COMMON MISTAKES CLIENTS MAKE IN TAX-FREE EXCHANGES

(AND THE SOLUTIONS ACCOUNTANTS CAN USE TO HELP THEIR CLIENTS AVOID THESE MISTAKES!!)

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Clients selling real estate and engaging in tax-free exchanges under Section 1031 of the Internal Revenue Code often rely upon professional exchange companies such as affiliates of escrow and title companies to draft their exchange documents, to advise them on tax and even legal issues, and to help them to close their exchanges. These professional exchange companies, in turn, attempt to limit their liability exposure by including exculpatory statements in their form exchange documents stating that the exchanging property owner "does not rely upon the professional exchange company for legal or tax advice," and further advise clients to "use their own separate tax professionals." Despite these warnings, clients often fail to utilize their accountant's services, and instead rely solely upon the professional exchange company to structure and document their exchanges.

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However, without proper advice from their accountants, clients can make mistakes in structuring their exchanges, resulting in the client recognizing taxable income.[1] The discussion below focuses on some of the more common mistakes and suggests alternative solutions for accountants to employ to help their clients avoid these mistakes.

MISTAKEN BELIEF THAT THE PROPERTY BEING EXCHANGED IS ONLY REAL ESTATE AND DOES NOT INCLUDE PERSONAL PROPERTY

A basic Section 1031 exchange requirement is that the property sold (the "Relinquished Property") and the property received (the "Replacement Property") must be "like-kind." Generally, real estate is classified as like-kind to other interests in real estate. Thus, land can be exchanged for improved real estate,[2] and a 30-year or more leasehold can be exchanged for a fee interest in real estate.[3]

Real Estate Cannot Be Exchanged For Personal Property. If the Relinquished or Replacement Property consists of personal property,

[1] Although the federal long-term capital gain rate is currently only 15%, the federal tax rate on real estate straight-line depreciation recapture is 25%. Additionally, the alternative minimum tax may apply and state income taxes may also be imposed on the real estate sale's gain.

[2] Treas. Regs. §1.1031(a)-1(b).

[3] Treas. Regs. §1.1031(a)-1(c). Under Rev. Rul. 78-72, 1978-1 CB 258, options to renew a lease are counted in determining whether a lease has a term of 30 years or more to run.

then the other property must also consist of similar like-kind personal property or, alternatively, "like-class" personal property[4] to other depreciable tangible personal property. Depreciable tangible personal properties are of a "like-class" if the properties are within the same "General Asset Class" or "Product Class."[5]

Real estate ***cannot*** be exchanged tax-free for personal property. Unfortunately, some clients unwittingly violate this like-kind requirement by failing to recognize that a building being exchanged may include personal property such as refrigerators, washers and moveable stoves in apartment buildings, or where cost segregation studies have been performed.

Incidental Property Exception Only Applies to the Identification Rules and Does Not Apply to Determine if Properties Are "Like-Kind". Clients sometimes mistakenly believe that the Treasury Regulations' "incidental property exception," which states that minor items of personal property do not have to be separately ***identified*** in a deferred tax-free exchange, also applies to the like-kind property requirement of Section 1031.[6] However, the

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[4] *See* Treas. Regs. §1.1031(a)-2(b)(1).

[5] Product classes are based upon the North American Industry Classification System. Reg. §1.1031(a)-2T.

[6] *See* Treas. Regs. §1.1031(k)-1(c)(5)(i) which states that for the deferred exchange rules, "incidental property" is property transferred with a larger item of property in a standard commercial transaction which has an aggregate fair market value not exceeding 15% of the

"incidental property exception" only applies to determine whether a property is being properly ***identified*** for purposes of complying with the ***time requirements*** of the deferred exchange rules. If even a small amount of personal property is transferred or received along with real property, then like-kind or like-class personal property ***must*** also be transferred or received in the exchange in order to satisfy Section 1031's requirements.

How Both Personal Property and Real Estate Can Comprise Parts of the Building. Personal property can comprise a portion of a building where parts of that building are reclassified from real to personal property. Today, sophisticated building owners reduce their income taxes by accelerating depreciation and amortization deductions through reclassifying building parts as "personal property."[7] This avoids having to depreciate portions of the building over the long 39-year recovery period for commercial property or 27½-year period for residential property, using the straight-line method. Reclassified personal property can be amortized and depreciated over shorter time periods (usually five or

value of the larger property which relates to such incidental property.

[7] The IRS in Rev. Rul. 2003-54, I.R.B. 2003-23, explained how to classify property as personal property. "Personal property" includes tangible personal property as defined in the former investment tax credit rules of Treas. Regs. §1.48-1(c). Rev. Proc. 87-56, 1987-2 C.B. 674 sets forth the class lives of various types of property. For an example of IRS approvals of cost segregation studies, see IRS LMSB Memorandum issued December 6, 2003 on "Planning and Examination of Cost Segregation Issues in Restaurant Business," published in BNA Daily Tax Report, December 18, 2003.

seven years) using the double declining balance method.[8] Prior bonus depreciation deductions of 30% and 50% in the property's first year created an even greater tax incentive to reclassify building parts as personal property.[9]

In order to reclassify parts of a building as personal property, clients and their accountants commonly perform cost segregation studies. Cost segregation studies are based upon the tax laws outlined in ***Hospital Corp. of America v. Commissioner***.[10] The reclassified personal property is then depreciated over a shorter recovery life than the real property. Thus, carpet and window coverings can be recovered over five years.[11] Similarly, specialized refrigeration, restaurant, medical, manufacturing or computer equipment, and the plumbing, electrical, ventilation, and flooring systems in connection with specialized systems can be classified as personal property to be depreciated over short recovery periods.[12] Other potential personal property items include

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[8] *See* I.R.C. §§168(c) and 168(e)(1). Most personal property associated with real estate will have a seven-year recovery period. However, the IRS in Ann. 99-82, 1999-32 I.R.B. 44 stated that certain personal property used in rental real estate, such as appliances, carpeting and furniture, would have a recovery period of five years.

[9] *See* §168(k)(1).

[10] 109 T.C. 21 (1997), *nonacq*. 1999-35 I.R.B. 314.

[11] *See* Ann. 99-82, *id*.

[12] *See* ***Hospital Corp. of America v. Commissioner***, *supra*, note 7; and ***Piggly Wiggly Southern, Inc. v. Commissioner***, 803 F.2d 1572 (11th Cir. 1986).

office cabinetry, carpeting, special lighting fixtures,[13] gasoline pump canopies[14] and retail signs.[15]

Solutions Where Only the Relinquished or the Replacement Property Contains Personal Property. In order to meet the like-kind property requirement of Section 1031, when personal property comprises part of the Relinquished or Replacement Property, the same like-kind or like-class personal property should also be included in the other property. The multiple property like-kind rules apply to determine the classification of the various properties where both real and personal property are being exchanged.[16] Even minor amounts of personal property involved in real property exchanges can trigger gain recognition. Under the multiple asset exchange Treasury Regulations where both personal and real property are part of the building being exchanged, the real and personal properties must be classified and put into like-kind or like-class exchange groups.

If only the Relinquished Property (or only the Replacement Property) contains personal property, then the amount of gain recognized by exchanging the non-like personal property will be

[13] *See* ***Shoney's South, Inc. v. Commissioner***, T.C. Memo 1984-413.

[14] In Rev. Rul. 2003-54 I.R.B. 2003-23, the IRS ruled that gasoline station pump canopies are not inherently permanent structures and are tangible personal property to be recovered over five or nine years, depending on the depreciation system used.

[15] *See* ***Southland Corp. v. U.S.***, 611 F.2d 348 (Ct. Cl. 1979).

[16] Treas. Regs. §1031(j)-1.

limited to the personal property's fair market value. Thus, if the personal property has little or no value, the recognized gain may not be significant. Clients may wish to obtain an appraisal to substantiate a low value of the personal property and to obtain the Relinquished Property buyer's agreement to that low value (however, such buyer may, in fact, prefer a higher valuation for its purchased personal property in order to increase the buyer's own depreciation deductions).

An alternative tax strategy for exchanging into like-kind property where there has been a cost segregation study is to argue that reclassified personal property remains "real estate" for Section 1031 purposes based upon the definition of real property under state law.[17] Exchanging parties can argue that reclassified "personal property" is still "real estate" for Section 1031 purposes based upon the fact that only the special federal tax rules under Sections 168 and 167 allow parts of buildings to be classified as personal property for tax depreciation purposes. For Section 1031 purposes, however, state law determines if property is personal or real.[18]

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[17] Many states, including California, classify items (including property that might otherwise be personal property) which are permanently affixed to a building as "real property." *See* California Civil Code §658.

[18] The IRS in Priv. Ltr. Rul. 8443054 indicates that state law principles apply to determine if property is real estate for §1031 purposes.

MISTAKE OF NOT PROPERLY STRUCTURING AN EXCHANGE INTO IMPROVEMENTS WHICH ARE TO BE CONSTRUCTED IN THE FUTURE

Clients sometimes sell their Relinquished Property and then exchange into Replacement Property where improvements are to be constructed on the Replacement Property in the future. However, contracts to construct improvements are ***not*** like-kind to real property for tax-free exchange treatment.

The Treasury Regulations indicate that improvements being constructed on the Replacement Property will qualify as being like-kind to real estate to the extent that such Replacement Property's partially constructed improvements are classified as real estate under state law on the date of receipt.[19] Therefore, in a deferred exchange, the client may acquire Replacement Property that is to be improved during the 180-day (or due date of the client's income tax return, if sooner) deferral period. The improvements to the Replacement Property that are not completed prior to the end of this deferred exchange period will still be considered substantially the same as the Replacement Property identified by the client within the 45-day identification period if: (i) the improved Replacement Property would have been considered substantially the same property as identified by the client had it been completed when it was received by the client, and (ii) when the Replacement Property is

[19] *See* Treas. Regs. §1.1031(k)-(1)(e).

received by the client the partially completed Replacement Property improvements constitute real property under applicable state law.[20] If the Replacement Property improvements are constructed after the client receives the Replacement Property in a completed forward exchange, then such Replacement Property improvements will not qualify to receive tax-free exchange treatment under Section 1031. Therefore, where the client finds that it must use the Relinquished Property's exchange proceeds to construct improvements on the Replacement Property after the exchange deferral period, the client should restructure the exchange to become a reverse exchange, rather than a conventional forward exchange.

Using a Reverse Tax-Free Exchange. To be able to construct improvements on the Replacement Property which will qualify for like-kind exchange treatment, clients often will have the Replacement Property's improvements constructed by an independent party, and then at a later date exchange into that Replacement Property. For example, the client may do a "reverse tax-free exchange" by first having the Replacement Property land acquired by an independent party (who must not be classified as the seller's agent for tax purposes) and then have that independent party construct the improvements on the land. When the improvements are constructed and become part of the Replacement Property, the

[20] *See* Treas. Regs. §1.1031(k)-1(e)(iii).

Replacement Property (including the newly constructed improvements) is then exchanged for the Relinquished Property.

<u>Using an Exchange Accommodation Titleholder Under Rev. Proc. 2000-37</u>. One form of a reverse exchange – referred to as a "parking arrangement" – is where the Replacement Property is first acquired or "parked" with a third party, who is referred to in Rev. Proc. 2000-37[21] as an exchange accommodation titleholder or "EAT." Rev. Proc. 2000-37 provides a safe harbor for parking arrangements where the Replacement Property is acquired (by the EAT) prior to the disposition of the Relinquished Property. The IRS in Rev. Proc. 2004-51[22] stated that Rev. Proc. 2000-37 will not apply where the taxpayer owns the Replacement Property before the exchange. It is not clear what would happen if the taxpayer owned the Replacement Property at one time prior to the exchange and then disposed of the Replacement Property in an unrelated transaction before the exchange. Rev. Proc. 2000-37 permits the EAT to borrow money from the exchanging party, and for the exchanging party to guaranty the EAT's construction loans. Unfortunately, exchanging parties may have difficulty meeting this Revenue Procedure's time requirements which mandates that the exchanging party ***receive*** the Replacement

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[21] 2000-40 I.R.B. 308. The Revenue Procedure allows several alternative safe harbor parking arrangements using a third-party "exchange accommodation titleholder."

[22] 2004-33 I.R.B. 211. This Revenue Procedure indicates that the IRS continues to study parking transactions in the §1031 area.

Property ***within 180 days*** of the EAT acquiring title to the Replacement Property. Because of potential construction delays, the EAT in many cases may take longer than 180 days to construct the improvements.[23]

Structuring Parking Arrangements Outside of the Safe Harbor of Rev. Proc. 2000-37. If the requirements of the Rev. Proc. 2000-37 safe harbor cannot be met, the exchange may still be structured to qualify under Section 1031 based upon case law authority.[24] In a typical non-safe harbor transactions, an independent accommodator first acquires the Replacement Property on which the improvements are to be constructed. The client arranges for the accommodator's acquisition financing and the improvement's construction financing from either the client or from the client's lender. The client in many cases has an option to acquire the Replacement Property after the improvements are constructed to complete the exchange. When the client is prepared to sell the client's Relinquished Property to a buyer, the client closes the exchange by using a qualified

[23] Rev. Proc. 2000-37 specifically states that the Revenue Procedure does not override existing law with respect to parking arrangements. For a thorough discussion of Rev. Proc. 2000-37, see Borden, Lederman and Spear, *Build-to-Suit Ruling Breaks New Ground For Taxpayers Seeking Swap Treatment*, Journal of Taxation, Vol. 98. No. 1, January 2003, at 22.

[24] *For an example, see* ***Fredericks v. Commissioner***, T.C. Memo 1994-27, where the Tax Court upheld tax-free exchange treatment on property improvements constructed in the future.

intermediary to transfer the client's Relinquished Property and to acquire the Replacement Property from the independent accommodator.

In ***J. H. Baird Publishing Co.***[25] an accommodator acquired the Replacement Property and constructed improvements thereon on behalf of the taxpayer. In that case, the accommodator was not found to be an agent of the taxpayer. Similarly, in ***Fred L. Fredericks*** the accommodator who acquired the Replacement Property was not classified as the taxpayer's agent even though the accommodator was owned and controlled by the taxpayer who acquired the Replacement Property to build improvements thereon. On the other hand, in ***DeCleene v. Commissioner***[26] the taxpayer was denied tax-free exchange treatment where the taxpayer transferred the taxpayer's land to a third party who was required to construct the improvements and then transferred the land with the improvements back to the taxpayer. One lesson to be learned from these three court decisions is that clients desiring to construct improvements on the Replacement Property should ***not*** first take title to the Replacement Property, but should instead use an independent accommodator to take title and construct the improvements. The IRS in Rev. Proc. 2004-51 again emphasized its position that if the taxpayer owns the Replacement

[25] 39 T.C. 608 (1962), acq. 1963-2 C.B. 4.

[26] 115 T.C. 457 (2000). On the other hand, see Private Letter Ruling 200111025 which recognized a successful §1031 exchange where the documentation provided that the accommodator would have a risk of loss or an economic benefit from their ownership of the parked Replacement Property.

Property which the taxpayer intends to exchange into, the requirements of §1031 will not be satisfied. Additionally, the accommodator's acquisition of the Replacement Property should be structured so that the burdens and benefits of the Replacement Property's ownership are shifted, as much as possible, to the accommodator in order for the accommodator (and not the client)to be recognized for tax purposes as the Replacement Property owner until the exchange can be completed.

MISTAKE OF FAILING TO RECOGNIZE THAT EXCHANGING RELINQUISHED PROPERTY SUBJECT TO A DEED OF TRUST OR OTHER LIABILITY IS THE EQUIVALENT OF RECEIVING TAXABLE MONEY

Gain on a Section 1031 exchange is recognized to the extent of the money and the fair market value of other property received.[27] This money or other property received is sometimes referred to as "boot." If the Relinquished Property is subject to a deed of trust or other liability, then the amount owed on this deed of trust, which the client is relieved of in the exchange, is treated as money or "boot" received by the client.[28] The Regulations provide that the amount of indebtedness that the client is relieved of in the exchange is netted against the amount of the liabilities that the

[27] Treas. Regs. §1.1031(b)-1(c). There is no distinction between the assumption of a liability and the acquisition of the property subject to a liability. *See* I.R.C. §1031(d).

[28] I.R.C. §1031(b).

client assumes or takes the Replacement Property subject to.[29] Replacement Property indebtedness for purposes of the "netting rules" also includes a new deed of trust placed upon the Replacement Property at the time it is acquired by the client. However, money or other property received by the client in an exchange cannot be netted against the consideration given in the form of the client's assumed liabilities on the Replacement Property.[30]

What Happens Where Exchanged Properties Consist of Both Real Estate and Personal Property. Where the Relinquished Property is encumbered by a deed of trust, the client can unexpectedly have recognized gain because the Treasury Regulations require that all of the liabilities in an exchange be allocated among each property exchange group (based on the relationship of each property group's fair market values) even if these liabilities are not secured by a particular exchange group's properties.[31] Thus, the liability netting rules can surprisingly produce recognized gain where both real and personal property are involved in the exchange.

Consequences of Reducing a Partner's Share of Partnership Liabilities When Doing an Exchange. What are the tax consequences

[29] Treas. Regs. §1.1031(b)-1(c).

[30] Treas. Regs. §1.1031(d)-2.

[31] Treas. Regs. §1.1031(j)-(1)(b)(2).

where the Relinquished Property is owned by a partnership? Section 752(a) states that any increase in a partner's share of liabilities is considered a contribution of money by that partner to the partnership. Any decrease in partner's share of liabilities is considered as a distribution of money to the partner by the partnership under Section 752(b). On a distribution of property to a partner, that partner must recognize gain to the extent that such deemed distribution exceeds such partner's adjusted basis in its partnership interest immediately before the distribution.[32] Thus, on the first leg of an exchange when the Relinquished Property (which is encumbered by a loan) is conveyed to the qualified intermediary, there is a reduction in the partner's share of liabilities. Upon the exchange's second leg where there is the acquisition of the Replacement Property subject to a loan, there would be an increase in the partner's share of liabilities.

In Rev. Rul. 2003-56 the IRS ruled on the tax consequences of partnership liabilities in a deferred Section 1031 exchange occurring over two taxable years. Rev. Rul. 2003-56 held that if the partnership enters into a deferred like-kind exchange in which the Relinquished Property subject to a liability is conveyed in year one, and the Replacement Property subject to a liability is acquired in year two, the two liabilities are netted for purposes of the

[32] *See* §731(a).

Section 752 rules.[33] Similarly, under Rev. Rul. 2003-56, if the Relinquished Property has relief of liabilities in excess of the Replacement Property's liabilities, the resulting gain is taxable in year one when the Relinquished Property is transferred. This result in Rev. Rul. 2003-56 should be contrasted with the tax result where the cash boot received in a deferred exchange covering two taxable years is recognized as taxable income in year two (and not in year one).

Refinancing the Relinquished Property Before an Exchange. Clients who sell real estate in a tax-free exchange may want to receive money but not have to recognize taxable gain. Normally money received from an exchange escrow is taxed to the selling client as "boot." However, instead of receiving taxable cash as part of the exchange, the client could refinance the Relinquished Property immediately before the exchange and receive these refinancing loan proceeds tax free.[34] The Replacement Property after the exchange needs to be subject to at least the same amount of indebtedness as the selling client was relieved of on the Relinquished Property to avoid gain recognition.

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[33] Rev. Rul. 2003-56 is an analysis under the §1031 rules, and ***not*** the 752 Regulations.

[34] *See* ***Garcia v. Commissioner***, 80 T.C. 491 (1983), acq. 1984-1 C.B. 1, and ***Fredericks v. Commissioner***, T.C. Memo 1994-27.

The IRS took the position 20 years ago in a private letter ruling that encumbering property immediately before an exchange may result in "boot."[35] However, the IRS has not been successful in asserting this private letter ruling's position in court cases.

Refinancing the Replacement Property After an Exchange. Another tax planning strategy is for the selling client to first complete the tax-free exchange and then refinance the Replacement Property, thereby receiving the refinancing loan proceeds tax free. In order to avoid an IRS challenge that the refinancing proceeds received from the Replacement Property are "boot" to the client, the Replacement Property refinancing should be done only after the closing of the escrow for the acquisition of the Replacement Property, and should be done by a separate escrow and closing statement.

Avoid Having a Step Transaction When Refinancing the Property. To avoid IRS assertions that the refinancing loan proceeds received by the client are instead taxable "boot" from the exchange under a step transaction theory, the refinancing of the Replacement Property after the exchange or of the Relinquished Property before the

[35] *See* Priv. Ltr. Rul. 8434015.

exchange should not be tied to the exchange by any written or oral understandings.[36]

NOTE TO TAX ADVISOR: **split article here for the two magazine issues**

PARTNERSHIP DISTRIBUTES REAL PROPERTY TO THE PARTNERS FOLLOWED IMMEDIATELY BY THE PARTNERS DOING A TAX-FREE EXCHANGE, THE SO-CALLED "DROP AND SWAP"

Partnerships and limited liability companies desiring to split up sometimes first liquidate and distribute all of the partnership's Relinquished Property to its partners as tenants-in-common, followed by the former partners immediately selling the Relinquished Property. The selling former partners then exchange into different properties and some partners even receive cash. However, the liquidation of a partnership which is then followed by an immediate exchange of the liquidated property risks violating the Section 1031 requirement that exchanging partners "hold" both the Replacement Property and the Relinquished Property for "productive use in a trade or business or for investment" purposes.

The IRS ruled in the 1970's that taxpayers did not "hold" the Relinquished Property for the required qualified use, where the

[36] In Priv. Ltr. Rul. 200019014, the IRS ruled that liabilities placed on Replacement Property which do not have a bonafide business reason apart from the exchange, may ***not*** be applied under the liability "netting" rules.

property was received by the taxpayer as a liquidating distribution from a legal entity and then immediately exchanged by the taxpayer for the Replacement Property.[37] Contrary to this IRS ruling, the Tax Court in ***Mason v. Commissioner***[38] held that exchanges by partners who received the Relinquished Property in a partnership liquidation qualified for tax-free exchange treatment. Similarly, in ***Bolker v. Commissioner***[39], the Ninth Circuit Court of Appeals held that shareholders qualified for tax-free exchange treatment even though the shareholders exchanged the Relinquished Property after they received that property in a corporate liquidation. The Ninth Circuit in ***Bolker*** held that Section 1031 only requires that the taxpayer own the property before entering into the exchange and have no intent either to liquidate the property or to use it for personal purposes.

Solution to First Liquidate the Partnership and Then Hold the Relinquished Property as Tenants-In-Common Before Doing an Exchange. A common tax planning strategy is to have the former partners of a liquidated partnership hold their Relinquished Property tenancy-in-common interests for an extended time period before they exchange those tenancy-in-common interests for the Replacement Property. The

[37] *See* Rev. Rul. 77-337, 1977-2 C.B. 305.

[38] T.C. Memo 1988-273. ***Mason*** did not specifically address the §1031 "holding" requirement issue.

[39] 760 F.2d 1039 (9th Cir. 1985).

former partners' tenancy-in-common relationship must be structured so as not to be treated as a partnership for tax purposes.[40] The Regulations allow a co-tenancy to avoid being classified as a partnership if the co-tenancy is simply maintaining, repairing and renting the property. Management activities by the co-tenancy should be limited as much as possible in order that the relationship does not rise to a business relationship resulting in partnership tax status. The co-tenants should have a written co-tenancy agreement preserving the normal rights of a co-tenancy under state law. To formalize the appearance of a tenancy-in-common, the tenants-in-common names should be titled on the property's deed, and the partnership's liquidation should be legally formalized by filing the requisite state dissolution and termination documents.[41]

Revenue Procedure 2002-22's Guidance on How to Be Classified as a Tenancy-in-Common. The IRS issued Rev. Proc. 2002-22 to list the conditions under which the IRS will consider a request for a ruling that a tenancy-in-common interest will not be treated as a partnership interest for tax purposes.[42] Rev. Proc. 2002-22 was

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[40] *See* Treas. Regs. §301.7701-1(a)(2).

[41] For an example on how ***not*** to create a valid co-tenancy relationship, *see* ***Chase v. Commissioner***, 92 T.C. 874 (1989), where the tenants-in-common did not execute the sale's escrow agreement, and the partnership continued to manage the property and allocate economic benefits as though the tenancy-in-common distribution had not occurred.

[42] Rev. Proc. 2002-22, 2002-14 I.R.B. 733. For a detailed discussion of Rev. Proc. 2002-22, *see* McKee, Nelson and Whitmire, Federal Taxation of Partnerships and Partners, 3rd Ed. at ¶3.03[5] of Supp.

issued in response to the real estate syndication industry that has grown up over the past several years to market real estate tenancy-in-common interests to persons needing Replacement Property to complete their Section 1031 exchanges. This Revenue Procedure states that its conditions are "not intended to be substantive rules and are not to be used for audit purposes." However, because of the uncertainty of when a tenancy-in-common becomes a partnership for tax purposes, IRS field agents are likely to defer to this Revenue Procedure's listed conditions on audits. Nonetheless, many tax professionals feel that violating certain of Rev. Proc. 2002-22's conditions is ***not*** fatal to being classified as a partnership.

As a practical matter, the requirements in Rev. Proc. 2002-22 serve as guidelines for structuring the tenancy-in-common ownership of the Relinquished Property for the time period before the completion of the exchange. Having the partnership liquidate its properties to its partners as tenants-in-common is probably the most frequently used technique where some partners want to exchange for property and other partners want to cash out. Taxpayers have relied upon the ***Bolker*** case, discussed above, and upon Rev. Proc. 2002-22 to liquidate and be treated as a tenancy-in-common (and not as a partnership). However, accountants should caution their clients that one of Rev. Proc. 2002-22's conditions is that the IRS will not issue a favorable revenue ruling that the tenancy-in-common relationship is not taxed as a partnership where the exchanging tenants in common previously held their property interests through a partnership. This condition of the Revenue Procedure sends a "warning" of how the IRS might treat a partnership's liquidation followed by an exchange.

Based on Rev. Proc. 2002-22, tenancy-in-common co-ownerships should not file a partnership tax return, should not conduct business under a common name, should not by agreement or otherwise hold themselves out or identify themselves as partners, and should not indicate to third parties that they are conducting their real estate activities as a partnership.

Rev. Proc. 2002-22's conditions include a requirement that each co-tenant retain the right to approve the major decisions of the tenancy-in-common. These conditions include the requirement that each co-tenant have the right to approve the hiring of any manager and the sale, disposition or lease of the property, or creation of a lien. Because it is cumbersome for large numbers of co-tenants to approve a sale or lease, or to make other major decisions, some tenancy-in-common agreements contain an "implied consent" provision under which each co-tenant is provided notice of an event (i.e., a sale, lease, finance or reappointment of the manager), and then each co-tenant has a specified time period to object (such as 72 hours). If none of the co-tenants object to the proposed action within the specified time period, then that proposed action is deemed to have been approved by the co-tenants.

Some co-tenancies use a master lease to remove the need to have every co-tenant approve the individual leases for each of a property's many tenants (such as in an office or apartment building). Under a master lease structure, the co-tenancy leases the entire Replacement Property to one master tenant who in turn subleases the individual premises in the Replacement Property to each actual user tenant.

Using Disregarded Entities to Own Tenancy-In-Common Interests. Persons owning tenancy-in-common interests in the Replacement or Relinquished Property may wish to limit their personal liability exposure by owning their tenancy-in-common interest in a disregarded tax entity's name, rather than in their own individual names. Owning the tenancy-in-common interest in a disregarded tax entity, such as a single-member limited liability company, also avoids the problem of a death or bankruptcy of an individual co-tenant affecting the other tenants in common. Rev. Proc. 2002-22 permits disregarded tax entities to own a tenancy-in-common interest.[43]

[43] Where a Delaware statutory trust, which is a grantor trust, engages in a §1031 exchange, the IRS in Rev Rul. 2004-86, 2004-33 I.R.B. 191, stated that the grantor's trust's interest is treated as an ownership interest of the underlying trust assets. This Revenue Ruling, however, only allows the use of a Delaware statutory trust as a disregarded entity in limited situations.

PARTNERSHIP DISTRIBUTES CASH TO SOME PARTNERS WHEN ENGAGING IN A TAX-FREE EXCHANGE

Commonly, real estate partnerships desire to split up with certain partners receiving cash (referred to as the "cash-out partners"), and the remaining partners exchanging tax-free into other real estate. In an effort to achieve these dual goals, partnerships sometimes sell their real estate and use a portion of the sales proceeds to exchange tax-free into other real estate, while simultaneously distributing cash to the cash-out partners in full redemption of the cash-out partners' partnership interests. The partnership's intent is only for the cash-out partners to report taxable gain proportionate to the sales proceeds which they receive and for the remaining partners in the exchanging partnership to receive tax-free exchange treatment. However, even though only the cash-out partners may receive cash, all of the partners (including the remaining partners who desire to receive tax-free exchange treatment) would be taxed on the recognized gain if the partnership agreement allocates gain to all partners in proportion to their percentage interests.

Specially Allocating the Partnership's Gain to the Cash-out Partners. Partners may consider amending their partnership agreement to attempt to specially allocate all of the gain from the property's sale to only the cash-out partners, and none to the remaining partners who do the exchange. However, this special gain allocation is likely to fail to satisfy the substantial economic effect test under Section 704(b) in order to be recognized for income tax purposes. The reason is that this specially allocated gain to qualify under Section 704(b) would have to be reflected in the cashed-out partners' capital accounts, which in turn could alter the economic deal among the partners.[44]

Solution of Redeeming the "Cash-out" Partners For Cash Before the Exchange. An alternative tax structure for allocating all of the sale's taxable gain to only the cash-out partners is that prior to the Relinquished Property's sale, the partnership fully redeems the cash-out partners' partnership interests using partnership cash reserves. The partnership then proceeds to exchange the Relinquished Property for the Replacement Property in a qualifying tax-free exchange.

Solution of the Cash Out Partners Receiving a Promissory Note in the Exchange. Another alternative tax structure is for the partnership to sell the Relinquished Property for cash and a promissory note. After the Relinquished Property's sale, the cash-out partners receive a distribution of the promissory note in exchange for the full redemption of their partnership interests.

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[44] For a further discussion, see Real Property Exchanges, 3rd Ed., California Continuing Education of the Bar, pp. 455-458.

The promissory note is structured to pay the cash-out partners principal and interest in the year of the exchange and in the following calendar year. If an installment obligation is received in a Section 1031 exchange, then any gain recognized is deferred under the installment method of reporting until the note payment is received. The installment note's distribution to the partners will not accelerate the note's gain under Section 453, since Treas. Regs. Section 1.453-9(c)(2) states that a partner's receipt of an installment note in a Section 731 distribution does not result in gain under Section 453B. Therefore, the distribution of the promissory note to the cash-out partners will result in no recognized gain by the partnership, and there is no recognized gain to the cash-out partners until payments are made on the note.[45] Those partners desiring to receive tax-free exchange treatment then continue as partners in the partnership and have the partnership use their share of the property's sales proceeds to engage in a Section 1031 exchange. In a typical transaction, substantially all of the note's payments are made a short time after the close of the Relinquished Property's sale, with the remaining payments made shortly after the beginning of the immediate next tax year, in order to qualify for installment sale treatment under Section 453(b)(1). Sometimes clients are concerned with using an installment note when

[45] *See* I.R.C. §§453 and 731. The term "unrealized receivables" for §751 purposes is defined to mean rights to payments for property other than a capital asset. Treas. Regs. §1.751-1(c)(1). Accordingly, an installment note sale of a capital or §1231 asset, and its distribution by the partnership, would not be subject to §751(a) except perhaps to the extent gain on a §1231 asset is treated as ordinary income under §1231.

the Relinquished Property's buyer has a weak credit rating. One way to overcome a poor credit rated buyer is to have that buyer post a stand-by letter of credit as further collateral. Receipt of a stand-by letter of credit is not treated as a payment under the Section 453 installment sales rules.[46]

Solution of the Partnership Distributing a Tenancy-In-Common Interest in the Relinquished Property to the Cash-out Partners Prior to the Exchange. Another tax structure is for the partnership to first distribute a fractional tenancy-in-common portion of the partnership's Relinquished Property to the cash-out partners in full redemption of the cash-out partners' partnership interests. The cash-out partners and the partnership hold their respective Relinquished Property's interests as tenants-in-common for a period of time. The cash-out partners and the partnership then engage in a sale of the Relinquished Property. In the sale, the cash-out partners retain their cash sales proceeds (and report the sale's gain thereon), while the partnership uses its portion of the Relinquished Property's sales proceeds to enter into a tax-free exchange. The tenancy-in-common relationship must be structured so as not to be treated as a continuation of the former partnership for income tax purposes.[47] Additionally, the Section 1031 requirement

[46] Temp. Reg. 15A.453-1(b)(3)(i).

[47] *See* the discussion of Rev. Proc. 2002-22, above.

that the tenants in common "hold" the Relinquished Property for use in a trade or business, or for investment, must be satisfied.

CONTRIBUTION OF REPLACEMENT PROPERTY INTO A NEW PARTNERSHIP IMMEDIATELY AFTER THE COMPLETION OF THE EXCHANGE, THE SO-CALLED "SWAP AND DROP"

Clients receiving Replacement Property in a tax-free exchange may attempt to pool the Replacement Property's equity with other persons by first completing their tax-free exchange and then contributing their Replacement Property (or a tenancy-in-common interest in the Replacement Property) to a partnership with other persons. However, contributing Replacement Property to a partnership immediately following an exchange risks possibly violating the "holding" requirement of Section 1031 discussed above.[48] The IRS might argue that the Replacement Property was not "held" for productive use in a trade or business or for investment purposes, but instead was immediately disposed of by its contribution into a partnership. The IRS ruled in Rev. Rul. 75-292, that a prearranged transfer to a newly owned corporation of the Replacement Property did not qualify for tax-free exchange treatment because the Replacement Property had not been "held" by the exchanging party for a permissible use.

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[48] *See* Rev. Rul. 75-292, 1975-2 C.B. 333.

__Solution of Asserting That the "Holding" of Replacement Property By the Partnership is Attributed to the Original Exchanging Party__. Clients who immediately contribute interests in the Replacement Property to a partnership after completing an exchange might rely upon the Ninth Circuit case of ***Magneson v. Commissioner*** to assert that the partnership's holding of the Replacement Property should be attributed to the original exchanging property owner. The Ninth Circuit in ***Magneson*** stated that the taxpayer's contribution of the Replacement Property to a partnership did not violate the "held for" requirement of Section 1031 because the taxpayer intended to and did continue to "hold" the Replacement Property through its ownership of a general partnership interest and that there was a "mere change" in the form of the taxpayer's ownership of the Replacement Property. However, ***Magneson*** was decided for tax years before the enactment of Section 1031(a)(2)(D) which denies Section 1031 treatment to exchanges of partnership interests. The IRS today might argue that the step transaction doctrine should apply to a "swap and drop" transaction, making such a transaction an impermissible taxpayer's acquisition of a partnership interest as the Replacement Property. In other words, the IRS might argue that the taxpayer was receiving back a partnership interest in exchange for real estate, which violates Section 1031's like-kind property requirement.[49]

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[49] 753 F.2d 1490 (9th Cir. 1985). The Ninth Circuit's ***Magneson*** holding was based upon the Replacement Property being contributed to the partnership for a general

<u>Alternative Safer Tax Plan of Holding the Replacement Property as a Tenant in Common</u>. An alternative and safer tax plan would be for the client, after completing their exchange into the Replacement Property, to hold their Replacement Property as a tenant-in-common with the partnership for a substantial time period rather than immediately contributing their Replacement Property to the partnership. In order to avoid having the client's exchange and later contribution of the Replacement Property to the partnership being tied together as a step transaction for tax purposes, the client should not have an agreement (oral or written) to later contribute their Replacement Property to the partnership.[50] Additionally, the client's tenancy-in-common ownership of the Replacement Property should be structured so as not to be classified as a partnership for income tax purposes. *See* the discussion of Rev. Proc. 2002-22, above.

<u>MISTAKE OF NOT MAXIMIZING THE TIME TO IDENTIFY AND RECEIVE THE REPLACEMENT PROPERTY</u>

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partnership interest. Some commentators have suggested that ***Magneson*** is no longer applicable to §1031 exchanges since the ***Magneson*** was based on certain California general partnership statutes which have since been amended, and thus, today ***Magneson*** may have a very limited application.

[50] *See* ***Crenshaw v. U.S.***, 450 F.2d 472 (5th Cir. 1971) for the application of the step transaction doctrine to a partnership liquidation followed by a §1031 exchange.

Clients engaging in deferred tax-free exchanges must identify the Replacement Property within 45 days after closing the sale of the Relinquished Property. Additionally, in a deferred exchange the client must receive the Replacement Property on the earlier of the 180th day after the date that the Relinquished Property is transferred or the due date of the client's income tax return for the taxable year in which the transfer of the Relinquished Property occurs (taking into account allowed extensions).[51]

Maximizing the Time to Receive the Replacement Property. If the 180-day period to receive the Replacement Property ends after the due date of the client's federal income tax return for the tax year in which the Relinquished Property was transferred, then the client should file for a tax return extension to maximize the time period in which to receive the Replacement Property.

Alternative Ways to Identify the Replacement Property. Selling clients can identify three alternative Replacement Properties within 45 days of the Relinquished Property's sale without regard to the fair market value of the Replacement Properties or, instead, any number of Replacement Properties as long as the aggregate fair market value as of the end of the 45-day identification period does not exceed 200 percent of the aggregate fair market value of the

[51] Treas. Regs. §1.1031(k)-1(b)(2)(ii).

Relinquished Property.[52] Alternatively, clients can identify multiple Replacement Properties if the client timely closes the purchase of at least 95 percent of the value of all identified Replacement Properties before the end of the exchange period.[53]

Mistake (Tax Fraud!!) of Backdating Identification Documents. As some exchanging clients find themselves approaching the 45-day deadline without having yet identified their Replacement Property, they may be tempted to "backdate" identification documents in violation of the tax laws. Clients who falsify documents or change dates in an attempt to fall within the 45-day period should keep in mind the civil fraud case of ***Dobrich* v. *Commissioner***,[54] where the taxpayer was liable for penalties for backdating exchange identification documents.

How to Obtain More Time in Order to Identify the Replacement Property. A planning technique for a selling client to gain more time to identify the Replacement Property is for the client to delay the closing of the Relinquished Property's sale. For example, a client can obtain more time to identify the Replacement Property by including a provision in the Relinquished Property's sale agreement

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[52] Treas. Regs. §1.1031(k)-1(c)(4)(i).

[53] Treas. Regs. §1.1031(k)-1(c)(4)(ii)(B).

[54] 188 F.3d 512 (9th Cir. 1999).

giving the client an option to extend the Relinquished Property's escrow closing date. Another alternative solution is for the client to first lease the Relinquished Property to the buyer, with the buyer purchasing the Relinquished Property at a later date.

<u>MISTAKE OF FAILING TO VERIFY THE CREDITWORTHINESS OF THE QUALIFIED INTERMEDIARY</u>

Some clients engaging in a deferred tax-free exchange leave millions of dollars in the name of the qualified intermediary who is to complete their exchanges. Surprisingly, clients who are careful to obtain title insurance policies, perform due diligence on the Replacement Property, and verify the credit worthiness of their tenants often fail to verify the financial viability of their qualified intermediary. Exchanging clients should investigate the financial condition of the qualified intermediary which is holding and investing their exchange funds. There are also several different ways under the Treasury Regulations whereby clients can protect their Relinquished Property's sales proceeds being held by a qualified intermediary.

<u>Have the Qualified Intermediary Hold the Relinquished Property's Sales Proceeds in a Separate Escrow or Trust Account</u>. Most qualified intermediaries do not put the exchange funds into a separate trust or escrow account, which could protect these funds from the qualified intermediary's creditors. The Section 1031 Treasury Regulations permit the Relinquished Property's sale cash proceeds to be held in an escrow or trust account by the qualified intermediary.[55] The exchange documents must, however, limit the exchanging party's right to receive, pledge, borrow or otherwise receive the benefits of the cash or cash equivalents held in the trust or escrow account, except as permitted by the Treasury Regulations.

Use a Deed of Trust, Letter of Credit or Guarantee as Security. Clients can also have the qualified intermediary's obligations secured by a deed of trust, conforming standby letter of credit, or a third-party guarantee.[56] Clients should review the guaranty carefully to determine if the guaranty is a normal commercial guaranty with adequate legal protections. The standby letter of credit must be non-negotiable and should provide for the payment of the proceeds to escrow for the purchase of the Replacement Property rather than to the exchanging owner.[57]

MISTAKE OF VIOLATING THE RELATED PARTY EXCHANGE RULES

[55] Treas. Regs. §1.1031(k)-1(g)(3).

[56] Treas. Regs. §1.1031(k)-1(g)(2).

[57] Payment of the letter of credit proceeds to the exchanging party will result in the exchanging party receiving cash, which in turn could trigger recognized gain in an otherwise tax-free exchange. *See* Treas. Regs. §1.1031(k)-1(f)(2) and §15A.453-1(b)(3).

Even though properties may be exchanged tax free between related parties,[58] Section 1031(f) imposes a two-year holding period requirement for related parties engaging in a tax-free exchange. Basically, Section 1031(f) requires that where a client exchanges property with a related party, ***both*** parties to the exchange must hold their respective properties received in the exchange for at least two years after the exchange in order to receive tax-free exchange treatment.[59] Thus, if either related party to the exchange disposes of the property which they received in the exchange before the end of this two-year holding period, any gain or loss which would have been recognized in the exchange by either party will be recognized on the date that the disqualifying disposition occurred.[60]

Purpose of the Related Party Rules. The Section 1031(f) related party rules were added to the Internal Revenue Code to prevent taxpayers from exchanging low-basis property for high-basis property to avoid the recognition of gain on subsequent property sales or to accelerate a loss on retained property. The legislative history of Section 1031(f) states that the reason for the statutory

[58] *See, e.g.,* ***Coastal Terminals, Inc. v. U.S.***, 320 F.2d 333 (4th Cir., 1963); and ***Fredericks v. Commissioner***, T.C. Memo 1994-27.

[59] The determination of who is a related party is based upon §§267(b) and 707(b)(1).

[60] I.R.C. §1031(f)(1). There are exceptions for a disposition within the two-year period by reason of the death of either related party, compulsory or involuntary conversion of the exchanged property, or any disposition if neither disposition nor the exchange "has as one of its principal purposes the avoidance of federal income tax." I.R.C. §1031(f)(2).

change was that if an exchange of properties between related parties is shortly followed by a disposition of the property, effectively the related parties have "cashed out" of the investment, and thus Section 1031 non-recognition treatment should not apply.[61] Without the related party rules of Section 1031(f), taxpayers could exchange low basis Relinquished Property with a related party who had high-basis Replacement Property, and that related party could then sell the Relinquished Property (which acquired a new high tax basis in the exchange) and receive the sale's cash proceeds tax free.[62]

<u>Clients Should be Careful of Indirect Transfers to Related Parties</u>. The related party rules also cover "indirect" transfers between related parties. This "indirect" transfer rule may cause exchanging parties to unwittingly violate the related party rules when they utilize a qualified intermediary to do a deferred Section 1031 exchange.[63]

***Example*:** Taxpayer, property owner, transfers its Relinquished Property to a qualified intermediary who then transfers that Relinquished Property to an unrelated third

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[61] S. Fin. Rep. No. 56, 101st Cong., 1st Sess. 151 (1989).

[62] The related party's tax basis in the Relinquished Property which the related party receives in the exchange increases to the high tax basis of the Replacement Property that the related party transfers in the exchange. *See* I.R.C. §1031(d).

[63] I.R.C. §1031(f)(4) states that transactions structured to avoid the "purposes" of the related party rules of §1031(f) will not qualify for §1031 tax-free exchange treatment.

party for cash sales proceeds. The qualified intermediary then utilizes the cash proceeds from the Relinquished Property's sale to acquire the Replacement Property from a related party for cash, and transfers the Replacement Property to the taxpayer.

On this fact pattern, the IRS in Rev. Rul. 2002-83[64] ruled that the taxpayer would not receive tax-free exchange treatment, since the related party is deemed to have disposed of the Relinquished Property for cash within the prohibited two-year holding period. Rev. Rul. 2002-83 can be interpreted to mean that if a qualified intermediary is utilized in connection with exchanges between related parties and either related party receives cash, then the Section 1031(f) related party rules will apply to prevent tax-free exchange treatment.[65]

Many times a client with related party entities owning real properties, needs for business reasons to have these entities exchange these properties between themselves in order to have the real properties owned by the correct legal entity. Rev. Rul. 2002-83 and its application of Section 1031(f)(4) could unexpectedly

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[64] 2002-49 I.R.B. 927.

[65] *However, see* Priv. Ltr. Ruls. 200251008 and 200329021 where the IRS ruled that the related party rules do not apply where improvements on the Replacement Property are constructed by a related party. Here, an EAT constructed improvements on land which was leased from a related taxpayer.

under these circumstances produce recognized taxable gain to the client, especially where a qualified intermediary is used. To avoid Rev. Rul. 2002-83's application where the Replacement Property is acquired from a related party, clients should structure their exchange so that neither related party receives cash in the exchange, or from the sale of either the Relinquished Property or the Replacement Property, during the required two-year holding period.[66]

CONCLUSION

The cost effectiveness of professional exchange companies encourages clients to use their services to perform Section 1031 tax-free exchanges. However, accountants should also advise their clients on the multitude of tax issues inherent in tax-free exchanges. Professional exchange companies in their standardized documents warn clients to use outside professionals. Prudent clients will heed these warnings.

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[66] See Priv. Ltr. Rul. 200440002 in which related parties successfully engaged in a §1031 exchange using a qualified intermediary and neither party "cashed out" of their respective exchanged real property.