Like-Kind Exchange Corner

By Mary B. Foster

A Practical Guide to Code Sec. 1031 Identification Issues (Part II): Alternate and Multiple Properties and Identifying when the Replacement Property Is Under Production

In my prior article in the November–December 2013 issue of the JOURNAL OF PASSTHROUGH ENTITIES,[1] I discussed the identification requirements in forward exchanges and parking arrangements, focusing on the description of the identified property and the requirement that the taxpayer ultimately receive "substantially the same property as identified." This column will look at the rules for alternate identification and multiple properties, as well as the identification rules for property under production or construction. It will also address the identification of relinquished property in a parking arrangement when there are alternate taxpayers.

The 3-Property and 200% Rules

As I stated in my prior column on identification issues, the 45-day identification period goes by quickly for a taxpayer who has not located and tied up replacement property prior to the relinquished property disposition in a forward exchange. Fortunately, the regulations do allow the taxpayer to identify alternative properties, so if the taxpayer fails to acquire one identified property, the taxpayer will have other options. These alternatives also apply in a parking arrangement.

Forward Exchanges. The regulations contain what are known as the "3-property rule" and the "200% rule." Under these rules, the maximum number of replacement properties that may be identified in a forward exchange is:

1. three properties, without regard to the fair market value of the properties[2]; or
2. any number of properties, so long as their aggregate fair market value at the end of the

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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.[3]

While any replacement property received by the taxpayer before the end of the identification period is treated as timely identified, the property must be counted for the purposes of the 3-property rule and the 200% rule.[4] The regulations provide the following example: If 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, 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 ((2 x $100,000) minus $50,000).[5]

Parking Arrangements. There are no specific examples of how to apply the 3-property rule and 200% rule in parking arrangements. Rev. Proc. 2000-37 only states that "the identification must be made in a manner consistent with the principles described in section 1.1031(k)-1(c)" for identifying replacement property in a deferred exchange. For this purpose, "the taxpayer may properly identify alternative or multiple properties, as described in section 1.1031(k)-1(c)(4)."[6]

The 3-property rule can easily be applied to a parking arrangement. The taxpayer may identify up to three relinquished properties of any value, regardless of the value of the parked replacement property.[7]

The application of the 200% rule to a parking arrangement also seems relatively straightforward, provided that the replacement property is not under production or construction. The 200-percent limit in a parking transaction is most likely computed by doubling the purchase price of the parked replacement property at the time it is acquired by the exchange accommodation titleholder ("EAT"). Thus, a taxpayer can identify any number of relinquished properties, so long as their value, determined as of the end of the identification period, does not exceed 200 percent of the value of the parked replacement property.[8] Identifying when the parked replacement property is under production is discussed later in this article.

Issues with the 3-Property Rule

The most problematic issue with the 3-property rule is defining what constitutes "one" property. Obviously, the broader the definition, the more alternative properties that taxpayer will have to choose from, and, therefore, the greater the probability of a successful exchange. For example, a taxpayer may want to identify two contiguous lots as one property, thus leaving the taxpayer two more alternative designations rather than one alternative designation. Unfortunately, the regulations offer absolutely no guidance on the definition of one property, and there have been no rulings on it either. Therefore, a tax advisor can provide no real substantive guidance on this important issue.

The IRS did offer an interpretation of what constitutes "one property" in the context of co-tenancies owning multiple properties. This interpretation does not specifically apply to the identification rules, but nevertheless the principles applied still may be helpful. Rev. Proc. 2002-22[9] provides that the IRS will generally treat contiguous parcels as comprising a single business unit or "property." Even if the parcels are not contiguous, however, the IRS may treat multiple parcels as comprising a single business unit where there is a close connection between the business use of one parcel and the business use of another parcel. For example, an office building and a garage that services the tenants of the office building may be treated as a single business unit even if the office building and the garage are not contiguous.

Due to the lack of direct guidance on what constitutes one property for identification purposes, a taxpayer will have to take a pragmatic approach and weigh the risk of violating the 3-property rule with the risk of not being able to acquire replacement property sufficient to defer enough tax to make the exchange worthwhile. For example, suppose a taxpayer wants to identify three condominium units in the same condominium, which are being sold by the same seller under the same purchase agreement. All three units must be purchased together. It is not clear if this is one property or three properties under the 3-property rule. If there is a significant chance that the taxpayer will not actually obtain the three units with the result that the exchange fails, then the taxpayer will probably need to take the risk of treating them as one property and identifying other alternative other properties.

Another common example of the difficulty with the definition of one property can be found with packaged oil and gas interests. There are several wells involved but they are packaged together as one investment and must be purchased together under one agreement. It is not clear if they are one property or several properties for the purpose of the 3-property rule. The conservative approach would be to use the 200% rule in this situation.

Issues with the 200% Rule

Computing the 200% Limit. The 200% rule states that the 200-percent limit in a forward exchange is calculated based on the "aggregate fair market value of all the relinquished properties, as of the date the relinquished properties were transferred by the taxpayer." The fair market value of a relinquished property would likely be its purchase price because this is the price a willing buyer is paying. It would be difficult to argue for a higher fair market value, even if the buyer of the relinquished property sold it at a profit shortly thereafter.

The main issue in computing the 200-percent limit in a forward exchange is the treatment of selling costs and taxable boot received by the taxpayer. Do these amounts, which can be substantial, reduce the "aggregate fair market value" of the relinquished property and therefore the 200-percent limit? The examples in the regulations do not address the issue of selling costs or taxable boot in the 200-percent limit calculation. The only guidance is a private letter ruling in which the 200-percent limit was calculated based on the gross sales price, even though sales and exchange expenses were paid from the sales proceeds.[10] The taxpayer in this private letter ruling also represented that it might receive taxable cash boot from the sale of the relinquished property.

An exchange with a relinquished property underwater in debt or in foreclosure also raises issues about how to compute the 200-percent limit. The 200% rule states that the aggregate values of all the identified properties cannot exceed 200 percent of the "value" of the relinquished property at the time it was transferred by the taxpayer. In an underwater situation, the "value" of the relinquished property could mean the actual fair market value, which makes sense when the property is subject to recourse debt. "Value" could also mean the fair market value of the relinquished property subject to nonrecourse debt, even though the fair market value could be significantly less than the debt relief amount. Alternatively, in the nonrecourse debt situation, "value" could also be the amount of the outstanding principal amount of the nonrecourse debt, which is treated as the consideration received by the taxpayer from the transfer of the relinquished property.[11] This definition is more in keeping with the spirit of the 200% rule because the intent of the rule is to give the taxpayer identification alternatives equal to twice the exchange value of the relinquished property. With nonrecourse debt, the exchange value of the relinquished property is presumably the amount of the nonrecourse debt because it likely would be treated as liability relief in the exchange.[12]

Computing the Value of the Identified Properties in a Forward Exchange. For purposes of the 200% rule in a forward exchange, the fair market value of the identified replacement properties is determined at the end of the identification period. If a taxpayer hopes to obtain replacement property for a below-market price, the taxpayer may want to use the higher market price in applying the 200% rule. The IRS could potentially argue that a higher value should have been used, and this may put the taxpayer over the 200-percent limit. This scenario could occur if the identified property is not acquired by the taxpayer in the exchange, but is sold shortly thereafter to another buyer at a significantly higher price. Taxpayers should be cautious with the valuations when using the 200% rule, and err on the high side of value to avoid exceeding the 200-percent limit.

Many taxpayers will include the estimated values of the identified replacement properties in the identification notice. However, the regulations describing the 200% rule do not require that the taxpayer include the valuations. Sometimes, the QI involved will require the valuations be included to make sure that the taxpayer understands the 200-percent limitation. A taxpayer should double check the addition of the values, as mistakes in totaling the values are sometimes made. A taxpayer who makes an error in computing the values and thus ends up over 200-percent limit will need to look for other indicia of the fair market value, such an appraisal or market valuation, to hopefully save the identification and thus the exchange.

The following example from the regulations illustrates the 200% rule. The example does not state that the valuation was included in the written document. It also does not state how the fair market values of the identified properties were determined.[13]

> **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% of the aggregate fair market value of real property X (200% x $100,000 = $200,000). Therefore, the requirements of the 200% rule are satisfied, and real properties L, M, N and P are all identified before the end of the identification period.

Consequences of Exceeding the Three-Property and 200-Percent Limits

The regulations provide that if the taxpayer identifies more than three properties and the total value of the identified properties exceeds the 200-percent limit, then the taxpayer will be deemed to have not identified any replacement property and the transfer of the relinquished property will be taxed as a sale.[14] This is a harsh result. There are two limited exceptions to this rule.

The first exception provides that any replacement property received by the taxpayer before the end of the identification period will be treated as properly identified, regardless of whether the 3-property rule and 200% rule are subsequently violated at the end of the identification period.[15]

The second exception provides that if the 3-property rule and 200% rule are violated, the taxpayer is still treated as properly identifying any replacement property identified before the end of the identification period and received before the end of the replacement period, if the fair market value of the replacement property received is at least 95 percent of the aggregate fair market value of all identified replacement property.[16] This is referred to as the "95% rule." For purposes of the 95% rule, 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.[17]

It is perilous for the taxpayer to exceed three properties and the 200-percent limit in an identification in a forward exchange. Under the 95% rule, the taxpayer must acquire 95 percent of the identified properties. The risk always exists that one or more of such identified properties will be sold to someone other than the taxpayer before the end of the exchange period rendering it impossible to close on 95 percent of the properties identified.

The 95% rule might be used if the taxpayer is trading up in value and wants to spread the relinquished property proceeds among the multiple replacement properties. However, the taxpayer should have all the identified replacement properties tied up at the time of the identification. And the properties should perhaps close as one transaction so there is no chance the taxpayer will not acquire all of the properties. Otherwise, the taxpayer should not take this risk. Instead, the taxpayer should identify under the 3-property or 200% rules, acquire enough replacement property to defer the gain in the exchange, and then refinance the replacement properties and use the proceeds to purchase the additional properties outside of the exchange.

Most taxpayers will utilize the 3-property rule in both forward exchanges and parking arrangements. The 200% rule is only used in a forward exchange if the taxpayer intends to acquire several properties of lesser value than the relinquished property. It is used in a parking arrangement if the taxpayer is disposing of several relinquished properties of lesser value than the parked replacement property.

Multiple Relinquished Properties, Including Business Exchanges

If multiple relinquished properties are transferred in the same forward exchange, the 3-property rule and 200% rule will apply to the transaction as a whole, and not to each relinquished property or to each group of a type of relinquished property. The regulations provide that these rules apply regardless of the number of properties transferred by the taxpayer as part of the same forward exchange.[18] Therefore, separate relinquished properties often will be split into separate exchanges if possible, to allow the taxpayer to have additional alternative replacement property identifications. The subject of splitting exchanges was addressed in an earlier article in the *Like-Kind Exchange Corner*.[19]

If the relinquished property is a multi-asset business transferred in one transaction, it likely cannot be split into separate exchanges. If the replacement property is also a multi-asset business, the 3-property rule will not be workable because the business is comprised of more than three properties. The 200% rule must be used, or the taxpayer must acquire the replacement business prior to the end of the identification period. This is difficult for some taxpayers to grasp. They believe they should be able to simply identify three businesses without regard to the number of individual assets comprising the business.

The incidental property rule may be applicable if the business has one large asset that constitutes at least 85 percent of the aggregate value of all of the assets of the business. In such a case, the large asset and the "incidental" property will be treated as one property for the purposes of the 3-property rule.[20] The aggregate value of the incidental property will, however, count as part of the 200% rule. The incidental property typically must be transferred with the larger property in standard commercial transactions. For example, furniture, laundry machines and other miscellaneous items of personal property will not be treated as separate property under the 3-property rule from an apartment building with a fair market value of $1 million if the aggregate fair market value of the furniture, laundry machines and other personal property does not exceed $150,000.[21]

Special Identification Rules when the Replacement Property is under Production

In a forward exchange, the regulations permit the identification of replacement property not in existence or which is being produced at the time it is identified.[22]The terms "produced" and "production" have the meanings as provided in Code Sec. 263A(g)(1) and the regulations thereunder.[23] Under that section, the term "produce" is broadly construed and includes "construct, build, install, manufacture, develop, improve, create, raise, or grow."[24]

The identification of property under production must be unambiguous. The regulations provide that if improvements are to be constructed on real property, the property is properly identified if a legal description is provided for the underlying land andas much detail is provided regarding the construction of the improvements "as is practical" at the time the identification is made.[25] This raises the issue of how much detail is "practical." The regulations contain no examples to assist in determining what level of detail is sufficient. Thus, it could mean a copy of the plans and specifications of improvements if they exist at the time of the identification. However, it might be unreasonably costly to provide the QI with a copy of the drawings. In such case, several paragraphs describing the improvements would hopefully be adequate. The plans and specifications could be incorporated by reference for extra protection.

No example is given in the regulations for identifying personal property to be produced. However, unlike real property, which can be partially complete when received by the taxpayer, personal property must be complete before it is received by the taxpayer in the exchange. Thus, the taxpayer often will have executed a contract identifying the specific equipment under production prior to the end of the identification period. For example, an aircraft or vessel takes more than 180 days to construct and production will have started prior to the disposition of the relinquished property. Identification issues might arise with creative personal property, such as artwork, and could be more difficult to describe in detail.

For purposes of the 200% rule and the incidental property rule, 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.[26] The regulations do not establish a method for determining the estimated fair market value for real property construction, which is often subject to delays due to weather and other conditions. Presumably, the taxpayer could rely on an estimate provided by the construction contractor.

Note that if improvements are made to the replacement property prior to the receipt by the taxpayer, but not contained in the identification, then this could result in the receipt of unidentified property in the exchange because the completed property is not substantially the same as identified. This was discussed in detail in the prior column.

The 200-Percent Limit in Parking Arrangements. In a parking arrangement with replacement property under production, the 200-percent limit becomes problematic because it is based on the value of the parked replacement property, and that value is increasing during the parking period. Thus, it must be determined what replacement property value to use to determine the 200-percent limit. As discussed above, in a forward exchange when an identified replacement property is under production, the value is the estimated value of the replacement property as of the date it is expected to be received by the taxpayer.

One possible solution is to apply this principle in a parking arrangement so that the 200-percent limit would be calculated using the expected value of the replacement property, including improvements, on the date it is expected to be transferred to the taxpayer. This expected value could be determined using the construction schedule estimates in place as of the end of the identification period for the parking arrangement.[27]

There are two alternative valuation dates for the parked replacement property for 200% rule purposes. In a forward exchange without replacement property under production, the replacement properties values are determined at the end of the identification period. Therefore, the 200-percent limit in a parking arrangement could be based on the value of replacement property, including improvements, as of the end of the identification period for the parking arrangement. Finally, the value of the replacement property for the purposes of the 200% rule could be the value when it is first acquired by the EAT. Both of these alternative valuation dates seem unduly restrictive and not in keeping with the principles of the deferred exchange regulations. Unfortunately, no examples are contained in Rev. Proc. 2000-37.

Identifications in Alternate Parking Arrangements

Many businesses hold real properties in different taxable entities, and these properties may be alternative relinquished properties in a parking arrangement for a particular replacement property. In a private letter ruling, the IRS ruled that an EAT may enter into multiple and simultaneous qualified exchange accommodation arrangements ("QEAAs") with multiple taxpayers (related or unrelated) for the same parked property. The alternate taxpayers may acquire all or a portion of the parked property. The ruling generously found that each QEAA constitutes a separate and distinct QEAA with a separate application of the identification rules. Thus, for example, each taxpayer may identify up to three relinquished properties under the 3-property rule.[28] The 200-percent limit presumably would be calculated based on the value of the parked property described in the respective taxpayer's QEAA.

Conclusion

The identification rules are harsh, particularly in a forward exchange. The 45-day identification period goes by quickly, and a taxpayer may be forced to select properties without tying them up first or performing proper due diligence. Often, these property choices do not work out. The regulations provide limited relief with the 3-property rule and 200% rule. There are some issues with these rules, particularly with what constitutes one property for the 3-property rule.

My next article in this series will address identifications in combined forward exchanges and parking arrangements.

Endnotes

1 Mary B. Foster, Like-Kind Exchange Corner, *A Practical guide to Code Sec. 1031 Identification Issues (Part I): Describing the Identified Property and the "Substantially the Same As Identified" Requirement*, J. Passthrough Entities, Nov.–Dec. 2013, at 29.
2 Reg. §1.1031(k)-1(c)(4)(i)(A).
3 Reg. §1.1031(k)-1(c)(4)(i)(B).
4 Reg. § 1.1031(k)-1(c)(4)(ii)(A).
5 Reg. § 1.1031(k)-1(c)(4)(iii).
6 Rev. Proc. 2000-37, 2000-2 CB 308, Sec. 4.02(4).
7 LTR 201242003 (Oct. 19, 2012), CCA 200836024 (May 12, 2008).
8 Reg. §1.1031(k)-1(c)(4)(i)(B).
9 Rev. Proc. 2002-22, 2002-1 CB 733.
10 LTR 201048025 (Dec. 3, 2010).
11 Code Sec. 7701(g) provides that in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject.
12 LTR 201302009 (Jan. 11, 2013); see also Mary B. Foster, Like-Kind Exchange Corner, *Update of Foreclosures and Code Sec. 1031: LTR Approves Exchange of Property Given Back to Lenders*, J. Passthrough Entities, Mar–Apr. 2013, at 23.
13 Reg. §1.1031(k)-1(c)(7).
14 Reg. §1.1031(k)-1(c)(4)(ii).
15 Reg. §1.1031(k)-1(c)(4)(ii)(A).
16 Reg. §1.1031(k)-1(c)(4)(ii)(B).
17 *Id.*
18 Reg. 1.1031(k)-1(c)(4).
19 *See* Louis S. Weller, Like-Kind Exchange Corner, *What is the "Same" Deferred Exchange*, J. Passthrough Entities, Sept.–Oct. 2011.
20 Reg. §1.1031(k)-1(c)(5).
21 Reg. §1.1031(k)-1(c)(5)(ii).
22 Reg. § 1.1031(k)-1(c)(1).
23 Reg. §1.1031(k)-1(e)(1).
24 Reg. §1.263A-2.
25 Reg. §1.1031(k)-1(e)(2)(i).
26 Reg. §1.1031(k)-1(e)(2)(ii).
27 Rev. Proc. 2000-37 states that identification in a parking arrangement must made in manner consistent with the principles described in Reg. §1.1031(k)-1(c), but the identification rules for property under production are found in Reg. §1.1031(k)-1(e). Nevertheless, it seems that consistency requires that all of the identification principles for forward exchanges should apply to reverse exchanges.
28 LTR 201242003 (Oct. 19, 2012).