

**SELECT ISSUES WITH 1031 EXCHANGES**

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## BIOGRAPHICAL INFORMATION

Greg Lehrmann has devoted the last 31 years of his legal career exclusively to 1031 exchanges. While handling exchanges for investors and business owners, he also dedicates a significant portion of his time speaking to attorneys, CPAs, escrow officers, financial advisors, real estate agents and investors throughout the nation on the many ways to improve investment returns through IRC Section 1031.

## EDUCATION

- B.B.A. in Accounting, With Honors, The University of Texas
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## PROFESSIONAL ACTIVITIES

- Board Certified, Commercial Real Estate Law
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## REPRESENTATIVE PUBLICATIONS

- *Safe Harbor*, TEXAS REALTOR, July 2008
- *Keeping Uncle Sam Out of The Oil Patch*, LANDMAN, Jan./Feb. 2008
- *Using Advanced 1031 Exchange Strategies to Improve Client Investment Returns*, SOCIETY OF INDUSTRIAL AND OFFICE REALTORS® REPORT (Spring 2005)
- *1031 Tax-Deferred Exchanges: Evolving Rules, Greater Opportunities*, TIERRA GRANDE, July 2002

## PERSONAL

Mr. Lehrmann and his wife, Texas Supreme Court Senior Justice Debra Lehrmann, have two sons who are practicing attorneys and three beautiful grandchildren.



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## SELECT ISSUES WITH 1031 EXCHANGES

**THE BIG PICTURE:** Section 1031 of the US Tax Code allows owners of real property to defer taxes on the sale of real estate held for business or investment when buying other real estate to be held for business or investment. It was first enacted in 1921 when Congress recognized the importance of encouraging reinvestment in business assets in order to create jobs, increase personal income and ultimately maximize government revenue. Internal Revenue Code (I.R.C.) § 1031.

### I. THREE KEYS TO EVERY EXCHANGE: “LIKE-KIND”, “EXCHANGE”, AND “QUALIFIED INTERMEDIARY”

#### A. Like-Kind

Both the relinquished property and the replacement property must be held for business or investment. The term that the tax code assigns to this type of property is “like-kind.” But as applied by the regulations and courts, the properties that are interchangeable can be very different from each other. “The words ‘like-kind’ refer to the nature or character of the property, not to its grade or quality.” Treas. Reg. § 1.1031(a)-1(b) (as amended in 2020).

#### 1. The following types of real property interests have been held to be “like-kind.”

- Real property in the city exchanged for a ranch or farm. *Rutland v. Comm’r*, 36 T.C.M. 40 (1977).
- A leasehold with 30 or more years to run exchanged for fee simple title. Treas. Reg. § 1.1031(a)-1(c).
- Residential rental exchanged for farmland and improvements. Rev. Rul. 72-151, 1972-1 C.B. 225.
- Improved real property exchanged for unimproved real property (but beware of depreciation recapture). *Barker v. Comm’r*, 74 T.C. 555 (1980).
- An exchange among cotenants of two or more parcels of real property so that each ends up with sole ownership of one of the parcels. Rev. Rul. 79-44, 1979-1 C.B. 265.
- A conservation easement in perpetuity in land exchanged for a fee interest in real property. I.R.S. Priv. Ltr. Ruls. 9232030 (May 12, 1992), 200201007 (Jan. 4, 2002), 200203033 (Jan. 22, 2002), 200203042 (Jan. 22, 2002).
- Raw land on which taxpayers operated a sand mining business exchanged for land and buildings. *Beeler v. Comm’r*, 73 T.C.M. 1982 (1997).
- A working interest in a producing oil lease exchanged for a fee simple interest in real property.

But some recapture will apply. Rev. Rul. 68-331, 1968-1 C.B. 352.

- Water rights that are perpetual and considered real property under state law exchanged for any other qualifying property as long as the water rights are not narrowly restricted. I.R.S. Priv. Ltr. Rul. 202309007 (Mar. 3, 2023); *Wiechens v. United States*, 228 F. Supp. 2d 1080 (D. Ariz. 2002).
- Cell tower, billboard and fiber optic cable easements exchanged for any other qualifying property. I.R.S. Priv. Ltr. Rul. 201149003 (Dec. 12, 2011).
- Delaware Statutory Trusts (DSTs) exchanged for any other qualifying property. Rev. Rul. 2004-86, 2004-2 C.B. 191.
- Business or investment portions of land that are also used as a primary residence exchanged for any other qualifying property. *Rev Proc 2005-14*

NOTE: A growing number of people exchange land that does not generate cash flow, or rentals that produce cash but are high maintenance, for quasi “mailbox money” of triple net leased properties, Delaware Statutory Trusts or oil and gas royalties.

#### 2. Split-treatment transactions involve properties used partially as a principal residence and partially as a business or investment.

- Example: The sale of a farm or ranch that includes a primary residence. A landowner sells a 100-acre plot that includes 95 acres of farmland and 5 acres that is used as a primary residence. IRC § 121 allows the property owner to exclude up to \$250,000 (or \$500,000 if married filing jointly) on the gain of the sale of the primary residence, which provides full or partial tax deferral on the primary residence portion of the transaction. A 1031 exchange could be used for the remainder of the property, potentially achieving full tax deferral. The taxpayer and their tax advisor must allocate the portion used as a principal residence for tax exclusion under § 121, with the remaining portion qualifying for § 1031 deferral. The taxpayer can receive the sale proceeds directly from the closing on the principal residence allocation of the transaction. The taxpayer must have a QI in place for the § 1031 exchange portion of the transaction (i.e. the portion allocated to business or held for investment.) The QI will receive the portion of the sale proceeds for the business or investment portion and the QI will acquire like-kind replacement property pursuant to the § 1031 exchange rules and requirements. The taxpayer must meet all other requirements necessary for a § 1031 exchange.

- Example: The taxpayer owns a primary residence in which a portion of the house was rented as a short-term or long-term rental. The property is sold and the taxpayer receives the portion of the sale attributed to the principal residence portion (§ 121). A QI is engaged to hold the net proceeds from the sale of the rental portion of proceeds as a 1031 exchange. The same analysis applies if a portion of the house is used as a home office.

### 3. Vacation Homes

Revenue Procedure 2008-16 provides a safe harbor definition of investment property applicable to IRC Section 1031 exchange transactions closing after March 10, 2008 that involve the transfer of property consisting of a dwelling unit (defined below) or the acquisition of a dwelling unit as replacement property, involving a combination of personal use and rental activity. Rev. Proc. 2008-16, 2008-10 I.R.B. 547. In short, the IRS will not challenge whether a residential property or vacation home property is held for productive use in a trade or business or for investment if certain specified ownership and use requirements are met. This safe harbor provides useful guidance on the characterization of vacation property and may also be useful for planning things such as the conversion of a principal residence into a qualifying relinquished property.

A dwelling unit is defined as any real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including a sleeping space, bathroom and cooking facilities (e.g., a residential property). *Id.* The IRS will not challenge whether a dwelling unit qualifies as like-kind property held for productive use in a trade or business or for investment if: (1) the relinquished property is owned by the taxpayer for at least 24 months immediately prior to the 1031 exchange and a replacement property is owned for at least 24 months immediately after the 1031 exchange (the “qualifying use period”), and (2) within each of the two 12-month periods constituting the qualifying use period, the taxpayer must rent the property to another person or persons at a fair market rent for 14 or more days and the taxpayer’s personal use of the dwelling unit cannot exceed the greater of 14 days or 10 percent of the number of days during the 12-month period the dwelling unit is rented at a fair market rent.

Personal use of a dwelling unit occurs on any day in which the taxpayer is deemed to use the property for personal purposes under IRC § 280A(d)(2) (taking into account § 280A(d)(3) but not § 280A(d)(4)). Thus, personal use includes: (1) use by the taxpayer or any other person who has an interest in the property or by a family member; (2) use by any individual who uses the unit under an arrangement which enables the taxpayer to use some other dwelling unit (whether or not a rental

is charged for the use of such other unit); or (3) use by any other individual if rented for less than fair market value. A taxpayer can rent the property to a family member if (A) the family member pays fair market rent and (B) the family member uses the property as their principal residence. Whether a dwelling unit is rented at a fair market rental rate depends on all the facts and circumstances that exist when the rental agreement is entered. All rights and obligations of the parties to the rental agreement are taken into account.

If the taxpayer performs work on the property, the taxpayer and her tax advisor decides whether such time working on the property constitutes personal use of same.

### 4. The “held-for” requirement.

Like-kind properties must be held for productive use in a trade or business or for investment. This leads some tax practitioners to believe that exchanges are only available for properties they have held at least one year. Other practitioners believe that only a two-year holding period suffices. Both views are wrong. Section 1031 does not define the word “held.” The actual duration of holding is only one factor to be considered in determining the taxpayer’s intent. The IRS and the tax courts will look at all evidence surrounding the acquisition to determine whether the taxpayer’s use of the replacement property after the exchange is consistent with an intent to hold. *Black v. Comm’r*, 35 T.C. 90, 95 (1960); *Click v. Comm’r*, 78 T.C. 225 (1982); *Wagensen v. Comm’r*, 74 T.C. 653 (1980); *Regals Realty Co. v. Comm’r*, 127 F.2d 931 (2d Cir. 1942).

In *Reesink v. Commissioner*, 103 T.C.M. 1647 (2012), a husband and wife purchased a residential house as a replacement property with the intent to rent the property. Unfortunately, the taxpayers were unable to find a tenant willing to pay the rent they wanted, so they decided to sell their current residence and move into the rental home that they acquired in the 1031 exchange. They moved into the rental home only eight months after it was purchased in the 1031 exchange. Nevertheless, the Tax Court found that the taxpayers intended to hold the rental property as an investment at the time they engaged in the 1031 exchange.

In its decision for the taxpayers, the Tax Court found:

- The taxpayers placed many rental flyers throughout the town advertising the house as available for rent;
- The taxpayers showed the house to two different potential tenants;
- The taxpayers refrained from using the property for recreational use prior to moving into the property;
- The taxpayers decided to sell their personal residence almost six months after purchasing the replacement property;

- The taxpayers waited eight months after acquiring the property to move in.

The taxpayers also presented corroborative testimony. For example, one of the taxpayer's siblings testified that the taxpayers frequently mentioned their desire to move into the town where the replacement property was located but that they did not plan to do so for at least 3-4 years after their oldest child (who was 14 at the time) had graduated from high school. Additionally, the taxpayers' income had decreased substantially due to illness, and they did not feel they had enough cash flow to continue to pay the expenses associated with all of their properties.

The *Reesink* case shows the need for evidence of the taxpayer's intent to acquire property for use in a trade or business or to be held for investment. Every taxpayer should make significant and meaningful efforts to treat a replacement property acquired in a 1031 exchange as a qualifying property held for investment before converting this property into a personal residence or for any other non-qualifying purpose. Importantly, the intent is established not only by behavior during the exchange period but also by behavior before and after the exchange period. Determination of "intent to hold" is made on a case-by-case basis entailing examination of the specific facts at issue.

##### 5. Property held for resale.

The opposite of property held for investment is property held for resale. Real property held as "stock in trade or other property primarily for sale" is excluded from the tax deferral benefits of IRC Section 1031. Stock in trade describes property which is included in the inventory of a dealer and is held for sale to customers in the ordinary course of business. The gain on the sale of this type of property is taxed as ordinary income.

To qualify for a 1031 exchange, a taxpayer must be able to support that their "intent" at the time of the purchase was to hold the property for investment. Listed below are some factors the IRS may review to determine whether the intent was to hold the property for investment purposes. The burden of substantiating the investment intent is the responsibility of the taxpayer and the list set out below is not exhaustive.

- The nature and purpose of the acquisition of the property and the duration of ownership;
- The extent and nature of the taxpayer's efforts to sell the property such as listing the property for sale with a real estate agent;
- The number, extent, continuity, and substantiality of the sales;
- The use of a business office for the sale of the property;
- The character and degree of supervision or control exercised by the taxpayer over any representative selling the property;
- The time and effort the taxpayer habitually devoted to the sales.

The fact that a taxpayer is considered a dealer does not automatically disqualify them from performing a 1031 exchange. A dealer may be able to segregate assets that they intend "to hold for productive use in a trade or business or for investment" from their dealer property or property held primarily for sale. Some dealers have been advised by their tax advisors to form a separate entity, such as an LLC, to hold title to property for investment purposes that may be able to qualify for a 1031 exchange in the future.

It is important that all taxpayers, and particularly those that hold property for sale, review their transaction with an attorney or accountant before proceeding with a 1031 exchange. There are many issues not covered in this short discussion which may affect the ability of a taxpayer to successfully defend a 1031 exchange transaction. *Paullus v. Comm'r*, 72 T.C.M. 636 (1996); *Suburban Realty Co. v. United States*, 615 F.2d 171 (5th Cir. 1980).

Is a 12-year holding period long enough for property to be considered to be "held for investment"? While a holding period longer than a decade may seem sufficient, the intent of the taxpayer is more important than the length of the holding period. *Allen v. US*, 113 AFTR 2d 2014-2262 (2014). In *Allen* the taxpayer admitted that he originally acquired the property to develop and resell it. He argued that he changed his mind and decided not to develop the property, but continued to hold it "for investment" until he could sell it.

Whether a taxpayer intends to hold a property for resale or for investment at the time of an exchange can be a critical issue if an exchange is challenged by the IRS. Proving such intent can be difficult. A taxpayer's intent in holding a property is a question of fact. See *Austin v. Comm'r of Internal Rev.*, 263 F.2d 460, 461 (9th Cir. 1959). Courts take into account a number of factors to determine if the property was held for sale or for investment.

In *Allen*, the court found that the taxpayer originally acquired the property for development and resale and that the taxpayer failed to adequately prove that he changed his intent to "holding the property for investment." In deciding the case in favor of the IRS, the tax court cited the following evidence persuasive:

- Allen purchased the property in 1987; from 1987 to 1995 Allen attempted to develop the property on his own;

- Allen admitted he initially intended to develop the property on his own and then searched for partners to help develop the property;
- From 1995 to 1999 Allen brought in partners who contributed capital for development;
- In 1999, Allen sold the property to a developer;
- Allen made significant and extensive efforts to develop the property over many years, and failed to substantiate when his actions changed with regard to the property;
- Ultimately, Allen failed to provide any evidence to prove that his intent changed during the time of his ownership of the property.

Although the intent with respect to a property can change over time, the intent during the period immediately prior to the sale is critical. See *Tibbals v. United States*, 362 F.2d 266, 273 (Ct. Cl. 1966). The Court determined in *Allen* that the taxpayer failed to show when, how, or why his intent changed.

The *Allen* case demonstrates the need for solid evidence, documentation and establishment of clear facts and circumstances when a taxpayer asserts that her intent with regard to an exchange property changed from “intent to sell” to “intent to hold for investment.” In the event of an audit, the IRS and state tax authorities will require objective evidence supporting the taxpayer’s assertion of their change of intent. Every taxpayer should make significant efforts to document and collect evidence to establish change in intent. The best practice is to maintain separate entities that hold property for resale and that hold properties for investment.

#### 6. Partnership Drop-and-Swaps.

Like any taxpayer, a partnership or a limited liability company taxed as a partnership (“partnership”) can engage in a like-kind exchange under I.R.C. § 1031. Difficulties can arise, however, when the individual partners desire different outcomes with regard to the sale of property by the partnership. Some partners may wish for the partnership to continue and to do an exchange at the entity level; others may want to do their own exchange with their portion of the property; still others may wish to receive cash and simply pay the tax. What alternatives are available to the partners?

A taxpayer must own a capital asset to do a 1031 exchange. The fact that a partnership owns a capital asset does not mean that the individual partners have an ownership interest in that asset. The partners merely own partnership interests. Partnership interests are specifically excluded from Section 1031 under section 1031(a)(2)(D). Therefore, if an individual partner wants to do a 1031 exchange, the partner must convert his or her partnership interest into an interest in the capital asset owned by the partnership.

One method for accomplishing this, known as a “drop-and-swap,” involves the liquidation of a partnership interest by distributing an interest in the property owned by the partnership. After completion of the “drop,” the former partner will have converted his or her partnership interest into an interest in the actual property itself, as a tenant-in-common with the partnership. The property can then be sold, with the former partner and the partnership each entitled to do what they wish (sell or exchange) with their respective interests.

Related to the “drop-and-swap” is the “swap-and-drop.” This involves the same two steps, but in reverse order. The partnership completes the exchange (the “swap”), and then distributes an interest in the replacement property to the departing partner.

Caveat: Both the “drop-and-swap” and the “swap-and-drop” alternatives raise potential holding issues. If the “drop” occurs close in time to the “swap” (or vice versa), there may be some question as to whether the relinquished property (or replacement property) was “held for investment.” Also, if the drop appears too close in time to the swap, the partner’s exchange may be deemed an exchange by the partnership. *Comm’r of Internal Rev. v. Ct. Holding Co.*, 324 U.S. 331, 65 S. Ct. 707 (1945). Clearly, the more time that passes between the “drop” and the “swap” (or vice versa), the better.

A line of federal cases provides taxpayer-friendly authority against challenges by the IRS. *Bolker v. Comm’r of Internal Rev.*, 760 F.2d 1039 (9th Cir. 1985); *Mason v. Comm’r*, 55 T.C.M. 1134 (1988); *Maloney v. Comm’r*, 93 T.C. 89 (1989). However, some state taxing authorities (notably, the California Franchise Tax Board) aggressively challenge exchanges, and argue that they are not bound by these federal cases. Also, changes made in 2008 to the federal partnership tax return, IRS Form 1065, make it easier to detect when drop and swap transactions have occurred, thus making such transactions more vulnerable to challenge by taxing authorities.

In some instances, a majority of the partners may want the partnership to complete an exchange, but one or more of the other partners may want to be “cashed out” with the sale of the relinquished property. One way to accomplish this is for the partnership simply to cash from the sale in an amount sufficient to purchase the departing partners’ partnership interests. This cash, however, would be “boot,” and would require the partnership to allocate the resulting gain among all the partners.

When an individual completes an exchange and then immediately contributes the replacement property to an entity, or when an entity exchanges property immediately after receiving it as a contribution, a holding period issue could arise. Such an issue was resolved in the taxpayer’s favor in the *Magneson* case, which involved an exchange by an individual, followed

immediately by a contribution of the replacement property to a general partnership. *Magneson* provides useful authority against challenge by the IRS, and the same logic was applied at the state level in Oregon, *see Dep't of Rev. v. Marks*, 20 Or. Tax. 35 (2009), although its application in other states is not clear.

As stated above, partnership interests are specifically excluded from the application of Section 1031. A very narrow exception applies to a partnership that has elected, under Section 761(a), not to be subject to the partnership taxation provisions of Subchapter K. The election applies only to a partnership: (i) for investment purposes only and not for the active conduct of business; (ii) where the partners hold title to the property as co-owners; (iii) where each owner reserves the right to separately take or dispose of his or her share of the property; and (iv) which has no active trade or business. If a partnership makes such an election, a partnership interest will be treated as an interest in the underlying assets, and can be exchanged under Section 1031.

In Private Letter Ruling 202416012, a trust terminated and distributed tenant-in-common interests in the trust property to the beneficiaries subject to an already-executed sales agreement. I.R.S. Priv. Ltr. Rul. 202416012 (Apr. 19, 2024). The beneficiaries met the “held” requirement.

#### 7. Building on already-owned property.

In a typical improvement exchange, a taxpayer uses a QI to sell a relinquished property. An affiliate of the QI, referred to as an exchange accommodation titleholder (EAT), uses the proceeds from the relinquished property sale to purchase a replacement property from a third-party seller, improve the replacement property, and transfer improved property to the taxpayer within 180 days after the day the relinquished property was transferred.

The use of the EAT and QI in this manner allows the taxpayer to control the property and improvements built thereon. Because the EAT is treated as owning the property for federal income tax purposes, the taxpayer is able to reinvest the proceeds from the sale of the relinquished property in the land and improvements on a tax-deferred basis pursuant to IRC Section 1031. This creates greater tax deferral for the taxpayer because instead of having taxable boot for a reduction in debt or proceeds not reinvested, they can reinvest more equity into the replacement property in the form of real property improvements.

It is well established that a taxpayer cannot include improvements to property already owned as replacement property. However, the IRS released Private Letter Rulings 200251008 and 200329021, which set forth structures whereby an EAT made improvements to a property owned by an affiliate or related party and then the taxpayer received the

improved property as qualifying replacement property. Although these rulings do not have identical circumstances, they do share a similar approach:

- Taxpayer enters into a qualified exchange accommodation agreement (QEAA) with the EAT and enters into an exchange agreement with a QI;
- Taxpayer’s affiliate or related party leases the replacement property to EAT at fair market rent, for a term of not less than 30 years, as part of the QEAA as defined in Revenue Procedure 2000-37;
- Taxpayer (or a third-party bank where the taxpayer gives its personal guaranty) lends EAT the funds needed to construct improvements on the leased property;
- Taxpayer assigns its rights to the sale contract of the relinquished property to the QI;
- Taxpayer assigns its rights in the QEAA to the QI;
- QI uses proceeds from the sale of the relinquished property to pay EAT;
- EAT uses the proceeds received from the QI to pay for improvements and/or to pay the construction loan in full; and
- QI directs EAT to transfer the improved replacement property directly to the taxpayer.

#### 8. Seller-financing a 1031 Exchange.

Promissory notes are specifically excluded from the definition of “like-kind.” I.R.C. § 1031(a)(2)(B) and (C). Many property owners intending to do a 1031 agree to finance a large portion of the sales price, only to learn that this usually disqualifies them from doing a 1031. When a taxpayer agrees to take a promissory note as part of the relinquished property’s sale, there are three choices for handling the note:

Option 1. Exclude the note from the exchange, and pay applicable taxes. The taxpayer becomes the note’s beneficiary at the closing, paying taxes on the capital gain and interest as payments are made, using the installment sale method outlined in I.R.C. § 453. If the amount of the note equals or exceeds the capital gain, the taxpayer will not benefit from a 1031 exchange.

Option 2. Provide a cash loan to the buyer at the relinquished property’s closing. The seller brings cash to the closing for the amount of the loan, and the cash is shown on the sale settlement statement. The taxpayer is listed as the beneficiary on the installment note, and both the cash from the sale and the cash for the note are transferred to the QI.

Option 3. Include the note in the exchange by initially designating the QI as the beneficiary on the installment note, potentially deferring capital gain taxes. Under this option the taxpayer has four alternatives for using the note as part of the consideration for purchasing replacement property in a 1031 exchange:

- A. The taxpayer utilizes the note for the down payment on the replacement property. The seller of the replacement property accepts the installment note as partial consideration for the purchase price. The QI assigns the note to the seller at the replacement property closing.
- B. The taxpayer purchases the note from the QI, enabling the intermediary to apply the note proceeds to the replacement property purchase.
- C. The buyer of the relinquished property pays off the note directly to the QI before the taxpayer closes on the replacement property. The QI adds the payoff to the exchange proceeds, which are then wired to the closing officer for the replacement property purchase.
- D. The taxpayer locates an investor willing to purchase the installment note, replacing it with cash. The sale proceeds are added to the existing exchange funds and applied to the replacement property purchase. Typically, the note is sold at a discount, ranging from 25% to 35%, reducing the attractiveness of this option.

## B. Exchange

### 1. The structure.

The most common exchange format, the delayed exchange, requires investors to work with a third-party principal called a qualified intermediary (QI). The QI documents the exchange (by preparing the necessary paperwork), holds the exchange proceeds on behalf of the taxpayer, and structures the exchange after assignment of the sale and purchase contracts. Treas. Reg. § 1.1031(k)-1(a).

After closing the sale of the relinquished property, exchangers have 45 calendar days to identify potential replacement properties. This identification must be in writing, signed by the exchanger, and the properties must be unambiguously described (for example, either by a legal description or property address). There are specific rules about how many properties an exchanger can identify.

After the 45-day identification period, exchangers have an additional 135 days (making it a total of 180 days from the sale of the relinquished property) to close on the purchase of one or more of the identified

replacement properties. An exchanger may only acquire one or more identified properties.

Caveat 1: The actual deadline for ending the exchange is 180 days after the exchange is opened or the date the tax return is due, whichever is earlier. I.R.C. § 1031(a)(3)(A). In *Christensen v. Commissioner*, 71 T.C.M. 3137 (1996), *aff'd*, 142 F.3d 442 (9th Cir. 1998), the Christensens filed their tax return on April 15 for the period in which they opened their exchange and acquired replacement property within 180 calendar days. However, the purchase of replacement property closed after they had already filed their tax return. The tax court cited failure to comply with the deadlines, specifically the requirement to complete the 1031 exchange within 180 days or the tax filing date, whichever is earlier, as the reason tax deferral was not allowed.

The Christensen's should have filed a tax extension prior to closing on the purchase of the replacement property to have the entire 180-day exchange period available to purchase like-kind property.

Caveat 2: By itself, a sale followed by a purchase does not qualify as a 1031 exchange, even if the intent to perform an exchange was expressed prior to the closing of the sale. In *Crandall v. Commissioner of Internal Revenue*, T.C. Summ. Op. 2011-14 (Feb. 15, 2011), a taxpayer sold an undeveloped parcel of land in Arizona which had been held for investment. The taxpayer intended to exchange out of the Arizona property and into a property in California. Upon the sale of the Arizona property, the buyer's purchase money was deposited in an escrow account with the title company handling the closing in Arizona. The taxpayer later instructed the title company to transfer some of the escrowed funds to a title company in California who had been engaged to close the purchase of other investment property for the taxpayer. The property being acquired in the second escrow met the like-kind requirement under § 1031.

However, instead of utilizing one of the safe harbor arrangements authorized in the regulations, such as using a qualified intermediary to facilitate the exchange, the taxpayer merely left the proceeds in the title company's escrow and told the escrow officer he was performing an exchange. The IRS subsequently disallowed the exchange on the grounds that the taxpayer had constructive receipt of the sale proceeds. The IRS assessed a tax on the sale, interest on the underpayment of tax and penalties. On appeal, the tax court ruled that the transaction was a taxable sale followed by a subsequent purchase because the escrow agreement did not expressly restrict the taxpayer's access to and use of the funds held in the escrow account. Lessons learned from *Crandall* include:

- Although the taxpayer intended to set up the transaction which qualified for a 1031 exchange, it is well established that a taxpayer's intention to take advantage of tax laws does not determine the tax consequences of their actual transactions. *Bezjian v. Comm'r of Internal Rev.*, 845 F.2d 217 (9th Cir. 1988); *Carlton v. United States*, 385 F.2d 238 (5th Cir. 1967).
- The reinvestment of proceeds from a cash sale of an investment property into a second property will not qualify for the tax-deferral benefits under § 1031. *Greene v. Comm'r*, 62 T.C.M. 512 (1991); *Coastal Terminals, Inc. v. United States*, 320 F.2d 333 (4th Cir. 1963); *Est. of Bowers v. Comm'r of Internal Rev.*, 94 T.C. 582 (1990); *Lee v. Comm'r*, 51 T.C.M. (CCH) 1438 (1986).
- Since the escrow account did not limit the taxpayer's right to receive, pledge, borrow or otherwise obtain the benefits of the proceeds or anything else to properly reflect the transaction as a 1031 exchange, the account was not deemed a qualified escrow account.
- It is essential to consult a qualified intermediary, have restrictions on the sale proceeds, and execute exchange documents prior to closing.

## 2. The 1031 Clause.

The validity of a 1031 exchange has never depended on a reference to it in the contract. The theory behind the fairly common inclusion in such a contract is that the 1031 does depend on the taxpayer's proceeds being assigned to a qualified intermediary. The reason to include the clause has traditionally been to foreclose the possibility that the other party to the contract could object to such an assignment.

On November 4, 2024, the Texas Real Estate Commission adopted several changes recommended by the TREC Broker-Lawyer Committee. The committee drafted a new addendum for a 1031 exchange that allows the seller or buyer to disclose an intent to use the subject property as a 1031 exchange and includes a statement that the parties will reasonably cooperate with one another. Providing this as an addendum, rather than in the contract, allows the parties to use it when applicable without causing unnecessary confusion. A reference to the new Addendum for Section 1031 Exchange is also added to Paragraph 22 of the contract. 22 Tex. Admin. Code § 537.67; Standard Contract Form TREC No. 60-0, Addendum for Section 1031 Exchange.

## C. **Qualified Intermediary (QI):**

A QI, also referred to as an accommodator or facilitator, is an entity that facilitates Internal Revenue Code Section 1031 tax-deferred exchanges. A QI is a person who:

1. is not the taxpayer or a disqualified person; and
2. enters into a written agreement with the taxpayer (the exchange agreement) under which the QI:

- Acquires the relinquished property from the taxpayer;
- Transfers the relinquished property to the buyer;
- Acquires the replacement property from the seller;
- Transfers the replacement property to the taxpayer.

The exchange agreement must expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise obtain benefits of money or other property held by the QI. Treas. Reg. § 1.1031(k)-1(g)(4)(i).

## II. **RELATED PARTY EXCHANGES**

### A. **Intent of certain prohibitions against conducting 1031 exchanges among related parties**

The related party rules were enacted to prevent related parties from "cashing out" of an investment and avoiding tax if either party's property is disposed of within two years of the exchange. In addition, Section 1031(f) states that the Internal Revenue Service reserves the right to invalidate any 1031 exchange in which the taxpayer cannot prove that the "exchange" did not have a principal purpose of avoiding taxes that would otherwise be due or avoiding the purposes of the related party rules.

### B. **Who is a related party?**

A related party is any person or entity bearing a relationship to the taxpayer. Although not an exhaustive definition, this includes:

- Family members, such as brothers, sisters, spouses, ancestors, and lineal descendants. (Stepparents, uncles, in-laws, cousins, nephews, and ex-spouses are not considered related.)
- A corporation or partnership in which more than 50% of the stock or more than 50% of the capital interest is owned by the taxpayer.

### C. **Related Party Scenarios**

#### 1. Simultaneous Exchange

When related parties directly swap with each other, both parties must hold the property acquired for two years following the exchange. If either party disposes of the property within the two-year holding period, capital gain taxes will need to be recognized.

#### 2. Delayed Exchange – Sale to a Related Party

In several Private Letter Rulings, the IRS has clarified that an exchange in which a taxpayer sells to a

related party and buys from an unrelated third-party seller will likely be respected, even if the related party disposes of the property during the two years following the exchange.

### 3. Delayed Exchange – Purchase from a Related Party

A taxpayer should not purchase a replacement property from a related party where the related party receives exchange proceeds and the taxpayer receives the property previously owned by the related party. I.R.S. Tech. Adv. Mem. 9748006 (Nov. 28, 1997). The IRS disallowed tax deferral to a taxpayer who purchased his mother's property as replacement property in a 1031 exchange. Tax deferral treatment is also denied to a taxpayer using a qualified intermediary to ultimately purchase replacement property from a related party. Rev. Rul. 2002-83, 2002-2 C.B. 927.

A conservative guideline: If the buyer and seller are related, and one of the parties ends up with the property and the other ends up with the cash, the exchange may be disallowed. Any exchange with a related party must be reported to the IRS on IRS Form 8824, Like-Kind Exchanges.

## III. PARKING ARRANGEMENTS

### 1. Safe-Harbor Reverse Exchanges

Revenue Procedure 2000-37 provides guidelines for the taxpayer to acquire the replacement property before the sale of the relinquished property is completed. Rev. Proc. 2000-37, 2000-2 C.B. 308. The reverse exchange can be the ideal solution if the taxpayer cannot delay the closing of the replacement property.

Rev. Proc. 2000-37 clarifies that the taxpayer cannot own both properties at the same time. It describes the ownership process as a "parking arrangement" because either ownership of the relinquished property or the replacement property is "parked" with an exchange accommodation titleholder (EAT). To park the ownership means a deed is recorded to transfer ownership to the EAT thereby the taxpayer owns one property and the EAT owns the other.

To fulfill the requirements of the safe harbor, the taxpayer must take title to the replacement property within 180 days after its parking.

### 2. Non-Safe-Harbor Reverse Exchanges

The regulations recognize that it is not always possible for a parking transaction to be concluded within 180 days. For example, in the case of new construction or property improvements, it takes time to get architect plans, permits, deal with inclement weather conditions, etc. Taking this into consideration, the regulations included a paragraph suggesting that "no (adverse) inference" was to be made for deals structured outside the safe harbor, by stating:

"No inference is intended with respect to the federal income tax treatment of arrangements similar to those described in this revenue procedure that were entered into prior to the effective date of this revenue procedure. Further, the Service recognizes that "parking" transactions can be accomplished outside of the safe harbor provided in this revenue procedure. Accordingly, no inference is intended with respect to the federal income tax treatment of "parking" transactions that do not satisfy the terms of the safe harbor provided in this revenue procedure, whether entered into prior to or after the effective date of this revenue procedure." *Id.*

This language was meant to leave the window open for matters that required more than 180 days to accomplish a completed exchange. For transactions that could only be done for a period in excess of 180 days, many advisors thought that the EAT might have to retain significant benefits and burdens of ownership of the parked property in order for the exchange to qualify.

The landscape for these transactions changed with the ruling in the Bartell case that was issued in 2016. That case pertained to a taxpayer who structured an exchange involving new construction with a corresponding parking arrangement for 24 months. The actual period ended up being 17 months. Predictably, the IRS challenged the tax reporting since it did not comply with historical requirements for a structure outside the safe harbor. However, the court concluded that the case law primarily required a third party to be in title to the property during the period of construction. *Est. of Bartell v. Comm'r of Internal Rev.*, 147 T.C. 5 (2016).

However, gradually since 2016 real estate investors and business owners have been structuring deals requiring more than 180 days in conformity with the Bartell decision. At this time in 2024, such a matter being done outside the safe harbor is somewhat commonplace and certainly the IRS is aware that it happens. A lot of time has elapsed since the case holding and there is no evidence that the IRS has disallowed this structure since then so it would seem that a parking arrangement that uses an Accommodator but does not require benefits and burdens to that party, is indeed possible.

## IV. ETHICAL ISSUES WITH 1031 EXCHANGES

### A. Qualified Intermediaries

A trap for the unwary: the QI industry is not regulated.

A QI can be anyone who is not "disqualified", including embezzlers and people who have never read the tax code. Those disqualified are (1) the agent of the exchanger; (2) a party related to the exchanger; and (3) a party related to the exchanger's agent. Furthermore, there is no federal or Texas regulation of qualified intermediaries. Treas. Reg. §1.1031(k)-1(k). Therefore, taxpayers and their advisors must perform their own due

diligence when selecting a QI. The QI national trade association is known as the Federation of Exchange Accommodators ([www.1031.org](http://www.1031.org)).

Careful selection of the QI is therefore essential to ensure the highest level of expertise and security of funds.

### B. The 45-Day Rule

One aspect of 1031 exchanges that presents opportunities for fraud relates to the 45-day identification requirement. Treas. Reg. §1.1031(k)-1(a)-(e) provides detailed rules on the proper method and manner of identifying replacement property to satisfy the time requirements of IRC §1031(a)(3). The period within which the taxpayer must identify the replacement property (identification period) begins on the date on which the taxpayer transfers the relinquished property and ends at midnight on the 45<sup>th</sup> day after that date. Treas. Reg. § 1.1031(k)-1(b)(2)(i).

In *Dobrich v. Commissioner*, 74 T.C.M. 985 (1997), the taxpayers committed tax fraud by falsifying the date the property was identified. The taxpayers misrepresented to the IRS that they had properly identified replacement property by back-dating documents in an attempt to reflect that a timely identification had been made. The tax court found evidence of the taxpayers' intent to defraud and ruled that they were liable for a Section 6663 fraud penalty. In addition, the taxpayers pleaded guilty to a criminal charge of causing the delivery of false documents to the IRS. The taxpayers were held liable for the \$2.2 million in capital gains taxes they were attempting to defer, plus an additional 75% fraud penalty of \$1.6 million.

### C. The "Intent to Hold" Requirement

As discussed above, courts will look at all evidence surrounding the acquisition of property to determine whether the taxpayer's use after the exchange is consistent with an intent to hold. *Black*, 35 T.C. at 95; *Click*, 78 T.C. at 231-33; *Wagensen*, 74 T.C. at 660; *Regals Realty Co.*, 127 F.2d at 933-34.

In *Goolsby v. Commissioner of Internal Revenue*, T.C.M. 2010-64 (Apr. 1, 2010), the taxpayers exchanged a relinquished property in California for two replacement properties located in Georgia. Two months after the exchange was completed, the taxpayers moved into one of the replacement properties and used it as their personal residence. The Tax Court rejected the taxpayers' argument that certain other facts demonstrated that they intended to rent the property when they acquired it and decided later to move into the property. As a result, the taxpayers were liable for the capital gain taxes allocable to that portion of their exchange and also for an accuracy-related penalty for understatement of tax. In rejecting the taxpayers' argument, the Tax Court found that the taxpayers:

- Conditioned the purchase of the replacement property on the sale of their former primary residence in California;
- Asked their QI about converting an investment property into a residence before the exchange was completed;
- Failed to research whether the covenants of the homeowner's association would permit the replacement property to be used as a rental and generally did little research on the rental market;
- Placed a rental advertisement in a small neighborhood newspaper for only two months and made no other efforts to rent the property;
- Began preparations to finish the basement of the replacement property within two weeks after purchasing the property.

Based upon these facts, the Tax Court concluded the taxpayers intended to move into the replacement property and lacked the intent to hold for investment at the time of acquisition.

Caveat: Goolsby also demonstrated that discussions with the taxpayer's QI are not privileged. Any non-privileged discussions evidencing a contrary intent before, during, or after the exchange are fair game for the IRS.

## V. INVOLUNTARY TRANSFERS

Section 1033 of the tax code provides for the deferral of gain that is realized from an "involuntary conversion." Such a conversion includes property that is destroyed in a casualty, property that is destroyed in a casualty, property that is lost due to theft and property that is transferred as the result of condemnation or the threat of condemnation. All of the rules are different, including there is no involvement of a qualified intermediary.

NOTE: Whereas most of the requirements of Section 1033 are more taxpayer friendly than those of Section 1031, there is one major exception: Section 1033 generally requires the replacement property to be "similar or related in service or use", as opposed to the very broad definition of "like-kind" property under Section 1031. IRC §§1031 and 1033.

## VII. RECENT DEVELOPMENTS

See attached "Addendum for Section 1031 Exchange" promulgated by the Texas Real Estate Commission for use by Texas real estate licensees effective January 3, 2025.





PROMULGATED BY THE TEXAS REAL ESTATE COMMISSION (TREC)

11-04-2024

ADDENDUM FOR SECTION 1031 EXCHANGE



CONCERNING THE PROPERTY AT: \_\_\_\_\_
(Street Address and City)

- A. [ ] Seller [ ] Buyer intends to use this Property to accomplish an exchange of like-kind properties under Section 1031 of the Internal Revenue Code, as amended.
B. The parties will reasonably cooperate to accomplish the exchange provided: (i) the non-exchanging party will not incur any additional expense or liability; and (ii) closing will not be delayed as a result of the exchange.

Buyer \_\_\_\_\_

Seller \_\_\_\_\_

Buyer \_\_\_\_\_

Seller \_\_\_\_\_



The form of this addendum has been approved by the Texas Real Estate Commission for use only with similarly approved or promulgated forms of contracts. Such approval relates to this contract form only. TREC forms are intended for use only by trained real estate license holders. No representation is made as to the legal validity or adequacy of any provision in any specific transactions. It is not intended for complex transactions. Texas Real Estate Commission, P.O. Box 12188, Austin, TX 78711-2188, (512) 936-3000 (www.trec.texas.gov) TREC No. 60-0.

TREC NO. 60-0
TXR 1956

