lieu of replacement property. On May 17, 1991, B transfers real property X to C and identifies real property T as replacement property. On September 4, 1991, C purchases real property T for $100,000 and transfers real property T to B.

(ii) Because B has the right on May 17, 1991, to demand $100,000 in cash in lieu of replacement property, B is in constructive receipt of the $100,000 on that date. Thus, the transaction is a sale and not an exchange, and the $60,000 gain realized by B in the transaction (i.e., $100,000 amount realized less $40,000 adjusted basis) is recognized. Under section 1031(d), B's basis in real property T is $100,000.

EXAMPLE 4. (i) Under the exchange agreement, B has the right at all times to demand up to $30,000 in cash and the balance in replacement property instead of receiving replacement property in the amount of $100,000. On May 17, 1991, B transfers real property X to C and identifies real property U as replacement property. On September 4, 1991, C purchases real property U for $100,000 and transfers real property U to B.

(ii) The transaction qualifies as a deferred exchange under section 1031 and this section. However, because B had the right on May 17, 1991, to demand up to $30,000 in cash, B is in constructive receipt of $30,000 on that date. Under section 1031(b), B recognizes gain in the amount of $30,000. Under section 1031(d), B's basis in real property U is $70,000 (i.e., B's basis in real property X ($40,000), decreased in the amount of money that B received ($30,000), increased in the amount of gain recognized ($30,000), and increased in the amount of additional consideration paid by B ($30,000) in the deferred exchange).

EXAMPLE 5. (i) Assume real property X is encumbered by a mortgage of $30,000. On May 17, 1991, B transfers real property X to C and identifies real property V as replacement property, and C assumes the $30,000 mortgage on real property X. Real property V is encumbered by a $20,000 mortgage. On July 5, 1991, C purchases real property V for $90,000 by paying $70,000 and assuming the mortgage and transfers real property V to B with B assuming the mortgage.

(ii) The consideration received by B in the form of the liability assumed by C ($30,000) is offset by the consideration given by B in the form of the liability assumed by B ($20,000). The excess of the liability assumed by C over the liability assumed by B, $10,000, is treated as "money or other property." See section 1.1031(b)-1(c). Thus, B recognizes gain under section 1031(b) in the amount of $10,000. Under section 1031(d), B's basis in real property V is $40,000 (i.e., B's basis in real property X ($40,000), decreased in the amount of money that B is treated as receiving in the form of the liability assumed by C ($30,000), increased in the amount of money that B is treated as paying in the form of the liability assumed by B ($20,000), and increased in the amount of the gain recognized ($10,000) in the deferred exchange).

(k) DEFINITION OF DISQUALIFIED PERSON.

(1) For purposes of this section, a disqualified person is a person described in paragraph (k)(2), (k)(3), or (k)(4) of this section.

(2) The person is the agent of the taxpayer at the time of the transaction. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction. Solely for purposes of this paragraph (k)(2), performance of the following services will not be taken into account -

(i) Services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under section 1031; and

(ii) Routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.

(3) The person and the taxpayer bear a relationship described in either section 267(b) or section 707(b) (determined by substituting in each section "10 percent" for "50 percent" each place it appears).

(4) The person and a person described in paragraph (k)(2) of this section bear a relationship described in either section 267(b) or section 707(b) (determined by substituting in each section "10 percent" for "50 percent" each place it appears).

(5) This paragraph (k) may be illustrated by the following examples. Unless otherwise provided, the following facts are assumed: On May 1, 1991, B enters into an exchange agreement (as defined in paragraph (g)(4)(iii)(B) of this section) with C whereby B retains C to facilitate an exchange with respect to real property X. On May 17, 1991, pursuant to the agreement, B executes and delivers to C a deed conveying real property X to C. C has no relationship to B described in paragraphs (k)(2), (k)(3), or (k)(4) of this section.

EXAMPLE 1. (i) C is B's accountant and has rendered accounting services to B within the 2-year period ending on May 17, 1991, other than with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under section 1031.

(ii) C is a disqualified person because C has acted as B's accountant within the 2-year period ending on May 17, 1991.

(iii) If C had not acted as B's accountant within the 2-year period ending on May 17, 1991, or if C had acted as B's accountant within that period only with respect to exchanges intended to qualify for nonrecognition of gain or loss under section 1031, C would not have been a disqualified person.

EXAMPLE 2. (i) C, which is engaged in the trade or business of acting as an intermediary to facilitate deferred exchanges, is a wholly owned subsidiary of an escrow company that has performed routine escrow services for B in the past. C has previously been retained by B to act as an intermediary in prior section 1031 exchanges.

(ii) C is not a disqualified person notwithstanding the intermediary services previously provided by C to B (see paragraph (k)(2)(i) of this section) and notwithstanding the combination of C's relationship to the escrow company and the escrow services previously provided by the escrow company to B (see paragraph (k)(2)(ii) of this section).

EXAMPLE 3. (i) C is a corporation that is only engaged in the trade or business of acting as an intermediary to facilitate deferred exchanges. Each of 10 law firms owns 10 percent of the outstanding stock of C. One of the 10 law firms that owns 10 percent of C is M. J is the managing partner of M and is the president of C. J, in his capacity as a partner in M, has also rendered legal advice to B within the 2-year period ending on May 17, 1991, on matters other than exchanges intended to qualify for nonrecognition of gain or loss under section 1031.

(ii) J and M are disqualified persons. C, however, is not a disqualified person because neither J nor M own, directly or indirectly, more than 10 percent of the stock of C. Similarly, J's participation in the management of C does not make C a disqualified person.

(1) [Reserved]

(m) DEFINITION OF FAIR MARKET VALUE.

For purposes of this section, the fair market value of property means the fair market value of the property without regard to any liabilities secured by the property.

(n) NO INFERENCE WITH RESPECT TO ACTUAL OR CONSTRUCTIVE RECEIPT RULES OUTSIDE OF SECTION 1031.

The rules provided in this section relating to actual or constructive receipt are intended to be rules for determining whether there is actual or constructive receipt in the case of a deferred exchange. No inference is intended regarding the application of these rules for purposes of determining whether actual or constructive receipt exists for any other purpose.

(o) EFFECTIVE DATE.

This section applies to transfers of property made by a taxpayer on or after January 5, 1992. However, a transfer of property made by a taxpayer on or after May 16, 1990, but before January 5, 1992 will be treated as complying with section 1031(a)(3) and this section if the deferred exchange satisfies either the provisions of this section or the provisions of the notice of proposed rule making published in the Federal Register on May 16, 1990 (55 F.R. 20278).

[T.D. 8346, 56 FR 19938, May 3, 1991]

SECTION 1.468B-6 QUALIFIED ESCROW ACCOUNTS AND QUALIFIED TRUSTS USED IN DEFERRED EXCHANGES OF LIKE-KIND PROPERTY UNDER SECTION 1031(a)(3).

Sections 1.468B-6 through 1.468B-9 are added to read as follows:

(a) SCOPE. This section provides rules under section 468B(g) relating to the current taxation of income of a qualified escrow account or qualified trust established in connection with a deferred exchange under section1031(a)(3).

(b) DEFINITIONS. As used in this section, deferred exchange, relinquished property, replacement property, qualified escrow account, qualified trust, qualified intermediary, exchange period, and escrow holder have the same meanings as in Sec. 1.1031(k)-1. Also, as used in this section, taxpayer means the transferor of the relinquished property, and transferee means the person who is treated as owning the relinquished property for federal income tax purposes after its transfer by the taxpayer. Further, owner means the person treated as owning the assets of the qualified escrow account or qualified trust under paragraph (c) of this section.

(c) INCOME OF QUALIFIED ESCROW ACCOUNT OR QUALIFIED TRUST--

(1) IN GENERAL. Except as otherwise provided in paragraph (c)(2) of this section, and except for purposes of determining whether a transaction qualifies as a deferred exchange, the taxpayer is the owner. Thus, the taxpayer must take into account in computing the taxpayer's income tax liability all items of income, deduction, and credit (including capital gains and losses) of the qualified escrow account or qualified trust.

(2) TRANSFEREE OR QUALIFIED INTERMEDIARY HAS ALL THE BENEFICIAL USE AND ENJOYMENT OF ASSETS OF A QUALIFIED ESCROW ACCOUNT OR QUALIFIED TRUST. If the transferee or the qualified intermediary has all the beneficial use and enjoyment of assets of a qualified escrow account or qualified trust, the transferee or qualified intermediary is the owner. Thus, the transferee or qualified intermediary must take into account in computing its income tax liability all items of income, deduction, and credit (including capital gains and losses) of the account or trust. The following factors, and other relevant facts and circumstances in a particular case, will be considered in determining whether the transferee or the qualified intermediary, rather than the taxpayer, has the beneficial use and enjoyment of assets of an account or trust and thus is the owner--

(i) Which person enjoys the use of the earnings of the account or trust;

(ii) Which person receives the benefit from appreciation, if any, in the value of the assets of the account or trust; and

(iii) Which person is subject to a risk of loss from a decline, if any, in the value of the assets of the account or trust.

(d) APPLICATION OF SECTION 7872. If the transferee or the qualified intermediary is the owner under paragraph (c)(2) of this section, section 7872 may apply if the deferred exchange involves a below-market loan from the taxpayer to the owner. See section 7872(c)(1) for the loans to which section 7872 applies.

(e) REPORTING OBLIGATIONS OF THE ESCROW HOLDER OR TRUSTEE--

(1) IN GENERAL. The escrow holder of a qualified escrow account and the trustee of a qualified trust must, for each calendar year (or portion thereof) that the account or trust is in existence, report the income of the account or trust on Forms 1099 in accordance with the information reporting requirements of subpart B, Part III, subchapter A, chapter 61, Subtitle F of the Internal Revenue Code. The Forms 1099 must show the escrow holder or trustee as the payor and must show the proper payee. See paragraph (e)(2) of this section for the determination of the proper payee.

(2) PERSON TREATED AS PAYEE. In satisfying the reporting obligations of paragraph (e)(1) of this section, the following rules apply to the escrow holder of a qualified escrow account and the trustee of a qualified trust--

(i) If no written statement described in paragraph (f) of this section is provided to the escrow holder or trustee, the escrow holder or trustee must treat the taxpayer as the owner and the payee of the income of the account or trust; and

(ii) If a written statement described in paragraph (f) of this section is provided to the escrow holder or trustee, the escrow holder or trustee must treat the person specified on the statement (see paragraph (f)(3) of this section) as the owner and the payee of the income of the account or trust.

(3) RELIEF FROM PENALTIES FOR FILING INCORRECT INFORMATION RETURN OR PAYEE STATEMENT. For purposes of sections 6721 and 6722, the escrow holder of a qualified escrow account or trustee of a qualified trust will not be treated as failing to file or furnish a correct information return or payee statement solely because, in preparing a Form 1099, the escrow holder or trustee relies on a statement described in paragraph (f) of this section and therefore treats the person specified on the statement (see paragraph (f)(3) of this section) as the owner and the payee of the income of the account or trust. If a statement described in paragraph (f) of this section is not provided to the escrow holder or trustee, the escrow holder or trustee will not be treated as failing to file or furnish a correct information return or payee statement solely because, in preparing a Form 1099, the escrow holder or trustee relies on the absence of the

statement and therefore treats the taxpayer as the owner and the payee of the income of the account or trust.

(f) STATEMENT PROVIDED TO ESCROW HOLDER OR TRUSTEE. If under paragraph (c)(2) of this section, the qualified intermediary or transferee is the owner, the taxpayer and the owner must furnish to the escrow holder or trustee a statement that--

(1) Is signed by the taxpayer and the owner;

(2) Is furnished to the escrow holder or trustee within 30 days after the taxpayer transfers the relinquished property; and

(3) Specifies the person treated as the owner and thus as the payee of the income of the account or trust.

(g) EFFECTIVE DATE--

(1) IN GENERAL. This section applies to qualified escrow accounts and qualified trusts established after the date of publication of final regulations in the Federal Register.

(2) TRANSITION RULE. With respect to a qualified escrow account or qualified trust established after August 16, 1986, but on or before the date of publication of final regulations in the Federal Register, the Internal Revenue Service will not challenge a reasonable, consistently applied method of taxation for income earned by the account or trust. The Internal Revenue Service will also not challenge a reasonable, consistently applied method for reporting such income.

(h) EXAMPLES. The provisions of this section may be illustrated by the following examples in which T is the taxpayer, B is the transferee, and QI is the qualified intermediary:

EXAMPLE 1.

(i) T uses the calendar year as the taxable year and the cash receipts and disbursements method of accounting. T enters into a deferred exchange agreement with B. Under the agreement, T will transfer property (the relinquished property) to B, and B must transfer to T within the exchange period consideration (cash or replacement property or both) having the same market value as that of the relinquished property. B's obligations under the agreement are secured by the assets of a qualified escrow account. The deferred exchange does not involve the use of a qualified intermediary.

(ii) Under the agreement, B must deposit cash into the qualified escrow account equal to the agreed upon fair market value of the relinquished property on the date the property is transferred to B. The agreement provides that the cash deposited into the escrow account must be invested in a money market fund.

(iii) The agreement provides that B is entitled to receive the interest earned on the escrow account in consideration for B's performance of services in connection with the exchange.

(iv) On September 1, 1999, T transfers the relinquished property to B. The property is unencumbered and has a fair market value of $100,000 on September 1, 1999. B deposits $100,000 into a qualified escrow account. The $100,000 is invested in accordance with the exchange agreement in a money market fund. During 1999, $2,000 of interest is earned on the escrow account. During January 2000, an additional $400 of interest is earned on the escrow account. On February 1, 2000, B uses $100,000 of the funds in the escrow account to purchase replacement property identified by T, and on this same date B transfers the replacement property to T. The interest earned on the escrow account, $2,400, is paid to B from the escrow account in consideration for B's performance of services.

(v) Paragraph (c)(1) of this section applies and T must take into account in computing T's income tax liability for 1999 and 2000 the $2400 of interest earned on the escrow account in those years even though the interest is paid to B as compensation for B's services. Paragraph (c)(1) of this section applies for the following reasons. T, rather than B, enjoys the use of the earnings of the escrow account since the earnings are used to discharge T's obligation to pay B for B's services. B is not considered to have all the beneficial use and enjoyment of the assets of the escrow account merely because the compensation that B is entitled to receive is based on the earnings of the escrow account.

(vi) The escrow holder must file Forms 1099 for 1999 and 2000 and furnish T with payee statements with respect to the interest earned on the escrow in 1999 and 2000. See paragraph (e)(1) of this section.

EXAMPLE 2.

(i) The facts are the same as in Example 1 except that the agreement between B and T requires B to pay $100,000 to QI; under the agreement between T and QI, QI is obligated to transfer to T within the exchange period consideration (cash or replacement property or both) equal to $100,000 plus interest thereon at 4 percent compounded semiannually; QI's obligation to transfer this consideration is secured by the $100,000 received from B, which QI must deposit into a qualified escrow account; the assets of the escrow account must be invested in a money market fund; and, as compensation for QI's performance of services to facilitate the deferred exchange, QI is entitled to receive the excess of the interest earned on the escrow account over the amount of interest (computed at 4 percent compounded semiannually) payable to T in cash or property.

(ii) QI deposits the $100,000 received from B into a qualified escrow account, and the $100,000 is invested in a money market fund earning interest at 4.8 percent compounded semiannually. During 1999, $1,600 of interest is earned on the escrow account. During January 2000, an additional $400 of interest is earned on the escrow account. On February 1, 2000, QI uses $101,667 of the funds in the escrow account to purchase replacement property, which is transferred to T. This transfer satisfies QI's obligations under the agreement because $1,667 is the amount of interest that is earned on $100,000 at 4 percent compounded semiannually for 5 months. Of the $2,000 in interest earned on the escrow account in 1999 and 2000, $1,667 is used to purchase replacement property, and the remaining $333 is paid in cash to QI as compensation for QI's services.

(iii) Paragraph (c)(1) of this section applies and T must take into account in computing T's income tax liability for 1999 and 2000 the $2000 of interest earned on the escrow account in those years even though $333 of the interest is paid to QI as compensation for QI's services.

(iv) The escrow holder must file Forms 1099 and furnish T with payee statements with respect to the $2000 of interest earned on the escrow in 1999 and 2000. See paragraph (e)(1) of this section.

[64 FR 4801, February 1, 1999]

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