Law Offices of Robert A. Briskin, a Professional Corporation
1901 Avenue of the Stars, Suite 1700, Los Angeles, California 90067

Certified Specialist - Taxation Law
The State Bar of California
Board of Legal Specialization

Telephone: (310) 201-0507
Facsimile: (310) 201-0588
E-mail: rbriskin@rablegal.com
Website: rablegal.com

2005 UPDATE ON SOLVING LIKE-KIND EXCHANGE PROBLEMS

by

Robert A. Briskin

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Without proper advice from their accountants, clients make mistakes in structuring real estate exchanges, which can result in the client receiving recognized taxable income. The discussion below focuses on solutions which accountants can employ to help their clients avoid mistakes on §1031 exchanges and the latest cases and IRS pronouncements in the tax-free exchange area.

The first issue that accountants examine for clients who are contemplating doing an exchange is the amount of tax that the client would otherwise have to pay if the client chose not to do the exchange, and instead sold the Relinquished Property and recognized the gain. The federal long term capital gain rate is currently at a low 15% rate, with straight line depreciation recapture on real estate taxed at 25%. Additionally, California imposes a 9.3% tax rate[1] and in some cases the federal Alternative Minimum Tax may apply.

1. PROPERTY BEING EXCHANGED MAY INCLUDE BOTH REAL ESTATE AND PERSONAL PROPERTY.

A basic Section 1031 exchange requirement is that the property sold (the "Relinquished Property") and the property received (the

[1] There is an additional California tax of 1% on income over $1,000,000. Additionally, there are currently several proposed California ballot measures to raise the California income tax rates for higher income level taxpayers.

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"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]

1.1 **<u>Real Estate Cannot Be Exchanged For Personal Property</u>**. If the Relinquished Property consists of personal property, then the Replacement Property must also consist of similar like-kind personal property or, alternatively, "like-class" personal property to the Relinquished Property's depreciable tangible personal property.[4] Depreciable tangible personal properties are of a like-class if they are within the same "General Asset Class" or "Product Class." Product classes are based on the North American Industry Classification System under Temp. Regs. §1.1031(a)-2(b)(3). Real estate <u>cannot</u> be exchanged tax-free for personal property. Unfortunately, some owners unwittingly violate this like-kind requirement by failing to recognize that personal property is often included as part of the building being exchanged (such as refrigerators, washers and moveable stoves in apartment buildings), or where cost segregation studies have been performed.

1.2 **<u>The Incidental Property Exception Only Applies to the Deferred Exchange Identification Rules, and It Does Not Apply to Determine If Properties Are "Like-Kind"</u>**. Exchanging parties sometimes mistakenly believe that the "incidental property exception," under which §1.1031(k)-1(c)(5)(i), which states that minor items of personal property do not have to be separately <u>identified</u> in a deferred tax-free exchange, also applies to the like-kind property requirement of Section 1031.[5] However, this "incidental property exception" <u>only</u> applies to determine whether

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[2] Treas. Regs. §1.1031(a)-1(b).

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

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

[5] For purposes of 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 larger property's value. The incidental property must relate to the larger item of property.

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the 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 exchanged along with real property, then like-kind personal property must also be received in the exchange in order to satisfy Section 1031's like-kind property requirements.

1.3 **What Happens When Personal Property Comprises Part of the Building**? Personal property is present where parts of buildings are reclassified as personal property. Reclassification allows sophisticated building owners to reduce their income taxes by accelerating depreciation and amortization deductions and avoiding the 39-year straight-line recover period for commercial property or the 27½ year straight line period for residential property.[6] Reclassified personal property can be amortized and depreciated over shorter time periods (usually five or seven years) using the double declining method. [See §§168(c)(e)(1).] Most personal property associated with real estate will have a seven-year recovery period. However, certain personal property used in rental real estate, such as appliances, carpeting and furniture, will have a 5-year recovery period. Prior to January 2005, an even greater tax incentive existed to reclassify building parts as personal property —first year bonus depreciation deductions of 30% and 50% were available under §168(k)(1).

In order to reclassify parts of buildings as personal property, real estate owners and their accountants commonly perform cost segregation studies.[7] These cost segregation studies are based upon the tax rules outlined in ***Hospital Corp. of America v.***

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[6] 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 the IRS internal memorandum issued on December 6, 2003 on "Planning and Examination of Cost Segregation Issues in Restaurant Business."

[7] Many accounting firms and appraisal companies market to clients cost segregation studies as a way to save taxes. For a discussion of cost segregation studies' standards in order to classify building parts as "tangible personal property," rather than as part of the building's inherently permanent structure, see the case of ***Whiteco Industries, Inc. v. Commissioner***, 65 T.C. 664 (1975), *acq.* 1980-1 C.B. 1.

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Commissioner.[8] The reclassified personal property is then depreciated over a shorter recovery life than the real property.[9] Specialized refrigeration, restaurant, medical, manufacturing or computer equipment, and the plumbing, electrical, ventilation, and flooring systems in connection with specialized systems may be classified as personal property to be depreciated over short recovery periods.[10] Also, office cabinetry, carpeting, special lighting fixtures,[11] gasoline pump canopies[12] and retail signs[13] may be classified as personal property to be depreciated over a much shorter time than real estate.

In certain real estate projects such as a shopping center, the project's name may have value to be amortized over 15 years under Section 197.

1.4 **Solutions Where the Relinquished Property Contains Personal Property**. Even minor amounts of personal property involved in real property exchanges can trigger gain recognition. To meet the §1031 like-kind property requirement, when personal property comprises part of the Relinquished Property or the Replacement Property, then like-kind or like-class personal

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[8] 109 T.C. 21 (1997), *nonacq*. 1999-35 I.R.B. 314.

[9] Even real estate owners who in the past may have failed to segregate out "personal property" to receive these increased depreciation deductions can still do so on their current federal income tax returns. *See* Rev. Proc. 2002-9, 2002-3 I.R.B. 327 for doing an automatic IRS consent to change in accounting method for depreciation methods. On December 31, 2003 the IRS issued Rev. Proc. 2004-11 which confirmed that a change or adjustment in a property's useful life is not a change in the method of accounting based on newly issued Temp. Treas. Regs. §1.446-1T(e)(2)(ii)(d). Rev. Proc. 2004-11 even allows taxpayers who claimed less than the property's "allowable" depreciation to change to the correct depreciation amount in the year of the property's sale.

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

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

[12] 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.

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

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property should 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.[14] If only the Relinquished Property (or Replacement Property) contains personal property, then, to avoid gain recognition, some exchanging parties evidence that the other property's personal property has no value and thus is not part of the exchange. Clients can obtain an appraisal to substantiate a low value, as well as an agreement on that value from the Relinquished Property's buyer (however, such buyer may prefer a higher valuation to increase its own depreciation deductions).

An alternative tax strategy for exchanging into like-kind property following a cost segregation study is to argue that the reclassified personal property remains "real property" for purposes of the Section 1031 like-kind exchange rules based upon the definition of real property under California state law.[15]

2. __HOW TO STRUCTURE AN EXCHANGE INTO IMPROVEMENTS WHICH ARE TO BE CONSTRUCTED IN THE FUTURE__.

Clients sometimes wish to sell the Relinquished Property and then exchange into the Replacement Property when improvements are to be constructed on the Replacement Property at a later date. However, contracts to construct improvements are ***__not__*** like-kind to real property for §1031 tax-free exchange treatment.

In a deferred exchange, a client may acquire Replacement Property to be improved during the 180-day deferral period (or due

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[14] 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 is part of the building's property being exchanged, the real and personal properties must be classified and put into like-kind or like-class exchange groups. Treas. Regs. §1031(j)-1.

[15] Exchanging parties can argue that reclassified "personal property" is still "real estate" for purposes of the §1031 like-kind exchange rules based upon the fact that it is only special federal statutory tax rules under §§168 and 167, that allow parts of buildings to be classified as personal property for tax depreciation purposes. For §1031 purposes, however, state law generally determines if property is personal or real. *See, for example,* Priv. Ltr. Rul. 8443054. California law classifies items (including prior personal property) which is permanently affixed to the building as "real property." *See* California Civil Code §658.

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date of the client's return, if sooner). Under Regs §1.1031(k)-1(m)(3)(iii), improvements not completed before the end of the deferred-exchange period will still be deemed substantially the same as the Replacement Property identified by the client within the 45-day identification period, if: (1) the improved Replacement Property would have been considered substantially the same property as identified by the client, had it been completed when received by the client; and (2) when the Replacement Property is received, the partially completed improvements constitute the real property under applicable state law.

2.1 **Reverse Tax-Free Exchange**. To construct improvements on the Replacement Property which will qualify for like-kind exchange treatment, sellers 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 seller may do a "reverse tax-free exchange" by first having the Replacement Property acquired by an independent party (who must not be classified as the seller's agent for tax purposes) and then have this independent party construct the improvements. When the improvements are fully constructed and become part of the real property, the Replacement Property (including the newly constructed improvements) are then exchanged for the Relinquished Property.

2.2 **Solution of Using a "Safe Harbor" Reverse Exchange Under Rev. Proc. 2000-37**. One form of a reverse exchange is referred to as a "parking arrangement" where the Replacement Property is first acquired or "parked" with a third party, who is referred to in Rev. Proc. 2000-37[16] as an "exchange accommodation titleholder" or "EAT." Rev. Proc. 2000-37 provides a safe harbor for parking arrangements whereby the Replacement Property's acquisition is completed prior to the disposition of the Relinquished Property. Where an exchanging taxpayer satisfies Rev. Proc. 2000-37, the IRS will not challenge the parking arrangement.

In Rev. Proc. 2004-51,[17] the IRS stated that Rev. Proc. 2000-37 does not apply to Replacement Property held in a qualified EAT if

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[16] 2000-40 I.R.B. 308. The Revenue Procedure allows several alternative safe harbor parking arrangements using a third-party "exchange accommodation titleholder."

[17] Rev. Proc. 2004-51, IRB 2004-33, 294, indicates the IRS continues to study parking transactions in the §1031 area.

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the Replacement Property is owned by the taxpayer within the 180-day period ending on the date of the transfer of the Replacement Property to the EAT. Thus, Rev. Proc. 2004-51 follows the theme of the ***DeCleene*** decision where the taxpayer was denied tax-free exchange treatment where the taxpayer transferred taxpayer-owned land to a third party who then was required to construct the improvements and transfer that land with the newly constructed improvements back to the taxpayer.[18] To avoid the adverse result of Rev. Proc. 2004-51, the Replacement Property should be transferred by the taxpayer to an unrelated party more than 180 days before the Replacement Property is transferred to the EAT.

Under Rev. Proc. 2000-37, the EAT is permitted to borrow money from the exchanging party, and the exchanging party is permitted to guaranty the EAT's construction loans. Rev. Proc. 2000-37 allows the EAT to enter into an accommodation agreement with the client allowing client loans, leases and indemnification agreements with the EAT that effectively could make the EAT the client's agent. Therefore, if all the requirements of 2000-37 cannot be satisfied (and only a portion of the requirements can be satisfied), the client, by only using this Rev. Proc. in part, can unwittingly create an agency relationship with the EAT, denying the client §1031 treatment.

One of the principal difficult provisions of 2000-37 that clients may not be able to satisfy is the Revenue Procedure's time requirements which mandates that the exchanging party receive the Replacement Property within 180 days of the EAT acquiring title to the Replacement Property. Because of potential construction delays, the exchange accommodation titleholder may likely take longer than 180 days to construct the improvements.[19] Accordingly, many taxpayers that cannot satisfy this 180-day time requirement and still utilize the other provisions of 2000-37 may have walked into a trap by creating an "agency relationship" with their EAT, which will in turn cause them not to satisfy the §1031 exchange requirement. Therefore, sellers desiring to exchange into improvements to be constructed over a period longer than 180 days should instead choose to do their construction exchange based upon

[18] ***DeCleene v. Commissioner***, 115 T.C. 457 (2000).

[19] 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.

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case law authority and not follow Rev. Proc. 2000-37's safe harbor provisions.

2.3 **How to Do Parking Arrangements Outside of Rev. Proc. 2000-37 and Rev. Proc. 2004-51 (So-called "Non-safe Harbor Construction Exchanges")**. If the safe harbor provisions of Rev. Proc. 2000-37 (as modified by Rev. Proc. 2004-51) cannot be met, an exchange may still be structured to qualify under §1031 based upon case law.[20] In a typical non-safe harbor transaction, an independent accommodator[21] first acquires the Replacement Property on which the improvements are to be constructed. The accommodator's acquisition financing and the construction financing may come from either the client or the client's lender. In many cases, the client has an option to acquire the Replacement Property after the improvements are constructed in order to complete the exchange. When the client is prepared to sell the Relinquished Property to the buyer, the client closes the exchange by using a qualified intermediary to transfer the Relinquished Property and acquire the Replacement Property from the accommodator.[22]

In ***J. H. Baird Publishing Co.***[23], an accommodator who acquired the Replacement Property and constructed improvements thereon on

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

[21] See ***J. H. Baird Publishing Co.***, 39 T.C. 608 (1962), acq. 1963-2CB4. An accommodator is a person independent of the taxpayer who takes title to the Replacement Property in the construction exchange, so that the taxpayer does not own both the Replacement Property and the Relinquished Property at the same time. If the taxpayer were to own both properties (whether legally or beneficially) at the same time, there could not be an "exchange" for §1031 purposes.

[22] Generally, a qualified intermediary will not want to serve directly as the accommodator for the construction of the improvements because of liability concerns. A qualified intermediary is a person who enters into a written exchange agreement with the taxpayer and, as required by the agreement, acquires Relinquished Property from the taxpayer, transfers it and acquires like-kind Replacement Property and transfers the Replacement Property to the taxpayer. The qualified intermediary cannot be the taxpayer or the taxpayer's agent or related to the taxpayer or the taxpayer agent; see Regs. §1.1031(k)-1(g)(4)(iii).

[23] See footnote 21 above.

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the taxpayer's behalf was not held to be the taxpayer's "agent." Similarly, in ***Fredericks***[24], an 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. On the other hand, in ***DeCleene***[25], the taxpayer was denied tax-free exchange treatment when the taxpayer transferred land to a third party that constructed improvements and transferred the improved land back to the taxpayer. The ***DeCleene*** holding is similar to Rev. Proc. 2004-51, where the IRS emphasized its position that §1031 will not apply to taxpayers who already own the Replacement Property that the taxpayer intends to exchange into.

These court decisions instruct clients who do non-safe harbor construction exchanges to not take title to the Replacement Property, but instead to use an accommodator to take title and construct the improvements on the Replacement Property. The accommodator must not be classified as the taxpayer's agent. Additionally, the accommodator's Replacement Property acquisition should be structured to shift the "burdens and benefits" of the Replacement Property's ownership (such as some risk of loss and some profit potential) to the accommodator so that the accommodator, and not the client, will be recognized for tax purposes as the Replacement Property's owner until the exchange is completed. How long can you have all of the Replacement Property's appreciation go only to the client and no benefits of ownership go to the accommodator? At some time in the future you should give some profit to the accommodator. The accommodator can be given a risk of loss by having the accommodator contribute money to the Replacement Property's acquisition. Ten percent invested by the accommodator should be enough of any investment. What about an investment of only three to five percent of the Replacement Property's cost?

Do not make the accommodator an agent of the taxpayer or be able to bind the taxpayer.

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[24] See footnote 20 above.

[25] See ***Donald DeCleene*** at 115 T.C. 457 (2000). However, the IRS in PLR 200111025 recognized a successful §1031 exchange and the accommodator was not the taxpayer's agent, when the documentation showed an intent to do a §1031 exchange. PLR 200111025 used a title company as the accommodator and predated Rev. Proc. 2000-37.

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The accommodator could obtain the monies to contribute to acquire the Replacement Property (and thus have an investment in the Replacement Property) by such methods as: (i) the taxpayer loaning monies to the accommodator; (ii) the accommodator pays monies from the accommodator's pocket to purchase the Replacement Property; or (iii) the accommodator becomes a joint venturer of an unrelated party and the taxpayer (with the taxpayer owning less than 50% of this joint venture) and a bank, by nonrecourse financing, loaning monies to the joint venture for the Replacement Property's acquisition and construction thereon.

On November 30, 2004, the IRS chief counsel issued a Field Advice Memorandum FAA20050203, which discussed a construction exchange predating Rev. Proc. 2000-37. This Field Advice Memorandum discussed the factors that could evidence the beneficial "ownership" for tax purposes of the Replacement Property by the accommodator. However, in this fact situation the IRS stated that the taxpayer (and not the accommodator) had beneficial ownership of the Replacement Property (thus causing the taxpayer to not qualify under §1031), even though the accommodator had legal title to the Replacement Property, reasoning that the accommodator only received a fee out of the transaction, and that the taxpayer had all of the economic benefits and burdens of ownership. The IRS found that the taxpayer bore the risk of economic loss or physical damage to the property and received the benefits of profits from the property's operations and appreciation, rather than the accommodator.

In issuing Rev. Proc. 2004-51, the IRS stated that it was continuing to study parking transactions, including transactions in which a person related to the taxpayer transfers a leasehold in land to an accommodation party, and the accommodation party makes improvements to the land and transfers the leasehold with the improvements to the taxpayer in exchange for other real estate." Thus, the IRS continues to study construction exchanges and future pronouncements are probable in this area.

3. PARTNERSHIP DISTRIBUTES REAL PROPERTY TO THE PARTNERS FOLLOWED IMMEDIATELY BY THE PARTNERS DOING A TAX-FREE EXCHANGE (SO-CALLED "DROP AND SWAP EXCHANGES").

When partnerships[26] desire to split up, they sometimes first liquidate and distribute all of the partnership's Relinquished

[26] These tax rules also apply to limited liability companies.

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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, this arrangement risks violating a basic requirement of Section 1031, which is that exchanging partners must "hold" both the Replacement Property and the Relinquished Property for "productive use in a trade or business or for investment." Although there is no specified length of time that the exchanging former partners must "hold" the Relinquished Property before entering into an exchange, the former partners should own the Relinquished Property as tenants-in-common long enough to evidence their intention to hold the property for investment, or trade or business purposes.

3.1 **Liquidation Followed By an Exchange**. The IRS has ruled that taxpayers did not "hold" the Relinquished Property for the required qualified use, where the property was received by the taxpayer as a liquidating distribution from a legal entity and then immediately exchanged for the Replacement Property.[27] Contrary to this IRS ruling, the Tax Court in ***Mason v. Commissioner***[28] 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***[29], 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 held that §1031 only requires a taxpayer to own the Relinquished Property before entering into the exchange and to have no intent either to liquidate the Relinquished Property or to use the Relinquished Property for personal purposes.

3.2 **Solution to First Liquidate the Partnership and Then to Hold the Liquidated Relinquished Property as Tenants-In-Common Before Doing an Exchange**. A safer tax strategy is to have the former partners hold their tenant-in-common interests in the

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

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

[29] 760 F.2d 1039 (9th Cir. 1985). In ***Bolker***, the corporation liquidated under former Section 333 followed by the shareholders entering into an exchange of the liquidated property.

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Relinquished Property for an extended time period before they exchange those interests for the Replacement Property. However, for tax purposes the former partners' tenancy-in-common relationship must be structured so as not to be treated as a partnership for tax purposes.[30] Thus, the formalities of a tenancy-in-common relationship should be observed. to formalize the appearance of a tenancy-in-common, the individual 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, such as a Form LP-3 Certificate of Dissolution for liquidating California limited partnerships.[31]

3.3 **How to Be Classified as a Tenancy-in-Common and Not as a Partnership For Tax Purposes**. The IRS issued Rev. Proc. 2002-22 to list the conditions under which the IRS will consider a revenue ruling request that a tenancy-in-common interest (sometimes known as a "TIC") will not be treated as a partnership interest for tax purposes. Rev. Proc. 2002-22 was issued in response to the real estate syndication industry that has grown up to market tenancy-in-common interests in large real estate properties to those persons needing Replacement Property to complete their Section 1031 exchanges.

Clients who consider purchasing tenancy-in-common interests must also review non-tax issues such as the quality of the underlying property's tenants, the amount of management costs and fees, whether there are any guarantees, and how the client will sell the client's tenancy-in-common interest at a later date and for how much. The syndicator under this Rev. Proc. cannot have a buy back right. These syndicated TICs are securities which must comply with federal and state securities laws. Because real estate

[30] 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. *See* Treas. Regs. §301.7701-1(a)(2). 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. There should be a written co-tenancy agreement which preserves the normal rights of a co-tenancy under state law.

[31] For an example on how not to create a valid co-tenancy relationship, *see* ***Chase v. Commissioner***, 92 T.C. 874 (1989), where the tenant-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.

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brokers generally do not have a securities license, TICs have recently been marketed through the securities industries.

Rev. Proc. 2002-22 states that it's 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 Rev. Proc.'s listed conditions on audit. Nonetheless, many tax advisors feel that violating certain of its conditions does not automatically trigger partnership classification. As a practical matter, the guidelines in Rev. Proc. 2002-22 are a safe harbor for structuring TICs which are acquired as Replacement Property in like-kind exchanges.

Having a partnership liquidate its properties to partners as tenants-in-common is probably the most frequently used technique when some partners want to exchange for property and others want to cash out. Taxpayers have relied on ***Bolker*** (discussed above) for the §1031 "holding" issue, and on Rev. Proc. 2002-22 to be treated as tenants-in-common. However, accountants should caution their clients that under Rev. Proc. 2002-22, the IRS will not issue a favorable ruling when the exchanging tenants-in-common previously held their property interests through a partnership. This prohibition on previously owning the property through a partnership, contained in Rev. Proc. 2002-22, sends a "warning" of how the IRS might treat a partnership liquidation followed by an exchange.

A summary of Rev. Proc. 2002-22's major provisions is as follows:

(i) The tenancy-in-common or "TIC" may only be created for one property.

(ii) Each TIC owner must hold title to the real property directly or through a single member limited liability company as a tenant-in-common.

(iii) The number of TIC co-owners may not exceed 35 persons.

(iv) The TIC co-owners should not file a partnership return, conduct business under a common name, nor hold itself out as a business entity.

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(v) The TIC co-owners must unanimously approve sales agreements, leases, deeds of trust and encumbrances, and management agreements of the property. Other agreements would require only a majority approval.

(vi) A manager cannot be hired for a period in excess of one year, and the TIC owners cannot give a general power of attorney to the manager.

(vii) Each TIC owner must share profits and losses in proportion to their tenancy-in-common percentage interest.

(viii) Each TIC owner must have the right to partition, sell and transfer, lease, and encumber its interest without the approval of any of the other TIC owners.

(ix) If the property is sold, any debt encumbering that property must be repaid, and the proceeds distributed to the TIC owners on a pro rata basis.

(x) Each TIC co-owner may have an option to acquire an interest of another TIC co-owner at a fair market value, but a TIC co-owner may not acquire an option to sell its interest to the promoter, a lessee, or another TIC co-owner (*i.e.,* a "put"). No permission in Rev. Proc. to have a right of first refusal in the other TIC co-owners' interests.

(xi) The TIC's activities must be limited to those customarily performed in connection with the maintenance of real estate.

(xii) A lease cannot be entered into with a TIC co-owner's consent.

There is an exception that permits a TIC co-owner to waive partition rights where a lender asks for the partition waiver by the co-tenants.

Rev. Proc. 2002-22 requires each TIC co-owner to retain the right to approve the major decisions of the tenancy-in-common. Thus, Rev. Proc. 2002-22 states that each co-tenant must retain 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 may be cumbersome with large numbers of co-tenants to approve a sale or lease, or to make a major decision, some tax professionals structure tenancy-in-common agreements with an

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"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 60 days). If none of the co-tenants object to the proposed action, then that action is deemed to have been approved. Some professionals feel that this time period to object can only be applied to the manager's agreement (and such "objection method" may not be applied to the lease, sale or financing of the property).

Some TIC agreements have a long triple-net master lease of the Replacement Property to a master tenant (who may be related to the syndicator/promoter of these Section 1031 arrangements), and then this master tenant subleases the property to other tenants who are the actual users. Using this type of a master lease removes the need of each co-tenant to approve the leases for all the various property's tenants (such as in an office or apartment building). Query: Does a "master lease" violate Rev. Proc. 2002-22?

The IRS on April 1, 2005 released favorable Priv. Ltr Rul. 200513010 under Rev. Proc. 2002-22. In Priv. Ltr. Rul. 200513010, a company acquired a property that was triple-net leased to unrelated tenants. The acquiring company then proceeded to sell undivided tenancy-in-common fractional interests in the acquired property to no more than 35 persons. The co-tenancy agreement between the co-owners required <u>unanimous consent</u> to enter into any leases of the property, sale of the property, reappointment of a property manager or the incurrence of debt on the property. For all other action, the approval of more than 50% of the undivided fractional interest was required. All of the property's income, expenses and net sales proceeds were allocated among the tenants-in-common in proportion to their percentage ownership interests. Each co-tenant retained the right to exercise its right of partition, but before exercising such right, it had to offer to sell its co-tenancy interests to the other co-tenants at fair market value. There was also a management agreement with a related management company to manage the property. There was a procedure for non-renewal of this management agreement and allowing co-owners to object to provisions in the management agreement. The IRS held that the co-ownership arrangement <u>satisfied all</u> of the conditions set forth in Rev. Proc. 2002-22. The structure satisfied the requirement of each co-tenant retaining the right to approve the hiring of the manager, the sale of the property and the lease of the property. Of special importance was that each co-owner could exercise a right to terminate the management agreement annually. Additionally, the tenancy-in-common arrangement did not become a

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"business" because the activities of the management company and the co-tenants were only those customarily done in triple-net leasing. Thus, the IRS held that the property did not constitute an interest in a partnership.

3.4 **Using Disregarded Entities to Own Tenancy-In-Common Interests**. Persons owning tenancy-in-common interests in the Replacement Property may wish to limit their personal liability by not owning the tenancy-in-common interest in their individual names. Rather, they may choose to utilize a disregarded entity, (such as a single-member limited liability company) to own their tenancy-in-common interests. Owning the tenancy-in-common interest in a single-member limited liability company is advantageous since the death or bankruptcy of the individual who owns the LLC tenant-in-common will not affect the other tenants in common. Rev. Proc. 2002-22 specifically states that disregarded entities can hold a tenancy-in-common interest.

3.5 **Using a Delaware Statutory Trust to Own Property in an Exchange**. When a Delaware statutory trust, which is a grantor trust, engages in a §1031 exchange, the Delaware statutory trust's interest is treated as an ownership interest of the underlying trust assets under Rev. Rul. 2004-86, 2004-33 IRB 191. This Revenue Ruling allows the use of a Delaware statutory trust as a disregarded entity only in limited situations. The Revenue Ruling states when a trust will be classified as a "trust" for tax purposes under Reg. §1.7701-4 or when it will be classified as a "business entity" under these Regulations. Where the trust entity is classified as a "trust," then this trust must also satisfy the grantor trust rules under §671 in order for the trust to be deemed to own an interest in the property for purposes of §1031. For example, if a Delaware trust is not treated as a "trust" for tax purposes (and instead is treated as a business entity), then the beneficial interest in that trust are treated as either an interest in a partnership or corporation under §7701, which in turn would not constitute valid like-kind "Replacement Property" under the §1031 rules.[32] In summary, a Delaware statutory trust qualifying under Rev. Rul. 2004-86 can have its beneficial interests exchanged tax free for real property under §1031. To qualify under this Revenue Ruling, the trust beneficiaries must not be involved in the

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[32] Instead, the beneficial interests in a trust classified as a partnership would violate §1031 rules on prohibiting exchanging real estate into partnership interests or from exchanging partnership interests for other partnership interests.

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operation or management of the trust, and the trustee <u>cannot</u> have any of the following powers:

(i) The trustee cannot dispose of the trust's property and then acquire new property (although the trustee can sell the trust's assets and dissolve the trust).

(ii) The trustee cannot enter into new leases.

(iii) The trustee cannot renegotiate a lease with an existing tenant.

(iv) The trustee cannot have new debt encumber the trust's assets.

(v) The trustee cannot renegotiate any existing debt.

(vi) The trustee cannot invest cash received to profit from market fluctuations (all cash must be invested in short-term Treasuries that will be distributed at the end of each calendar quarter).

(vii) The trustee may not make more than minor common nonstructural modifications to the trust's property not required by law.

The purpose of the above restrictions is to have a qualifying Delaware statutory trust engage only in the <u>passive holding</u> of rental real estate.

4. <u>CASHING OUT PARTNERS WHERE THE PARTNERSHIP ENGAGES IN A TAX-FREE EXCHANGE</u>.

Commonly, real estate partnerships desire to split up with certain partners receiving cash (referred to as the "cash-out partners"), and the remaining partners exchange tax-free into other real estate. 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, distributing cash to only the

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cash-out partners may result in all of the partners (including the remaining partners who desire to receive tax-free exchange treatment) being taxed on the sale's recognized gain if the partnership agreement allocates gain to all partners in proportion to their percentage interests.

4.1 **Solution of Special Allocations of the Partnership's Gain**. Partners may consider amending their the partnership agreement to specially allocate all of the gain on a property's sale to only the cash-out partners, and none of the gain to the remaining partners who do a §1031 exchange. However, this special gain allocation is likely to fail §704(b)'s substantial economic effect test, because the special gain allocation would have to be reflected in the cashed-out partners' capital accounts, which in turn could alter the economic deal among the partners.[33]

4.2 **Solution of Redeeming the "Cash Out" Partners For Cash Before the Exchange**. An alternative tax structure 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.

4.3 **Solution of 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 redemption of their partnership interests. 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.[34] 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

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

[34] If an installment obligation is received in a §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 §453, since Treas. Regs. §1.453-9(c)(2) states that a partner's receipt of an installment note in a §731 distribution does not result in gain under §453B.

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Section 1031 tax-free 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 (sometimes three percent or less of the note) made shortly after the beginning of the immediate next tax year, in order to qualify for installment sale treatment under Section 453(b)(1). Thus, distribution of the promissory note to the cash-out partners will not trigger recognized gain to the partnership nor to those partners until they receive payments. [§§453 and 731] For §731 purposes, "unrealized receivables" are defined under Regs. §1.751-1(c)(1) as rights to payment for property other than a capital asset. 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.

A concern with using an installment note is that if the buyer of the Relinquished Property has a weak credit rating, there may be a hesitancy by the sellers to accept an installment note. However, one way to overcome a poor credit rated buyer is to have this buyer post a stand-by letter of credit as further collateral. A stand-by letter of credit is not treated as a payment under Temp. Reg. 15A.453-1(b)(3)(i).

4.4 **Solution of the Partnership Distributing a Fractional Tenancy-In-Common Interest in the Relinquished Property to the Cash-Out Partners Prior to the Exchange**. Another alternative 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 redemption of the cash-out partners' partnership interests. The cash-out partners and the partnership (as tenants-in-common) 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. Also, the Section 1031 requirement that the tenants in common "held" the Relinquished Property for use in a trade or business, or for investment, must be satisfied.

5. CONTRIBUTING REPLACEMENT PROPERTY TO A NEW PARTNERSHIP IMMEDIATELY AFTER THE COMPLETION OF THE EXCHANGE (OR THE SO-CALLED "SWAP AND DROP").

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Sellers of Relinquished Property in a tax-free exchange may attempt to pool their 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 violating the "holding" requirement of Section 1031 discussed above.[35] In other words, the Replacement Property was not "held" for productive use in a trade or business or for investment purposes. Instead, the Replacement Property was immediately disposed of by its contribution to a partnership.

5.1 **Solution of Asserting That the "Holding" of Replacement Property is Attributed to the Original Exchanging Party**. Clients who contribute their interests in the Replacement Property to a partnership immediately after an exchange must rely upon the Ninth Circuit Court of Appeals case of ***Magneson***[36] to attribute the partnership's holding to the clients. Relying on ***Magneson***, however, could be a risky tax strategy. 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 because the taxpayer intended to, and did continue to, "hold" the Replacement Property through its ownership of a partnership interest. According to the Ninth Circuit, there was a "mere change" in the form of the taxpayer's ownership of the Replacement Property. Since ***Magneson*** was decided for tax years before the enactment of Section 1031(a)(2)(D), the IRS might today argue that based upon a step transaction, a "swap and drop" transaction is in substance a taxpayer's acquisition of a

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[35] The IRS ruled in Rev. Rul. 75-292, 1975-2 C.B. 333 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" for a permissible use.

[36] 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 partnership interest. Some commentators have argued that ***Magneson*** is no longer applicable to §1031 exchanges since the ***Magneson*** decision was based upon an exchange occurring prior to the enactment of §1031(a)(2)(D), which prohibited an exchange of partnership interests from qualifying under §1031, and that ***Magneson*** was based upon certain California partnership statutes, which have since been amended.

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partnership interest as Replacement Property which violates Section 1031's requirements. In other words, the IRS might argue today that in a ***Magneson*** transaction the taxpayer is effectively receiving back a partnership interest in exchange for real estate, which does not satisfy Section 1031's like-kind property requirement.

5.2 **Alternative Safer Tax Solution is to Hold the Replacement Property as a Tenant in Common**. An alternative and safer tax plan would be for the exchanging party to hold the Replacement Property as a tenant-in-common with the partnership for a substantial time period after completing the exchange and not to immediately contribute the Replacement Property to the partnership. In order to avoid the exchange and later partnership contribution being tied together as a step transaction for tax purposes, the exchanging party should not have an agreement to later contribute the Replacement Property to the partnership.[37]

6. EXCHANGING RELINQUISHED PROPERTY SUBJECT TO A DEED OF TRUST IS THE EQUIVALENT OF THE EXCHANGING PARTY RECEIVING TAXABLE CASH.

6.1 **Section 1031 Rules on Indebtedness**. Gain on a Section 1031 exchange is recognized to the extent of the cash and the fair market value of other property received (known as "boot").[38] If the Relinquished Property is subject to a deed of trust, then the amount owed on this deed of trust, of which the exchanging party is relieved in the exchange, is treated as money or "boot" received by the exchanging party under §1031(b).[39] The Regulations provide that the amount of indebtedness that the exchanging owner is relieved of in the exchange is netted against

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[37] *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. The tenancy-in-common relationship between the exchanging party and the partnership must still be structured so as not to be classified as a partnership for income tax purposes.

[38] 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).

[39] *See* I.R.C. §1031(b).

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the amount of the liabilities that the owner assumes or takes the Replacement Property subject to.[40]

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 exchanging party. However, cash or other property received by the seller/client in an exchange cannot be netted against the consideration given in the form of assumed liabilities on the Replacement Property.[41]

6.2 **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 seller 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 [*see* Treas. Regs. §1.1031(j)-(1)(b)(2)]. Thus, the liability netting rules can surprisingly produce recognized gain where both real and personal property are involved in the exchange.

6.3 **Consequences of Reducing a Partner's Share of Partnership Liabilities When Doing an Exchange**. What are the tax consequences 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 [see Section 731(a)]. 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 second leg where there is the acquisition of the Replacement

[40] *See* Treas. Regs. §1.1031(b)-1(c).

[41] Treas. Regs. §1.1031(d)-2.

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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 Section 1031 exchanges that occur over two taxable years. This Revenue Ruling states 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 Replacement Property subject to a liability is acquired in year two, the liabilities are netted for purposes of the Section 752 rules.[42] Similarly, under Rev. Rul. 2003-56, if the Relinquished Property has relief of liability 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 year one).

6.4 **Refinancing the Relinquished Property Before an Exchange**. Sellers of real estate in a tax-free exchange may want to receive cash but not have to recognize taxable gain. Normally cash received from an exchange escrow is taxed to the seller as "boot." However, instead of receiving taxable cash as part of the exchange, the seller could refinance the Relinquished Property immediately before the exchange and receive these refinancing loan proceeds tax free.[43]

The IRS took the position 20 years ago in a private letter ruling that encumbering property immediately before an exchange may result in "boot" in certain cases [See Priv. Ltr. Rul. 8434015]. The IRS in Priv. Ltr. Rul. 8434015 argued that the result in ***Garcia*** should not apply. However, to date there has been no case law authority supporting the IRS's position in Priv. Ltr. Rul. 8434015.

The Replacement Property after the exchange needs to be subject to at least the same amount of indebtedness as the seller

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[42] Rev. Rul. 2003-56 is an analysis under the §1031 rules, and not the 752 Regulations. Thus, it is unclear whether the tax rule of Rev. Rul. 2003-56 applies in the 1033 area.

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

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was relieved of on the Relinquished Property to avoid gain recognition.

6.5 **Refinancing the Replacement Property After an Exchange**. An alternate tax strategy is for the seller to first complete the tax-free exchange and then refinance the Replacement Property, thereby receiving the refinancing loan proceeds tax free. The refinancing of the Replacement Property allows the taxpayer to withdraw tax free by a loan the equity inherent in the Replacement Property. In order to avoid an IRS challenge that the financing proceeds received from the Replacement Property are "boot" to the taxpayer, the refinancing of the Replacement Property should not be done until after the closing of the acquisition of the Replacement Property, and should be done by a separate loan escrow and closing statement.

6.6 **Avoid Step Transaction When Refinancing the Property**. The refinancing of the Replacement Property after the exchange or the Relinquished Property before the exchange should not be tied to the exchange by written or oral understandings, in order to avoid IRS assertions that the loan proceeds received are taxable "boot" from the exchange under a step transaction theory.[44]

7. ***RELATED PARTY EXCHANGE RULES***.

Even though properties may be exchanged tax free between related parties,[45] 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 taxpayer exchanges property with a related party, both parties to the exchange must hold their respective properties for at least two years after the exchange in order to receive tax-free exchange treatment.[46] Thus, if either related party to the exchange disposes of the property that they received in the exchange before the end of this two-year holding period, any gain or loss which would have been recognized

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[44] 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.

[45] *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.

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

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in the exchange by either party will be recognized on the date that the disqualifying disposition occurred.[47]

7.1 **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.[48] 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.[49] This would result in the related party cashing out the investment tax free.

7.2 **Indirect Transfers to Related Parties**. 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.[50]

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[47] 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).

[48] The legislative history of §1031(f) states that the reason for the statutory 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 §1031 non-recognition treatment should not apply. S. Fin. Rep. No. 56, 101st Cong., 1st Sess. 151 (1989).

[49] 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).

[50] Furthermore, §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.

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In the recently decided Tax Court decision of ***Teruya Brothers, Ltd.***[51], the Tax Court held that using a qualified intermediary to purchase Replacement Property from the exchanging party's related entity was structured to avoid the "purposes" under §1031(f)(4). In ***Teruya Brothers, Ltd.***, there were two similar exchange transactions. In both exchanges, the taxpayer first transferred Relinquished Properties to a qualified intermediary. The qualified intermediary then proceeded to sell these Relinquished Properties to unrelated third parties. However, the qualified intermediary then used the Relinquished Properties' sales proceeds (along with additional monies contributed by the taxpayer) to purchase Replacement Property from the taxpayer's subsidiary corporation, which was related to the taxpayer. The subsidiary corporation had large NOLs. The subsidiary corporation used the NOLs to shelter the gain from one of the Replacement Property's sale.[52] The Tax Court, in citing legislative history, stated that §1031(f) should also apply where the Relinquished Property is transferred to an unrelated party (*i.e.*, here the unrelated qualified intermediary), who then exchanges this property with a related party within the two-year period. The Tax Court held that these transactions are "economically equivalent" to direct exchanges of properties between related parties. The economic result in ***Teruya Brothers, Ltd.*** was that the Relinquished Property investment was "cashed out" immediately and the exchanger's related party subsidiary corporation ended up with the cash proceeds and it used its NOL to shelter the Replacement Property's gain. The Tax Court held that under §1031(f)(4), transactions structured to avoid the "purposes" of the §1031(f) related party rules will not qualify for §1031 tax-free exchange treatment. The taxpayer argued that the exchange did not have as one of its principal purposes the "avoidance of Federal income tax," since there was recognized gain on the sale of the Replacement Property. However, this argument was unsuccessful since the subsidiary related party had a large NOL. Arguably, if the subsidiary did not have a large NOL, this argument may have worked. (However, the taxpayer probably would <u>not</u> have engaged in the exchange if there was no NOL in the related party subsidiary!)

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[51] 124 T.C. No. 4 (2005)

[52] The sale of another Replacement Property by the subsidiary corporation generated a capital loss which was disallowed under §267 as a loss on a sale between related persons.

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Similar to the facts in ***Teruya Brothers, Ltd.***, is IRS Rev. Rul. 2002-83[53] where the property owner transferred its Relinquished Property to a qualified intermediary who then transferred the Relinquished Property to an unrelated third party for cash sales proceeds. The qualified intermediary then utilized the cash proceeds from the Relinquished Property's sale to enter into a deferred exchange to acquire the Replacement Property from a related party for cash. The IRS in Rev. Rul. 2002-83 ruled that property owners exchanging low basis property would <u>not</u> receive §1031 tax-free exchange treatment, since the related party disposed of the Replacement Property for cash within the required two-year holding period. This exchange which was done though a qualified intermediary is characterized by the IRS as being a prohibited disposition of the Replacement Property by the related party within the required 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 apply to prevent tax-free exchange treatment.[54]

Many times a client with related party entities owning real properties needs to exchange these properties between their related party entities in order to have the real properties owned by the correct related entity. Section 1031(f)(4) could unwittingly produce recognized taxable gain to the client in these circumstances, especially where a qualified intermediary is used.

7.3 <u>**Solution to Avoid Violating §1031(f) Related Party Rules Where Using a Qualified Intermediary**</u>. One solution to avoid the result in ***Teruya Brothers, Ltd.***, and Rev. Rul. 2002-83 where Replacement Property is acquired from a related party, the exchange should be structured 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.

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[53] 2002-49 I.R.B. 927.

[54] *However, see* Priv. Ltr. Ruls. 200251008 and 200329021 where the IRS ruled that the §1031(f) related party rules do <u>not apply</u> where improvements on the Replacement Property are constructed by a related party. Here, an EAT constructed improvements on land which was <u>leased</u> from a party related to the exchanging taxpayer. Both construction exchanges qualified under Rev. Proc. 2000-37.

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The IRS in Priv. Ltr. Rul. 200440002 held that where related parties successfully engaged in a §1031 exchange using a qualified intermediary and neither party "cashed out" of its respective exchanged real property, no gain was recognized.

8. MAXIMIZING IDENTIFICATION AND REPLACEMENT PERIODS FOR DEFERRED EXCHANGES.

Clients engaging in deferred tax-free exchanges must identify the Replacement Property within 45 days after closing the Relinquished Property sale. Also, in a deferred exchange, the client must receive Replacement Property on the earlier of the 180th day after the Relinquished Property is transferred or the due date of the client's tax return for the tax year of such transfer (including extensions). [Regs. §1.1031(k)-(b)(2)(i)].

8.1 **Identifying the Replacement Property**. Sellers can identify: (i) 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 (ii) 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 Relinquished Property.[55] Alternatively, taxpayers can identify multiple Replacement Properties if the taxpayer timely closes the purchase of at least 95 percent of the value of all identified Replacement Properties before the end of the exchange period.[56]

8.2 **Tax Fraud by Backdating 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. Sellers 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***,[57] where the taxpayer was liable for penalties for backdating exchange identification documents. The ***Dobrich*** taxpayer also pled guilty in a companion criminal tax case for providing false documents to the IRS.

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[55] *See* Treas. Regs. §1.1031(k)-1(c)(4)(i).

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

[57] *See* ***Dobrich v. Commissioner***, 188 F.3d 512 (9th Cir. 1999).

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8.3 **How to Obtain More Time in Order to Identify the Replacement Property**. One technique for a client to gain more time to identify the Replacement Property is to delay the Relinquished Property's sale closing date. For example, a seller can obtain more time to identify the Replacement Property by including a provision in the Relinquished Property's sale agreement giving the seller an option to extend the Relinquished Property's escrow closing date. Another alternative solution is for the seller to first lease the Relinquished Property to the buyer, with the buyer purchasing the Relinquished Property at a later date.

8.4 **IRS Can Extend Time Periods in Event of Disasters**. Taxpayers who are "affected" by a Presidentially declared disaster or other event (such as terrorism or combat) and have difficulty because of the event in meeting the 45-day and 180-day deadlines may obtain an extension of 120 days under §§7508 and 7508A and IRS Notice 2005-3[58] (modifying Rev. Proc. 2004-13[59]). Under Notice 2005-3, if the last day of the 45-day or 180-day period falls on or after the date of the Presidentially declared disaster, then such last day is postponed by 120 days.[60] The exchanging client only qualifies for this postponement if: (i) the Relinquished Property was transferred on or before the date of the Presidentially declared disaster[61], and (ii) the taxpayer is "affected." "Affected" includes if the taxpayer cannot meet the 45-day or 180-day period because the Relinquished Property or Replacement Property is located in the disaster area, or if the attorney, qualified intermediary or taxpayer's principal place of business is in the disaster area, or if the lender will not fund because of the disaster.[62]

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[58] IRB 2005-5.

[59] 2004-4 IRB 335.

[60] Section 7508 postpones time for performing specific acts for individuals serving in the armed forces, while §7508A permits the Secretary to postpone deadlines for taxpayers affected by Presidentially declared disasters, terrorism or military action. The IRS will issue News Releases regarding postponements.

[61] There are also provisions for reverse exchanges with EATS under Rev. Proc. 2000-37.

[62] See Reg. §301.7508A-1(d)(1) for other ways the taxpayer is an "affected taxpayer."

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9. VERIFY THE CREDITWORTHINESS OF THE QUALIFIED INTERMEDIARY.

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, property owners 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 sellers should investigate the financial condition of the qualified intermediary which is holding and investing their exchange funds. There are also several alternative solutions under the Regulations by which sellers can protect their exchange funds being held by the qualified intermediary.

9.1 **Hold Relinquished Property's Sales Proceeds in a Separate Escrow or Trust Account**. 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 bankruptcy or creditors. However, the §1031 Regulations permit the Relinquished Property's sale cash proceeds to be held in an escrow or trust account to purchase the Replacement Property.[63] 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 account, except as permitted by the Regulations.

9.2 **Use a Deed of Trust, Letter of Credit or Guarantee as Security**. Sellers can also have the qualified intermediary's obligations secured by a deed of trust, conforming standby letter of credit, or a third-party guarantee.[64] Clients must review the guaranty carefully as to whether it is a normal commercial guaranty with adequate legal protections for the clients. 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.[65]

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[63] Treas. Regs. §1.1031(k)-1(g)(3).

[64] Treas. Regs. §1.1031(k)-1(g)(2).

[65] Payment of the letter of credit proceeds to the exchanging party will result in the exchanging party receiving cash (*i.e.*, "boot"), which in turn could trigger recognized gain

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10. SALE OF RESIDENCE AND SECTION 1031 EXCHANGES.

10.1 Selling and Using §121 With a Residence Received in a §1031 Exchange. The American Jobs Creation Act of 2004[66] amends the §121 rule of when a taxpayer can exclude gain from the sale of their principal residence where such residence was acquired in a like-kind exchange. A taxpayer can exclude up to $250,000 ($500,000 if the taxpayer is married and files a joint tax return) of gain realized on the sale of the taxpayer's principal residence under §121(a). Generally, for the principal residence sale to be eligible, the taxpayer must have owned and used that residence as the taxpayer's principal residence for at least two of the five years prior to the sale. The American Jobs Creation Act of 2004 adds an additional requirement which states that this §121 exclusion does not apply if the principal residence was acquired in a like-kind exchange in which any gain was not recognized within the five years prior to the principal residence's sale. The effective date of this provision is for sales or exchanges occurring after October 22, 2004.

10.2 Selling a Principal Residence Currently Being Utilized as Income Property. What happens where the client sells a residence which is currently being utilized by the client as rental property, but was the client's prior principal residence?

> **EXAMPLE**: Assume the client buys a house for $210,000 which the client has used as the client's principal residence from 2002 to 2004. From 2004 until 2006, the client rents out the residence to tenants and claims depreciation deductions of $20,000. In 2006 the client exchanges the house for $10,000 in cash and a townhouse with a fair market value of $460,000 that the client intends to rent out. The client realizes gain of $280,000 on the exchange.
>
> The client's exchange of the client's principal residence which the client has rent for less than three years, in exchange for cash and a rental townhouse, satisfies both §§121 and 1031. Section 121 does not require that the

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in an otherwise tax-free exchange. *See* Treas. Regs. §1.1031(k)-1(f)(2) and §15A.453-1(b)(3).

[66] P.L. 108-357.

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residence be used as the client's principal residence on the sale or exchange date. Because the client owned and used the residence as the client's principal residence for at least two years during the five-year period prior to the exchange, the client may exclude gain under §121. Because the residence is investment property at the time of the exchange, the client may also defer gain under §1031. Under Rev. Proc. 2005-14[67], the client applies §121 to exclude $250,000 of the $280,000 gain before applying the non-recognition rules of §1031. The client may defer the remaining $30,000 of gain, including the $20,000 gain attributable to depreciation, under §1031. Although the client receives $10,000 cash ("boot"), the client is not required to recognize this $10,000 gain because the boot is taken into account for purposes of §1031(b) only to the extent the boot exceeds the amount of the excluded gain. The client's basis in the Replacement Property is $430,000 (which equals the basis in the Relinquished Property of $190,000 increased by the gain excluded under §121 of $250,000, and reduced by the $10,000 cash that the client receives).

Rev. Proc. 2005-14 deals with other scenarios where a principal residence is used partly for business and partly as a residence.

CONCLUSION

Exchanging parties require the advice of their accountants to advise them on the multitude of tax issues inherent in tax-free exchanges. Solely relying upon the tax and legal advice of an exchange company (and clients failing to talk to their accountants) is fraught with tax risks which may prevent the exchanging parties from receiving tax-free exchange treatment.

[67] IRB 2005-7.

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