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SECTION 1031 EXCHANGES PLANNING FOR COMPLEX SITUATIONS

by

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Clients contemplating exchanging their real estate under §1031¹ should first determine the amount of tax that the client would otherwise pay if that client elected to not do a tax-free exchange into replacement property (“**Replacement Property**”), and instead sold their relinquished property (“**Relinquished Property**”) and recognized gain.

The federal long-term capital gain rate is currently at a maximum 20% rate, with straight-line depreciation recapture on real estate taxed at 25%. There is also the 3.8% Medicare tax on the lesser of the client’s Net Investment Income or the excess of the modified adjusted gross income over \$250,000 for joint returns (and \$125,000 for separate returns). Additionally, California imposes a 13.3% maximum income tax rate.² In some cases the alternative minimum tax may apply.

¹ All Code citations, unless otherwise noted, are to the Internal Revenue Code of 1986, as amended.

² This includes the additional California Proposition 63 tax of 1% on income over \$1,000,000 under the Mental Health Services Tax, Cal. Rev. & Tax Cd §1703. California, unlike the federal tax laws, does not have lower tax rates on capital gains.

Section 1031 is form-driven, and if the statute's requirements are met then the client can defer their sold property's (their Relinquished Property) gain. In the recently published Tax Court decision of *Estate George H. Bartell*³ the Tax Court held that §1031 is form driven, and if the statute's requirements are met then the client should be able to defer their gain under the provisions of §1031. The Tax Court in *Bartell* indicated that a formalistic approach should be applied to §1031, so that if the taxpayer satisfies the §1031 statutory requirements, the IRS should not be able to apply a "substance" over "form" judicial concept to deny §1031 treatment. The *Bartell* court applied the tax principals of the Ninth Circuit Court of Appeals decision in *Alderson*⁴.

Thus, taxpayers need to comply with the following requirements of §1031 in order to receive tax-deferred exchange treatment:

- Both the Relinquished Property and the Replacement Property must be "held" for productive use in a trade or business or for investment;
- The Relinquished Property and the Replacement Property must be of "like-kind" to each other; and

³ 147 T.C. No. 5 (decided August 10, 2016). The *Bartell* case was tried before the U.S. Tax Court in October 2006 and fully briefed by March 2007. However, the *Bartell* decision was not issued by Judge Gale until August 10, 2016, almost ten (10) years after the actual trial concluded. The fact that the decision took almost ten years and was a Tax Court published decision could be interpreted to mean that as long as the form of the §1031 statute is followed, then judicial doctrines should not be read into §1031 to deny taxpayers favorable §1031 tax treatment.

As of the date of the authorship of this Article it is not clear as to whether the IRS will be appealing the *Bartell* decision to the Ninth Circuit Court of Appeals or whether the IRS will acquiesce to *Bartell*.

⁴ 317 F. 2d 790 (9th Cir. 1963). *Alderson* specifically rejected applying a "benefits and burdens" judicial test to §1031. The Tax Court in *Bartell* also cited *Biggs*, 632 F. 2d 1171 (5th Cir. 1980), for the proposition that the accommodator that takes title to the Replacement Property does not have to assume the benefits and burdens of ownership in that Replacement Property. The *Bartell* case is also following the theme of the Ninth Circuit's previous decision of *Starker*, 602 F. 2d 1341 (9th Cir. 1979) where the Ninth Circuit held that the "form" of a forward §1031 exchange should govern and that exchanges do not have to be simultaneous.

- There must be an “exchange” of the Relinquished Property for the Replacement Property.

1. **PARTNERSHIPS DOING §1031 TAX-DEFERRED EXCHANGES.**

When a partnership⁵ desires to split up and sell its real estate, the partners may wish to exchange into different real properties, or some partners may wish to receive cash on the sale. Partnership interests cannot be exchanged and qualify for §1031 tax treatment pursuant to §1031(a)(2)(D).

Many times, in order to split up a partnership, the partnership first liquidates and distributes all of that partnership’s Relinquished Property to its partners as tenants-in-common, followed by those former partners immediately selling the Relinquished Property. The selling former partners then exchange into different properties and some partners even receive cash. However, this commonly used “drop-and-swap” technique risks violating a basic requirement of §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.”

In the IRS’s effort to monitor §1031 “drop and swap” transactions the Federal Partnership Tax Return Form 1065 has questions seeking information on whether a partnership has distributed tenancy-in-common interests to its partners.

Although there is no specified length of time under the §1031 statute 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 that property for investment, or trade or business purposes. The

⁵ These partnership tax rules also apply to limited liability companies.

former partners (who receive the Relinquished Property when the partnership is liquidated) want to hold that Relinquished Property long enough to be classified as a valid tenancy-in-common relationship after the partnership's liquidation, and not be classified as a "partnership" for federal income tax purposes.

1.1 **Dissolution and Liquidation of the Partnership, Immediately Followed By a §1031 Exchange of the Property.** The IRS in a published 1977 Revenue Ruling ruled that taxpayers did not "hold" the Relinquished Property for the required qualified use where that property was received by the taxpayer as a liquidating distribution from a legal entity and then immediately exchanged for the Replacement Property.⁶ Contrary to this IRS ruling, the Tax Court in *Mason*⁷ held that exchanges by partners who received the Relinquished Property in a partnership liquidation qualified for tax-free exchange treatment. Similarly, in *Bolker*⁸, 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 first received that property in a corporate liquidation. The Ninth Circuit in *Bolker* held that §1031 only requires taxpayers to own the Relinquished Property that the taxpayers received on liquidation before those taxpayers enter into the exchange and for those taxpayers to have no intent either to sell that Relinquished Property or to use that Relinquished Property for personal purposes.⁹

⁶ See Rev. Rul. 77-337, 1977-2 C.B. 305. In the §1033 area, the IRS has attacked drop and swap type of transactions under a step transaction argument in *Sandoval*, T.C. Memo 2000-189.

⁷ T.C. Memo 1988-273. *Mason* did not specifically address the §1031 "holding" requirement issue.

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

⁹ Taxpayers who desire to split up partnerships must also be aware that the IRS could attack the "drop and swap" transaction or similar split-up transactions under a step-transaction doctrine. In a step-transaction, if the steps are in substance integrated and focused to a particular result, then the tax significance of each of the separate steps is ignored, and instead the tax consequences of the step transaction as a whole is considered. The step transaction was utilized in *Crenshaw*, 450 F.2d 472 (5th Cir. 1971), to find that a transaction did not qualify as a §1031 exchange where the

1.2 **Tax Plan of Doing the “Drop-and-Swap” Transaction, by First Liquidating the Partnership and Then the Former Partners Hold the Received Liquidated Relinquished Property as Tenants-In-Common for a Substantial Time Period, Before Those Tenants-in-Common Do the Exchange.** A safer tax strategy is to have the former partners hold their tenant-in-common interests in the Relinquished Property (after the partnership liquidates) for a substantial time period before the former partners (who are now tenants-in-common) sell and exchange those tenant-in-common interests for the new Replacement Property. Additionally, the former partners’ tenancy-in-common relationship must be structured so as not to be treated as a partnership for tax purposes.¹⁰ Thus, the formalities of a tenancy-in-common relationship need to 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-4 Certificate of Cancellation for liquidating California limited partnerships.¹¹ Leases, property and liability insurance, and service contracts should be transferred to the new tenancy-in-common. Furthermore, the loans encumbering the Relinquished Property and title insurance need to be changed to the new tenancy-in-common.

taxpayer exchanged the property shortly after the taxpayer acquired the property in a partnership distribution.

The IRS may also attack a drop-and-swap §1031 transaction under a “substance-over-form” argument as it successfully did in *Chase*, 92 TC 874 (1989).

¹⁰ The Treasury 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 among the co-tenants which preserves the normal rights of a co-tenancy under state law.

¹¹ For an example on how not to create a valid co-tenancy relationship, see *Chase*, 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.

1.3 **Alternative Tax Plan Would Be For the Partnership to First Have the Partnership Do the §1031 Exchanges Into Multiple New Replacement Properties, Followed By a Later Distribution of These New Replacement Properties to Different Groups of Partners.** An alternative structure is that the partnership first completes the §1031 tax-free exchanges at the partnership level into multiple Replacement Properties; then approximately twelve (12) to twenty-four (24) months later the partnership liquidates and distributes each of the Replacement Properties to a specific group of partners. This alternative tax plan has several tax issues which must be addressed. First, the IRS may argue that the distributed Replacement Properties were not held after the exchange for investment purposes if those Replacement Properties are immediately distributed out of the partnership. Furthermore, if each Replacement Property is instead retained by the partnership, and that Replacement Property's income and distributions are allocated and distributed to only certain partners, then the IRS might assert that there has been an effective (or constructive) liquidation of that partnership (and a resulting violation of the "hold for" rules). Second, since many exchanges utilize the §1031 deferred exchange 45-day identification rules, there will be limits on the number of identified Replacement Properties, which in turn could prevent this alternative tax plan from working.

1.4 **IRS Guidelines On How to Be Classified as a Tenancy-in-Common and Not as a Partnership for Tax Purposes.** In order to liquidate the partnership and have the real estate owned as tenants-in-common, the new tenancy-in-common relationship cannot be classified for tax purposes as a continuing partnership. The IRS in Rev. Proc. 2002-22 lists conditions under which the IRS will consider issuing a revenue ruling that a tenancy-in-common interest (sometimes known as a "TIC") will not be treated as a partnership interest for tax purposes under §7701 (in order to qualify for §1031 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 Properties to complete their §1031 exchanges.

(a) **Consequences of Not Complying With Rev. Proc. 2002-22.** Rev. Proc. 2002-22 states that its conditions are not intended to be substantive rules and are not to be used for audit purposes, and rather are only a list of items to be complied with in order to obtain a favorable IRS revenue ruling. 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, most tax advisors feel that violating certain of Rev. Proc. 2002-22's conditions does not automatically trigger partnership classification. As a practical matter, Rev. Proc. 2002-22 provides guidelines for structuring TICs which are acquired as Replacement Property in like-kind exchanges.

(b) **Rev. Proc. 2002-22's Requirements.** A summary of Rev. Proc. 2002-22's major requirements in order for the IRS to issue a favorable revenue ruling are as follows:

(i) Each TIC owner must hold title to the real property directly or through a single member limited liability company as a tenant-in-common, but not by a separate taxable legal entity.

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

(iii) The co-owners should not hold themselves out as a separate legal entity. Thus, the TIC co-owners should not file a partnership return, conduct business under a

common name, nor hold themselves out as a business entity.

(iv) The TIC co-owners may enter into a tenancy-in-common agreement.

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

(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 co-owner must be able to transfer, partition and encumber their respective TIC interest without the approval of another TIC owner. To enable the tenancy-in-common agreement to comply with lender requirements, the Revenue Procedure states that lender requirements which are consistent with customary commercial lending practices will not be prohibited, such as lender requirements to control the alienation of the TIC interests. Thus, there is an exception that permits a TIC co-owner to waive partition rights where a lender asks for this partition waiver by the TIC co-tenants.

(viii) Each TIC owner must share profits and losses in proportion to their tenancy-in-common percentage interest. The reason for this requirement is that if losses or profits are specially allocated to only certain TIC co-owners, this appears to be more like a partnership than a TIC co-ownership arrangement.

(ix) The TIC co-owners must share any debt secured by a lien on the real property in proportion to the co-owners' TIC interests, and such debt must be recorded against

the property. If the property is sold, any debt encumbering that property must be repaid, and the net sales proceeds must be 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 on the date of exercise, 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). There is no permission in the 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) Any lender on the TIC's property may not be related to any TIC co-owner or the sponsor, manager or lessee of the property.

(xiii) Any payments to a sponsor that sets up the TIC or for the acquisition of the TIC interest and any of the sponsor's other services must be at fair market value and may not depend on the income or profits of the TIC-owned property. Therefore, a sponsor of a TIC interest cannot share in the net profits of the property for its services.

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: (i) the hiring of any manager; (ii) the sale and disposition of the property; (iii) the lease of the property; or (iv) creation of a deed of trust and lien on the property. 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 "implied consent" provision under which each co-tenant is provided notice of a major 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 or 90 days). If none of the co-tenants object to the proposed action, then that action is deemed to have been approved. Some tax professionals feel that this provision of a "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/sponsor of the TIC), and then this master tenant subleases the property to the tenants who are the actual property tenant users. Using 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).

(c) **Importantly, Rev. Proc. 2002-22 By Its Terms Does Not Apply to Liquidating Partnerships.** Having a partnership liquidate and distribute its properties to partners as tenants-in-common (followed by the property's sale) is a 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, clients should note that Rev. Proc. 2002-22 states that the IRS will not issue a favorable ruling when the exchanging tenants-in-common previously held their real estate in 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 a §1031 exchange.

(d) **Why Has the IRS Not Issued Many Revenue Rulings Under Rev. Proc.**

2002-22? Rev. Proc. 2002-22 provides the IRS requirements for obtaining an advance favorable revenue ruling as to whether an arrangement will be classified as a TIC (and not as a partnership). Rev. Proc. 2002-22's requirements are not absolute rules of tax law, and this Revenue Procedure does not create a safe harbor. Because it is difficult to satisfy each and every requirement of Rev. Proc. 2002-22, most sponsors of TIC interests (and other taxpayers) have not obtained a revenue ruling from the IRS.

There have only been a few Private Letter Rulings in the TIC area.¹² As an example 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 TIC interests in the acquired property to no more than 35 persons. The co-tenancy agreement between the TIC co-owners required unanimous TIC owner consents 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 actions, the approval of more than 50% of the undivided TIC owners was required. All of the property's income, expenses and net sales proceeds were allocated among the TIC owners in proportion to their TIC percentage ownership interests. Each TIC owner 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 TIC owners 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 TIC co-owners to object to provisions in the management agreement. The IRS held in Priv. Ltr. Rul. 200513010 that this co-ownership arrangement satisfied all of the conditions set forth in Rev. Proc. 2002-22. The structure satisfied

¹² See for example Priv. Ltr. Rulings 200327003 and 201622008.

the requirement of each TIC owner 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 TIC owner could exercise a right to terminate the management agreement annually. Additionally, the IRS held that this tenancy-in-common arrangement did not become a "business" because the activities of the management company and the TIC owners were only those customarily done in triple-net leasing. Thus, the IRS in Priv. Ltr. Rul. 200513010 held that the TIC ownership did not constitute an interest in a partnership.

(e) **Application of Rev. Proc. 2002-22 to Syndicated TIC's.** TICs offer clients the ability to quickly exchange into a suitable Replacement Property, which fits their cash return and replacement liability amount needs. TICs also allow clients to exchange into properties of a lesser value (since the client is only receiving a fractional tenancy-in-common interest in the property rather than having to exchange into an entire higher-priced property). TICs enable clients to have immediate professional management of their Replacement Property, and allows the clients to disburse their exchange proceeds among multiple Replacement Properties. Clients can compare various TICs, their rates of return and financing arrangements in order to competitively purchase a TIC Replacement Property on the most advantageous terms and for the most advantageous price. Clients who consider purchasing TIC interests, however, must carefully review non-tax issues such as the quality of the underlying property, the property's tenants, the amount of management and sales costs and fees, whether there are any tenant guarantees, and how the client will be able to sell the client's TIC interest at a later date and for how much (the so called "exit strategy"). The TIC syndicator/sponsor under Rev. 2002-22 Proc. cannot have a buy back right.

Syndicated TICs are securities which must comply with federal and state securities laws. Because real estate brokers generally do not have a securities license, TICs are often marketed through the securities industries.¹³

See the discussion, below, at paragraph 1.6 of Delaware statutory trusts which are now commonly used (instead of TIC interests) to syndicate fractional interests in real property for §1031 exchange purposes.

1.5 **Using Disregarded Entities (Such as Single Member LLCs) to Own Tenancy-in-Common Interests.** Persons owning tenancy-in-common interests in the Replacement Property may wish to limit their personal liability (such as for torts, environmental and lender liabilities) by not owning the TIC real estate 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 TIC interests.¹⁴ Owning the TIC real estate interest in a single-member limited liability company is advantageous since the death or bankruptcy of the individual who owns the LLC (which in turn owns the TIC interest) will not affect the other TIC owners. Rev. Proc. 2002-22 specifically states that disregarded entities can hold a TIC interest.

Additionally, many lenders today require that a TIC co-owner own their interest in a single-member LLC (so called "bankruptcy remote" entities), since this will remove the TIC interest from the risk of an individual's creditor problems, bankruptcy or death. If the

¹³ For a good discussion on the advantages of TICs, TIC due diligence items, and the tax and business issues of TICs, see Christine Tour-Sarkissian, *§1031 Exchanges and Tenancy-in-Common Interests*, **Real Property Law Reporter**, Continuing Education of the Bar of California, July 2006.

¹⁴ A single member limited liability company may acquire the Replacement Property. See Priv. Ltr. Rulings 9751012, 9807013, and 9850001. Also, as to the Replacement Property, the client can instead acquire all of the single member LLC membership interests. See Priv. Ltr. Rulings 200807005 and 2001180230. Finally, the Replacement Property can be transferred to a single member LLC right after the taxpayer acquires that Replacement Property in PLR 200131014.

single-member LLC files for bankruptcy under federal bankruptcy laws, it will facilitate an earlier dismissal or relief from an automatic stay. Finally, the single-member LLC is unlikely to have other major creditors outside of the property's lender.

1.6 **Using a Delaware Statutory Trust for the Replacement Property in a §1031 Exchange, Instead of Using TIC Interests.** Delaware statutory trusts are commonly used today to syndicate fractional interests in real property to persons who want Replacement Property in a §1031 exchange.

When a Delaware statutory trust, which is a grantor trust, engages in a §1031 exchange, the trust beneficiaries' interests are treated as ownership interests in the underlying real properties if the requirements of Rev. Rul. 2004-86, 2004-33 IRB 191 are satisfied. Thus, a Delaware statutory trust interest can be used as Replacement Property instead of a TIC ownership arrangement in certain circumstances. Delaware statutory trust interests have grown to become the preferred way to issue syndicated fractional interests in real property (replacing the prior preferred TIC syndications).

Rev. Rul. 2004-86 allows the use of a Delaware statutory trust as a disregarded entity in limited situations. This Revenue Ruling states when a Delaware 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." 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. If a Delaware statutory trust is not treated as a "trust" for tax purposes (and is instead treated as a business entity), then the trust's beneficial interests are treated as either an interest in a partnership or a corporation under §7701, which in turn would not constitute valid

like-kind "Replacement Property" under the §1031 rules.¹⁵ 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, which is similar to exchanging TIC interests.

To qualify under Rev. Rul. 2004-86, the trust beneficiaries cannot be involved in the operation or management of the trust, and the trustee cannot have any of the following powers:

(a) 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).

(b) The trustee cannot enter into new leases.

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

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

(e) The trustee cannot renegotiate any existing debt.

(f) 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).

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

¹⁵ If the beneficial interests in a trust were classified as a partnership, this would violate §1031 rules on prohibiting exchanging real estate into partnership interests or from exchanging partnership interests for other partnership interests.

The purpose of the above restrictions is to have a qualifying Delaware statutory trust, whose interests are to be exchanged tax-free under §1031, engage only in the passive holding of rental real estate.

These seven deadly sins summarized above will make it difficult in many cases to utilize Delaware statutory trusts. For example, under Rev. Rul. 2004-86, it may prove impractical to have the trustee not be able to renegotiate the terms of a lease or a loan. Furthermore, a prohibition on doing structural improvements to the property may not work, since in many cases property improvements are necessary. Rev. Rul. 2044-86 may only prove useful where the term of the loan is identical to the term of the lease and the lease is a triple net lease to only one tenant (and where that tenant has all duties of maintenance and construction of the improvements).

Master leases of the Replacement Property are a commonly used technique when using Delaware statutory trusts. The Master Lease tenant can then sublease portions of the Replacement Property to the ultimate tenant-user.

The Delaware statutory trust structure for owning real estate would work where additional capital is not required (again where there is a triple net lease to a high credit tenant). The Delaware statutory trust may also work where there is a long-term ground lease to a credit tenant or where there is a master lease of a development to another party who then subleases the properties (such as apartments or offices to the ultimate end users).

2. CASHING OUT PARTNERS WHERE THE PARTNERSHIP ENGAGES IN A §1031 TAX-DEFERRED EXCHANGE.

Commonly, real estate partnerships desire to split up with certain partners receiving cash (referred to as the "cash-out partners"), and then 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-deferred exchange treatment. However, distributing cash to only the cash-out partners may result in all of the partners (including the remaining partners who desire to receive §1031 exchange treatment) being taxed on the property's sale's recognized gain in proportion to the partners' percentage interests.

2.1 Tax Plan of Attempting to Do a Special Allocation of the Partnership's Gain to Only the Cash-Out Partners. Partners may consider amending their the partnership agreement to specially allocate all of the gain (for tax purposes) on the Relinquished 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 the §704(b) 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.¹⁶ For example, gain allocated to the cash-out partners increases the cash-out partners' capital accounts

¹⁶ For a further discussion, see **Real Property Exchanges**, 3rd Ed., California Continuing Education of the Bar, pp. 455-458. Also, see the substantiality rules of Reg. §§1.704-1(b)(2)(iii).

which in turn could cause those cash-out partners to be entitled to too much cash on the partnership's liquidation.

In the unpublished California State Board of Equalization decision of *Ahlers*, there was a special allocation of cash and the gain on a sale of a real property to only certain partners, while the partnership engaged in a §1031 tax-free exchange with the remaining cash proceeds. The California State Board of Equalization held that such "special allocation" of guaranteed cash payments to only the cash-out partners did not have substantial economic effect under the §704 rules and the Treasury Regulations promulgated thereunder. Instead, the California State Board of Equalization held that the partnership's income and gain must be allocated among all of the partners in proportion to the partners' percentage interests in the partnership.¹⁷ Thus, in *Ahlers* those partners who expected to receive tax-deferred exchange treatment were instead taxed on a portion of the sale's proceeds.

2.2 Tax Plan of Redeeming the Cash-Out Partners for Cash Before the Exchange, or After the Exchange, or Having Other Partners Purchase the Cash-Out Partners' Interests. An alternative tax structure is that prior to the Relinquished Property's sale, the partnership fully redeems the cash-out partners' partnership interests using existing partnership cash reserves. The partnership could then proceed to exchange the Relinquished Property for the Replacement Property in a qualifying tax-deferred exchange. Alternatively, the partnership could redeem the cash-out partners after the exchange is completed. Another alternative tax plan is for the other partners to purchase for cash before (or after) the exchange the cash-out partners' partnership interests. In all of these alternatives care must be taken to avoid having a step

¹⁷ *Appeal of Herman A. Ahlers and Donna M. Ahlers*, Cal. State Board of Equalization decision No. 257952 (Dec. 13, 2005).

transaction. Also the disguised sales rules of §707(a)(2) must be avoided where a partnership redemption is re-characterized. Finally, the partnership wants to avoid having a §708 technical partnership termination.

2.3 **Tax Plan of Having the Cash-Out Partners Receive a Promissory Note in the Sale of the Relinquished Property.** Another alternative tax structure is for the partnership to sell the Relinquished Property for both 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.¹⁸ Thus, only those partners who receive a distribution of the promissory note will have to recognize gain. The promissory note can be issued by the buyer or by the qualified intermediary as the maker (however, if the promissory note is issued by the qualified intermediary, then the partnership will have to replace the entire sales price and equity of the Relinquished Property to receive full §1031 tax treatment).

Those partners desiring to receive tax-deferred exchange treatment then continue as partners in the partnership and have the partnership use their share of the Relinquished Property's sales proceeds to engage in a §1031 tax-deferred exchange.

In a typical transaction, substantially all of the promissory note is paid to the cash-out partner shortly after the close of the Relinquished Property's sale, with the remaining payments (sometimes five percent or less of the promissory note's principal amount) made

¹⁸ If an installment promissory note is received in a §1031 exchange, then any promissory note gain recognized is deferred under the §453 installment method of reporting until the note payment is received by the payee. The distribution of the promissory note 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 partnership distribution does not result in gain under §453B. The distributee partner takes a substituted basis in the promissory note.

immediately after the beginning of the immediately next tax year, in order to qualify for installment sale treatment under §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.¹⁹ 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 received by the partnership on the sale of a capital or §1231 asset, and the distribution of that promissory note by the partnership to the cash-out partner, would not be subject to §751(a), except perhaps to the extent that the gain on a §1231 asset is treated as ordinary income.

A concern with using this installment promissory note tax planning strategy is that if the buyer of the Relinquished Property has a weak credit rating, there may be a hesitancy by the cash-out partners to accept the buyer's promissory note. However, one way to overcome a poor credit-rated buyer is to have that buyer post a standby letter of credit as further collateral. A standby letter of credit as security is not treated as a payment to the promissory note holder under Temp. Reg. 15A.453-1(b)(3)(i).

2.4 Alternative Tax Plan 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 as follows: First, the partnership distributes 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. Second, the cash-out partners and the partnership (which have become TIC owners of the Relinquished

¹⁹ See §§453 and 731. Need to avoid having a step transaction on the partnership's distribution of the promissory note to the cash-out partners.

Property) then engage in a sale of the Relinquished Property. In the sale of the Relinquished Property, 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 §1031 tax-deferred exchange.

The above tenancy-in-common relationship must be structured so as not to be treated as a continuation of the former partnership for income tax purposes (see discussion of preserving tenancy-in-common tax status, above). Also, the step-transaction doctrine needs to avoid being applied to the transaction. See discussion at paragraphs 1.1 and 1.2, above. The §1031 requirement that the tenants-in-common hold the Relinquished Property for use in a trade or business or for investment should not be an issue since the partnership, which always owned and held the Relinquished Property, will be doing the §1031 exchange.

2.5 **Alternative Tax Plan of Using the Partnership Division Rules.** The partnership could divide tax-free under the partnership division rules of §708. Utilizing §708 allows the partners to potentially do §1031 exchanges into different properties or even for one group of partners to receive cash while other partners engage in a §1031 exchange.

Under this partnership division tax plan the original partnership divides into two (2) partnerships. The original partners of the original partnership must own more than fifty percent (50%) of the capital and profits of each new partnership in order for the two new "resulting" partnerships to be classified as a "continuation" of the original partnership.²⁰ More than one partnership may be a continuation of the original partnership.²¹ Assuming that each new

²⁰ See §708(b)(2)(B) and Reg. §1.708-1(d)(1).

²¹ See Reg. §1.708-1(d)(2).

partnership is a continuation of the original partnership, then each continuing partnership is a continuation of all of the original partnership's tax elections.

Utilizing the tax-free partnership division rules has been approved by the IRS where the partnership's property has been condemned under the §1033 condemnation rules and the original partnership has received condemnation proceeds.²² In two Private Letter Rulings the IRS approved of each new partnership (which was a continuation of the original partnership) to being able to reinvest condemnation proceeds under §1033. Thus, in effectuating this plan of dividing the partnership into two partnerships, the original partners would have to own fifty-one percent (51%) of both continuing partnerships.²³ There remains some uncertainty in the §1031 area since there are no IRS pronouncements in using the partnership division rules with §1031.

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

Sellers of Relinquished Property in a tax-deferred exchange may attempt to pool their Relinquished Property's equity with other persons by: first, receiving their Replacement Property in a complete tax-deferred exchange; and second, then contributing that Replacement Property (or a tenancy-in-common fractional interest in that Replacement Property) to a partnership with other persons. Additionally, sellers may want to reinvest their exchange proceeds from the sale of a Relinquished Property into a Replacement Property which is owned in partnership form.

²² See Priv. Ltr. Rulings 8244124 and 200921009.

²³ Note in the corporate reorganization area, a corporation that is a successor under §381 can acquire the Replacement Property to complete a §1031 exchange. See Priv. Ltr. Rulings 9850001 and 200151017. Thus, §1031 exchanges are effectively considered items which are carried-over tax attributes for corporate reorganizations under §381(c), even though only §1033 (and not §1031) is listed as a carry-over tax attribute under §381(c)(13).

Contributing Replacement Property to a partnership immediately following an exchange risks violating the “holding” requirement of §1031 discussed above.²⁴ In other words, the Replacement Property was not “held” for productive use in a trade or business or for investment purposes. Instead, that Replacement Property was immediately disposed of by the fact that the Replacement Property was immediately contributed to a partnership.

Additionally, taxpayers cannot purchase a partnership interest as Replacement Property under §1031(a)(2)(D).

3.1 **Solution of Asserting that the “Holding” of Replacement Property is Attributed to the Original Exchanging Party.** Clients who contribute the Replacement Property (or an interest therein) to a partnership immediately after an exchange could rely upon the Ninth Circuit Court of Appeals *Magneson*²⁵ decision to attribute the partnership’s holding of the Replacement Property to the contributing partner. 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 “hold 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 §1031(a)(2)(D), the IRS and the Franchise Tax Board might today

²⁴ 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.

²⁵ 753 F.2d 1490 (9th Cir. 1985). The Ninth Circuit’s *Magneson* holding was based upon the fact that the Replacement Property was being contributed to the partnership in exchange 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 today would prohibit an exchange of partnership interests from qualifying under §1031), and, furthermore, that *Magneson* was based upon certain old California partnership statutes, which have been amended since the *Magneson* case exchange transaction.

argue that based upon a step transaction, a “swap and drop” transaction is in substance a taxpayer’s acquisition of a partnership interest as Replacement Property which violates §1031’s requirements. In other words, the IRS might argue today that in a *Magneson* type transaction the taxpayer is effectively receiving back a partnership interest in exchange for real estate, which does not satisfy §1031’s like-kind property requirement.

The taxpayer, in the published 2015 California State Board of Equalization decision of *Rago Development Corporation*,²⁶ prevailed where that taxpayer first engaged in a like-kind exchange under §1031, followed by that taxpayer transferring the Replacement Property to a limited liability company seven (7) months after the completion of the exchange. The lender required that the taxpayer transfer their Replacement Property to a limited liability company. The California State Board of Equalization in *Rago* held that the taxpayer “held” for §1031 purposes the Replacement Property for investment, first as tenants-in-common and then, second, after the Replacement Property’s transfer, to the transferee (the transferee was the taxpayer’s limited liability company). Thus, the Replacement Property was found to have been held for investment purposes and the Replacement Property’s later contribution by the taxpayer to the newly created limited liability company only altered the form of ownership, but it did not alter the objective to have held that Replacement Property for investment.

²⁶ California State Board of Equalization published decision 2015-SBE-001.

The California State Board of Equalization prior to its *Rago* published decision issued several non-citable and non-published decisions in the like-kind exchange area where the State Board of Equalization applied a step-transaction doctrine to deny tax-deferred exchange treatment for a swap-and-drop transaction in *Appeal of Frank and Mary Lou Aries*, SBE Appeal No. 464475; and in *Appeal of Gerald J. and Carol L. Marcil*, SBE Appeal No. 458832. In these two unpublished decisions the California State Board of Equalization found that a different taxpayer acquired the Replacement Property than had sold the Relinquished Property. *Aries* and *Marcil* are unpublished decisions decided before *Rago*, and thus these two earlier decisions not only do not have precedential value, but the California Franchise Tax Board will have difficulty in trying to follow their reasoning in light of the new 2015 published *Rago* decision.

The *Rago* decision will be helpful for California taxpayers who engage in swap and drop transactions and where a substantial time period passes between the exchange and the Replacement Property's later contribution to the partnership or LLC (in *Rago* it was seven months before the property was contributed to the LLC). *Rago's* denial of the application of the step transaction doctrine should also assist taxpayers doing drop and swap transactions, where the liquidation of the partnership occurs many months prior to the exchange and there is no evidence of a preplanned sale and exchange at the time of the partnership's liquidation.

3.2 An Alternative Tax Plan is for the Exchanging Party to Hold the Replacement Property as a Tenant-in-Common For a Period of Time After Completing the Exchange.

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 that Replacement Property to the partnership. In order to avoid the IRS claim that the exchange and the later partnership contribution should be tied together as a step-transaction for tax purposes, the exchanging party should not have an agreement to later contribute that Replacement Property to the partnership.²⁷ Additionally, the tenancy-in-common relationship between the exchanging party and the partnership must be structured so as not to be classified as a partnership for income tax purposes (see the discussion at paragraph 1.4, above).

3.3 An Alternative Tax Plan is to keep the Original Partnership Intact and then Have New Investors Invest into this Original Partnership.

Assume that the partners of the original partnership desire to sell their real property, and to use a §1031 exchange in order to

²⁷ 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.

exchange into a new Replacement Property. However, assume that the Replacement Property that the exchanging taxpayer desires to exchange into requires substantial new additional capital by new investors.

The alternative planning structure of the new investors purchasing a tenancy-in-common interest in the new Replacement Property (and also for the original partnership to purchase a tenancy-in-common interest in this same Replacement Property) may not work from a business standpoint. Many real estate deals are structured with some type of waterfall distribution formula where the new investors receive a preferred return on their capital, or the original partners (and original partnership) receive a substantial opportunity award fee. Having preferred returns or opportunity fees would make the tenancy-in-common structure appear more as a partnership arrangement for tax purposes (rather than as a tenancy-in-common), which would in turn deny §1031 tax-free exchange treatment.

An alternative tax structure for acquiring the Replacement Property is to have the new investors contribute new capital to the old original partnership. This alternative tax structure is described in the example, below.

Example of New Investors Investing in the Old Original Partnership:

Assume that the original partnership owns property that has a \$1 million income tax basis and a fair market value of \$10 million, or \$9 million of potential gain on a sale. This original partnership desires to sell its Relinquished Property and to acquire and exchange into a new Replacement Property with a fair market value of \$30 million, of which an additional \$10 million will be borrowed, requiring new capital of an additional \$10 million (this example ignores selling and closing costs).

This new additional capital will be contributed by the New Investors contributing \$10 million of cash to the original partnership after the partnership's sale of the Relinquished Property. The original partnership is kept intact and does not terminate under §708. The New Investors contribute \$10 million to the original partnership in exchange for a 50% partnership interest in the original partnership.

The original partnership then acquires the Replacement Property.

The original partners receive a §704(c) allocation (so that the original partners are allocated the \$9 million of built-in gain in the new Replacement Property due to their §1031 exchange into this Replacement Property).

4. **USING §1031 TO EXCHANGE INTO REPLACEMENT PROPERTY TO BE CONSTRUED IN THE FUTURE.**

Clients may desire to sell their Relinquished Property and then exchange into the Replacement Property when improvements are constructed on that Replacement Property at a later date. However, contracts to construct improvements are ***not*** like-kind to real property for §1031 tax-free exchange treatment.²⁸ Thus, the client cannot use §1031 to exchange into a construction contract to construct the Replacement Property in the future. Instead, the client in order to do a construction exchange should first have an independent third party construct the improvements on the Replacement Property that the client intends to exchange into, followed by the client later exchanging into that newly constructed Replacement Property.

4.1 **Improvements Can Be Constructed By a Third Party During the Deferred Exchange Time Period.** In a deferred exchange, a client may acquire from a third party Replacement Property to be improved by that third party during the 180-day deferral period (or due date of the client's return, if sooner). Under Reg. §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 taxpayer within the 45-day identification period, if: (i) the improved Replacement Property would have been considered substantially the same property as identified by the taxpayer, had it been completed when received by the taxpayer;

²⁸ See, for example, *Bloomington Coca-Cola Bottling Co.*, 189 F2d 14 (7th Cir. 1951).

and (ii) when the Replacement Property is received, the partially completed improvements constitute real property under applicable state law.

4.2 **The Solution to Qualify as a §1031 Exchange for Improvements to Be Constructed in the Future on the Replacement Property is For the Client to Do a 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 first constructed on that Replacement Property by an independent party (sometimes known as an "accommodator"), and then, second, at a later date sell their Relinquished Property and exchange into that Replacement Property (which Replacement Property will then also include the newly constructed improvements). Thus, the client "receives" the Replacement Property before that client sells the Relinquished Property (a "reverse" of a normal forward exchange).

For example, the seller may do a "reverse tax-free exchange" by first having the Replacement Property land acquired by an independent accommodator and then have that independent accommodator construct the improvements upon the Replacement Property land. When the improvements are constructed and become part of the Replacement Property, the Replacement Property (including the newly constructed improvements) is then secondly exchanged for the client's Relinquished Property.

For construction exchanges, there are generally two ways to do a reverse exchange: the first way is to qualify under the "safe harbor" provisions of Rev. Proc. 2000-37; and the second way is to do a "non-safe harbor" reverse exchange which does not qualify under Rev. Proc. 2000-37. Fortunately, the Tax Court recently in the published *Bartell*²⁹ decision allowed §1031

²⁹ See *Bartell* discussed at footnote 3, *supra*.

tax deferral treatment in a non-safe harbor reverse exchange. In *Bartell* the taxpayer had the accommodator first acquire the land on which the building improvements were constructed, the accommodator then completed construction of the building on such land, followed by the taxpayer's exchange into the completed building.

4.3 **Doing a "Safe Harbor" Reverse Exchange Under Rev. Proc. 2000-37.** A safe harbor reverse exchange is a "parking arrangement" whereby the Replacement Property is first acquired or "parked" with a third party, who is referred to in Rev. Proc. 2000-37³⁰ as an "exchange accommodation titleholder" or an "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 all of the requirements of Rev. Proc. 2000-37, the IRS will not challenge the EAT's ownership of the parked Replacement Property or challenge the EAT as being an agent of the taxpayer.

In Rev. Proc. 2004-51,³¹ the IRS stated that Rev. Proc. 2000-37 does not apply to Replacement Property held in a qualified EAT if that Replacement Property had been owned by the taxpayer within the 180-day period ending on the date of the transfer of that Replacement Property to the EAT.

Rev. Proc. 2004-51 applies to a taxpayer leasing land to the EAT, but Rev. Proc. 2004-51 does not specifically apply to a taxpayer's affiliate leasing land to the EAT. Rev. Proc. 2004-51 follows the theme of the Tax Court's *DeCleene*³² decision. In *DeCleene* the taxpayer

³⁰ 2000-40 I.R.B. 308. The Revenue Procedure allows several alternative safe harbor parking arrangements using a third-party "exchange accommodation titleholder".

³¹ Rev. Proc. 2004-51, IRB 2004-33, 294, indicates the IRS continues to study parking transactions in the §1031 area.

³² *Donald DeCleene*, 115 T.C. 457 (2000). IRS's position has been that the Relinquished Property cannot be exchanged for new improvements to be built on land already owned by the taxpayer. Also if the land is owned by the

was denied tax-free exchange treatment when that taxpayer transferred the taxpayer's owned land to a third party who then was required to construct the improvements on that land and transfer that land along with the newly constructed improvements back to the taxpayer. Note that in the *Bartell* case the Tax Court specifically allowed the accommodator's leasing of the Replacement Property (the land and completed improvements) back to the taxpayer (for the taxpayer's use) until the §1031 reverse tax-deferred exchange could be completed by the sale of the Relinquished Property.

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. Alternatively, if the improvements are to be built on land already owned by the taxpayer the taxpayer could arguably ground lease that land to the EAT during the construction period followed by a later transfer of the improvements and leasehold back to the taxpayer to complete the §1031 exchange.³³

If the requirements of Rev. Proc. 2000-37 are satisfied, then the EAT is permitted to borrow money from the exchanging party, the exchanging party is permitted to guaranty the EAT's construction loans, and the EAT may enter into an accommodation agreement with the taxpayer allowing the taxpayer to have loans, leases and indemnification agreements with the EAT that effectively makes the EAT the taxpayer's agent. However, if all the requirements of 2000-37 are not satisfied (and only a portion of those requirements are satisfied), then the taxpayer, if it uses

taxpayer's affiliates then the related party rules of §1031(f)(4) could apply to deny the taxpayer §1031 treatment.

³³ Note that using such a ground lease tax plan is still uncertain as to its tax results where the taxpayer already owns the land. However, the IRS has issued favorable Private Letter Rulings where the taxpayer's affiliate first leased the land to the EAT in Priv. Ltr. Ruls. 200329021 and 201408019.

Rev. Proc. 2000-37, can unwittingly create an agency relationship with the EAT, thereby denying the taxpayer §1031 treatment under Rev. Proc. 2000-37.

One of the difficult requirements of Rev. Proc. 2000-37 (which many clients fail to satisfy) is the requirement that the exchanging client receive the Replacement Property within 180 days of the EAT acquiring title to that Replacement Property. Under this 180 day rule the taxpayer must acquire the land and partially (or fully) completed improvements on the land from the EAT within 180 days. This 180 day rule even applies where the taxpayer's affiliate leases the land to the EAT. Because of potential construction delays, the EAT likely may take longer than 180 days to construct the improvements (or even construct part of the improvements).³⁴ Accordingly, clients who cannot satisfy this 180-day time requirement but still utilize the other provisions of Rev. Proc. 2000-37 may walk into a trap by creating an agency relationship with their EAT, which will in turn cause that client to not satisfy the §1031 exchange requirement. Therefore, if the client/seller desires to exchange into improvements which will be constructed over a period longer than 180 days, that client/seller should instead choose to do a non-safe harbor construction exchange and not use Rev. Proc. 2000-37.³⁵

4.4 **Solution of Doing a Reverse Exchange Outside of the Requirements of Rev. Proc. 2000-37 (the So-Called “Non-Safe Harbor Construction Exchange”)**. If all of the safe harbor requirements of Rev. Proc. 2000-37 cannot be satisfied, then the construction exchange can

³⁴ 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.

³⁵ Rev. Proc. 200-37 specifically states that no inference is intended by that Revenue Procedure as to parking arrangements which are similar to, but are outside of, the scope of that Revenue Procedure's requirements.

still be structured to qualify under §1031 based upon case law.³⁶ The recent taxpayer victory in the *Bartell* case permits clients to do non-safe harbor construction exchanges.

In a typical non-safe harbor transaction, an independent accommodator³⁷ 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 taxpayer or the taxpayer's lender. In many cases, the taxpayer has a future option to acquire the Replacement Property after the improvements are constructed in order to complete the exchange. When the taxpayer is prepared to sell the Relinquished Property to the third party buyer, the taxpayer then closes the exchange by using a separate qualified intermediary to transfer the Relinquished Property to the third party buyer and acquire the Replacement Property from the accommodator.³⁸

(a) **Prior to the *Bartell* Decision, in a Non-Safe Harbor Exchange the Case**

Law Focused on a Test that the Accommodator Not Be Classified as the Taxpayer's Agent.

In *J. H. Baird Publishing Co.*³⁹, an accommodator who acquired the Replacement Property and then constructed the improvements on that Replacement Property on behalf of the exchanging

³⁶ 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.

³⁷ 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, then there could not be an "exchange" for §1031 purposes. Also, see *Boise Cascade Corp.*, TC Memo 1974-315, and *Coastal Terminals Inc.*, 320 F2d 333 (4th Cir. 1963) for cases where the Relinquished Property's buyer acquired the Replacement Property and constructed the improvements on the Replacement Property.

³⁸ 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 that agreement, acquires the Relinquished Property from the taxpayer, transfers the Relinquished Property and acquires like-kind Replacement Property, and finally transfers the Replacement Property to the taxpayer. The qualified intermediary cannot be the taxpayer or the taxpayer's agent, nor be related to the taxpayer or to the taxpayer agent. See Regs. §1.1031(k)-1(g)(4)(iii).

³⁹ See footnote 37, above.

party was held not to be the taxpayer's agent. Similarly, in *Fredericks*⁴⁰, 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.

Before *Bartell* the IRS in Priv. Ltr. Rul. 200111025 emphasized the IRS's position that in order for a reverse exchange to qualify under §1031, the accommodator must not be the taxpayer's agent. To determine whether the accommodator is the taxpayer's agent, the IRS in Priv. Ltr. Rul. 200111025 indicated that the test of *National Carbide Corp.*⁴¹ should be applied, which is: (i) whether the accommodator is operating in the name of the taxpayer; (ii) whether the accommodator can bind the taxpayer by the accommodator's actions; (iii) whether the accommodator transmits money received by the accommodator to the taxpayer; (iv) whether the receipt of income is attributable to services of employees of the accommodator and to assets belonging to the accommodator; and (v) whether the business purpose of the relationship is the carrying on of an agent's normal duties.

Note the recent Tax Court *Bartell* decision did not use this agency test when approving of the reverse construction exchange.

(b) **Have the Accommodator Directly Acquire Title to the Replacement Property in a Non-Safe Harbor Exchange.** *DeCleene* instructs taxpayers who do non-safe harbor construction exchanges to not take title to the Replacement Property land (on which the improvements are to be constructed), but instead to use an accommodator to first take title to the

⁴⁰ See footnote 36, above.

⁴¹ 336 U.S. 422 (1949)

Replacement Property land, and then have the accommodator construct the improvements on that Replacement Property. See the discussion on using an affiliate of the taxpayer to ground lease the land to the accommodator in a safe-harbor reverse exchange at footnote 33, above. The Tax Court in *Bartell*, at footnote 17 of that decision, pointed out that in *Bartell's* facts the accommodator first purchased the Replacement Property on which the improvements were then constructed.

(c) **Evidence an Intent to Achieve a Qualified §1031 Tax-Free Exchange, and That There is an Integrated Plan to Exchange the Relinquished Property for the Replacement Property.** In Priv. Ltr. Rul. 200111025 the IRS indicated that the general requirements for a §1031 exchange to be realized in a parking arrangement is that: (i) the exchanging party demonstrates an intention to achieve a §1031 exchange; (ii) the steps in the various transfers of property are part of an integrated plan to exchange the Relinquished Property for the Replacement Property; and (iii) the accommodator is not the agent of the exchanging party (see the discussion above on agency).

(d) **Benefits and Burdens of Ownership Test Does Not Apply to a Non-Safe Harbor Reverse Exchange.** The *Bartell* case makes it clear that a "benefits and burdens" test no longer applies to reverse exchanges. Instead the "form" of the transaction governs.

Under a "burdens and benefits" test some risk of loss and some profit potential arguably would be vested in the accommodator so that the accommodator, and not the exchanging taxpayer, will be recognized as the Replacement Property's owner for tax purposes until the exchange is completed. However, the *Bartell* case rejected such a "benefits and burdens" test, and the Tax Court pointed out that the taxpayer in acquiring the Replacement

Property with its newly constructed improvements was obligated only to pay for the cost of the property and those new improvements. Thus, where the facts show that a §1031 exchange was contemplated, a third-party accommodator is utilized (and not the taxpayer) to take title to the Replacement Property land before the exchange for the purpose of doing a later exchange, then the accommodator does not have to assume the benefits and burdens of ownership of the Replacement Property. Furthermore, the *Bartell* decision even allows the taxpayer to guaranty the construction loan used to construct the new improvements on the Replacement Property.

The California State Board of Equalization prior to the *Bartell* decision had held that a benefits and burdens test should apply to non-safe harbor reverse exchanges.⁴² The FTB is likely now to follow the *Bartell* case and not apply a benefits and burdens test to reverse exchanges

(e) **Future of Reverse Exchanges.** The *Bartell* case makes it clear that reverse tax-free exchanges can be done under §1031 as long as the form of §1031 is followed. Specifically, upon the sale of the Relinquished Property the deferred exchange rules (of acquiring the improvements and the Replacement Property) will continue to apply. Furthermore, as long as the taxpayer has not yet sold the Relinquished Property, the taxpayer should have adequate time, based upon *Bartell*, to construct the taxpayer's improvements on the Replacement Property.

Based upon *Bartell*, the IRS in the future may issue future guidance in the reverse §1031 exchange area.

⁴² *Patricia Bragg*, nonpublished SBE Decision issued November, 2012. The IRS also prior to *Bartell* took the position that a benefits and burdens test should apply with reverse §1031 exchanges in *Field Advice Memorandum FAA 20050203*.

5. **HOW TO EXCHANGE PROPERTY WHICH INCLUDES BOTH REAL ESTATE AND PERSONAL PROPERTY.**

A basic §1031 exchange requirement is that the Relinquished Property sold and the Replacement Property received must be ðlike-kindö to each other. Generally, real estate is classified as like-kind to other interests in real estate. The Regulations state that the words ðlike-kindö, in the case of real estate, refers to the ðnature or character of the property and not to its grade or qualityö.⁴³

In the case of real estate, land can be exchanged for improved real estate. A 30-year or more Lessorö leasehold can be exchanged for a fee interest in real estate.⁴⁴ Also a tenantö leasehold interest in a lease which has less than 30 years remaining can be exchanged for a tenant leasehold estate of less than 30 years in another lease.⁴⁵

5.1 **Real Estate Cannot Be Exchanged For Personal Property.** If the Relinquished Property consists of personal property, then the Replacement Property must also consist of similar like-kind personal property or, alternatively, ðlike-classö personal property to the Relinquished Propertyö tangible personal property.⁴⁶ Depreciable tangible personal properties are of a like-class if they are within the same ðGeneral Asset Classö or ðProduct Classö.

⁴³ Treas. Regs. §1.1031(a)-1(b). Note however, that domestic real estate cannot be exchanged for foreign real estate under §1031(h).

⁴⁴ 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.

⁴⁵ See Rev. Rul. 76-301, 1976-2 CB 241.

⁴⁶ See Treas. Regs. §1.1031(a)-2(b)(1). When exchanging multiple classes of personal property, in order to analyze the amount of gain under §1031 the taxpayer must separate the different types of personal properties into exchange groups by like kind or like class. See Treas. Reg. §1.1031(j). Product classes are based on the North American Industry Classification System (“NAICS”) under Regs. §1.1031(a)-2(b)(3).

Real estate is not like-kind to personal property. Unfortunately, some taxpayers 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 previously been performed on the real property.⁴⁷

Personal property can also be created with farm crops. Crops remain as real property when not harvested. However, when those crops are harvested (and severed from the land) they become personal property. Similarly, if oil interests are severed from the real property and become a royalty stream, then the oil interests can become personal property.

5.2 **A Common Taxpayer Mistake is Failing to Understand that the Incidental Property Exception Only Applies to the Deferred Exchange Identification Rules, and Does Not Apply to Determine If the Relinquished and Replacement Properties Are in Fact “Like-Kind” to One Another.** Exchanging parties sometimes mistakenly believe that the “incidental property exception,” under Reg. §1.1031(k)-1(c)(5)(i), 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 §1031.⁴⁸ However, this “incidental property exception” only applies to determine whether 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 the same like-kind personal

⁴⁷ Land improvements classified in cost segregation studies still remain §1250 real property for §1031 purposes. Land improvements, which can be depreciated over 15 years (using the 150% declining balance method) are, for example, parking lots, sidewalks, outside lighting, patio areas and outside underground utilities.

⁴⁸ 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.

property must also be received in the exchange (as part of the Replacement Property) in order to satisfy §1031's like-kind property requirements.

5.3 What Happens When Personal Property Comprises Part of the Building.

Personal property is present where parts of buildings are reclassified in cost segregation studies as personal property. Reclassification of property by cost segregation studies allows sophisticated building owners to reduce their income taxes by accelerating depreciation and amortization deductions and avoiding the 39-year straight-line recovery period for commercial real property or the 27½ year straight line period for residential real property.⁴⁹ Reclassified personal property can be amortized and depreciated over shorter time periods (usually five or seven years) using the double declining method.⁵⁰ 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 five-year recovery period.

In order to reclassify parts of buildings as personal property, real estate owners and their accountants commonly perform cost segregation studies.⁵¹ These cost segregation studies are based upon the tax rules outlined in *Hospital Corp. of America*.⁵² The reclassified personal property is then depreciated over a shorter recovery life than the real property.⁵³ Specialized

⁴⁹ 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 Reg. §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".

⁵⁰ See §168(c).

⁵¹ 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.*, 65 T.C. 664 (1975), *acq.* 1980-1 C.B. 1.

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

⁵³ Even real estate owners who in the past may have failed to segregate out "personal property" to receive these

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.⁵⁴ Also, office cabinetry, carpeting, special lighting fixtures,⁵⁵ gasoline pump canopies⁵⁶ and retail signs⁵⁷ 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 §197.

5.4 **Recapture Rules of §§1245 and 1250 Can Also Trigger Gain on an Exchange.**

In addition to satisfying the §1031 "like-kind" property rules, in order for the gain on exchanged §1245 property to be deferred, the provisions of §1245(b)(4) must be complied with. Section 1245(b)(4) states that when §1245 property is exchanged, the property's §1245 recapture will not be recognized only to the extent like-kind §1245 property is received as Replacement Property having a fair market value equal or greater than the amount which would otherwise be recaptured on a taxable disposition of the §1245 property. Thus, when real estate with §1245 property (created by cost segregation studies or otherwise) is exchanged, then §1245 property must be part of the Replacement Property to avoid gain recognition under §1245(b)(4).

Similarly, §1250(d)(4) recaptures excess depreciation deductions over straight-line deductions when improved real property is exchanged. For example, this issue can arise when

increased depreciation deductions can still do so on their current federal income tax returns.

⁵⁴ See *Hospital Corp. of America*, *supra*, note 36; and *Piggly Wiggly Southern, Inc.*, 803 F.2d 1572 (11th Cir. 1986).

⁵⁵ See *Shoney's South, Inc.*, T.C. Memo 1984-413.

⁵⁶ 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.

⁵⁷ See *Southland Corp.*, 611 F.2d 348 (Ct. Cl. 1979).

land improvements are depreciated over 15 years at a 150% declining balance method. Generally, if improved real estate is exchanged for other improved real estate, §1250(d)(4) will not be an issue since the Replacement Property improvements should protect recognizing gain under §1250(d)(4).

5.5 **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, like-kind or like-class personal 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.⁵⁸

One tax strategy used by some exchanging parties to avoid recognizing gain when only the Relinquished Property (or the Replacement Property) contains personal property is to evidence that the other property's personal property has no value and thus is not part of the exchange. Clients might consider obtaining an appraisal to evidence that the personal property has no value. Clients might also include a provision in the Relinquished Property's purchase and sale agreement which states that the entire Relinquished Property's sales price is "allocated solely to" the real estate and that any personal property that might be included in the sale has nominal or no value. However, a Relinquished Property's buyer may refuse to include such a provision, and instead may prefer that a high value be allocated to the purchased personal property in order to

⁵⁸ 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'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.

increase the purchased personal property's income tax basis (which would in turn increase that Relinquished Property's buyer's depreciation deductions).

Another tax strategy for exchanging into like-kind property which might contain personal property is to argue that the reclassified personal property remains "real property" for purposes of the §1031 like-kind exchange rules based upon the definition of real property under state law.⁵⁹ Even though federal law controls to determine if property in a §1031 exchange is real or personal, state law is still relevant in that determination. The exchanging parties can assert that reclassified "personal property" from a cost segregation study should still be "real estate" for purposes of the §1031 like-kind exchange rules based upon the argument that it is only the special federal statutory tax rules under §§167 and 168, that allow parts of buildings to be classified as personal property for cost segregation purposes. Arguably, for §1031 purposes, state law⁶⁰ should be used to help determine if the property is personal or real and that California law

⁵⁹ State law is not determinative of whether property is personal property or real property for purposes of the like-kind exchange tax rules of §1031, although state law is relevant in this determination. Instead federal law controls and looks at all of the facts and circumstances. For example, in the area of natural gas lines that go through several states, the IRS chose to ignore conflicting state laws (as to whether those natural gas lines were real or personal property) and instead found the pipelines to be real property for purposes of §1031. See CCA 201238027.

⁶⁰ See, for example, Priv. Ltr. Rul. 8443054.

The Tax Court relied upon state law to determine whether supply contracts were treated as real estate for §1031 purposes in *Peabody Natural Resources Company*, 126 T.C. No. 14 (2006). In *Peabody* even though the Court found that the supply contracts were real property, the Court said for §1031 purposes the nature and character of the transferred contract rights must also be substantially alike to qualify as like-kind property. The Tax Court held that the supply contracts (which in *Peabody* were the right to extract coal from a mine) were derived from the ownership of the real property (the mine), and thus the supply contracts (being intricately attached to the real property) were like-kind to other fee interests in other real property. In other words, the supply contracts were an integral part of the taxpayer's ownership rights in the real property (the mine) and such supply contracts were inseparable from the fee ownership.

In PLR 200631012 the issue was whether a taxpayer who sold stock in a New York residential cooperative (which was being held for investment) could exchange the sales proceeds tax-free into real property. The IRS stated the determination of whether the stock in the cooperative was real or personal property is made under New York state law. New York law holds that stock in a cooperative is equivalent to an interest in real property. As such, the taxpayer could exchange tax-free under §1031 from stock in a New York residential cooperative into Replacement Property which was real estate.

In PLR 200805012 the IRS ruled that if development rights are real property for state law purposes then, such development rights are like kind to a fee interest in real estate.

classifies items (including prior personal property) which are permanently affixed to the building as "real property."⁶¹

Remember, however, that the §§1245(b)(4) and 1250(d)(4) rules, discussed above, must also be complied with to avoid gain recognition in the §1031 exchange. Accordingly, if §1245 property is part of the Relinquished Property (and does have a value), then like-kind §1245 property should be part of the Replacement Property to avoid gain recognition under §1245(b)(4).

6. HOW TO USE THE §1031 LIABILITY RULES TO HAVE THE EXCHANGING PARTIES RECEIVE CASH TAX-FREE.

6.1 Section 1031 Rules on Receipt of Cash and on Relief of Indebtedness. Gain on a §1031 exchange is recognized to the extent of the cash and the fair market value of other non-like-kind property received (known as "boot") under §§1031(b) and (c).

If the Relinquished Property is subject to a deed of trust,⁶² then the amount owed on this deed of trust obligation, of which the exchanging party is relieved of in the exchange, is treated as money or "boot" received by the exchanging party under §1031.⁶³ Fortunately, the Replacement Property that is acquired can have its amount of indebtedness netted against the indebtedness on the Relinquished Property for purposes of calculating the "boot".

The Regulations provide that the amount of indebtedness that the exchanging owner is relieved of in the exchange is netted against the amount of the liabilities that the owner assumes or takes the Replacement Property subject to.⁶⁴ The exchanging taxpayer is permitted to

⁶¹ See California Civil Code §658.

⁶² Reg. §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* §1031(d).

⁶³ See §1031(b) and Reg. §1.1031(b).

⁶⁴ Reg. §1.1031(b)-1(c).

encumber the Replacement Property as part of the closing of the acquisition of the Replacement Property and then to net such encumbrance against any debt that the taxpayer is relieved of on the Relinquished Property.⁶⁵

Replacement Property indebtedness for purposes of the netting rules does include 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 exchanging taxpayer in an exchange cannot be netted against the consideration given in the form of that taxpayer's assumed liabilities on the Replacement Property.⁶⁶

6.2 What Happens Where the Encumbered Relinquished Property Consists of Both Real Estate and Personal Property? Where the Relinquished Property consists of both real and personal property and is encumbered by a lien or deed of trust, the seller can unexpectedly recognize gain because the Treasury Regulations require that all of the liabilities in an exchange be allocated among each property exchange group (based upon the relationship of each property group's fair market values) even if these liabilities are not secured by a particular exchange group's properties.⁶⁷ 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 of a deferred exchange 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

⁶⁵ See PLR 9853028 and TAM 8003004 along with *Barker*, 74 T.C. 555 (1980).

⁶⁶ Reg. §1.1031(d)-2.

⁶⁷ See Reg. §1.1031(j)-(1)(b)(2).

partnership. Any decrease in a partner's share of liabilities is considered as a distribution of money to the partner by the partnership under §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 §731(a)]. Thus, on the first leg of a deferred 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 partnership liabilities. Upon the second leg of the exchange, where there is the partnership's acquisition of the Replacement Property subject to a loan, there would be an increase in the partner's share of partnership liabilities.

In Rev. Rul. 2003-56 the IRS ruled on the tax consequences of partnership liabilities in a §1031 exchange occurring 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 by the partnership in year one, and Replacement Property subject to a liability is acquired by the partnership in year two, the liabilities are netted for purposes of the §752 rules.⁶⁸ 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 recognized as taxable income 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 year two in a deferred §1031 exchange covering two taxable years is recognized as taxable income in year two when the cash is received (and not in year one).

⁶⁸ Rev. Rul. 2003-56 is an analysis under the §1031 rules, and not under the §752 Regulations. Thus, it is unclear whether the tax rule of Rev. Rul. 2003-56 also applies in the §1033 area.

6.4 Taxpayer Can Receive Cash Tax-free in a §1031 Exchange By Refinancing the Relinquished Property Before an Exchange. Sellers of real estate (the Relinquished Property) in a tax-free exchange may want to receive cash without having 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 taxpayer/seller could refinance the Relinquished Property before the exchange and receive these refinancing loan proceeds tax-free.⁶⁹

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 PLR 8434015]. The IRS in PLR 8434015 argued that the result in *Garcia* should not apply. However, to date there has been no case law authority supporting this IRS position in PLR 8434015.

The Replacement Property after the exchange still needs to be subject to at least the same amount of indebtedness that the seller was relieved of on the Relinquished Property in order to avoid gain recognition.

6.5 Taxpayer Can Receive Cash Tax-free in a §1031 Exchange By Refinancing the Replacement Property After an Exchange. An alternate tax strategy is for the taxpayer to first complete the §1031 exchange and then refinance the Replacement Property at a later date after the exchange closes. The taxpayer is able to receive these refinancing loan proceeds tax-free. The refinancing of the Replacement Property after completing the exchange allows the taxpayer to

⁶⁹ 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 proposed regulations that were never enacted to say debt incurred in anticipation of a §1031 exchange would be taxable boot in Prop. Reg. §1.1031(b)-1(c).

withdraw tax-free 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 from the exchange, the refinancing of the Replacement Property (and any loan commitment from the lender) should be done only after the closing of the acquisition of the Replacement Property, and (to be conservative in tax planning) should be done by a separate loan escrow and separate closing statement.

6.6 Clients Must Avoid a Step Transaction When Refinancing the Property. The refinancing of the Replacement Property after the exchange or of the Relinquished Property before the exchange should not be tied to the exchange by written or oral understandings or prearranged loans, in order to avoid IRS assertions that the received loan proceeds are taxable boot from the §1031 exchange under a step-transaction theory.⁷⁰

7. **HOW TO DO EXCHANGES BETWEEN RELATED PARTIES.**

Clients who have related partnerships and limited liability companies owning real estate might want to exchange this real estate between their legal entities in order to accomplish business goals such as liability protection, or may wish to achieve tax goals such as exchanging high tax basis land for low tax basis buildings thereby transferring their land's non-depreciable tax basis to their depreciable buildings' tax basis (or for transferring tax bases of some of the client's properties to those properties that the client will sell).

Properties may be exchanged tax-free between related parties under §1031.⁷¹

⁷⁰ In PLR 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.

⁷¹ 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.

Example of an Exchange Between Taxpayer and Related Entity: Taxpayer owns recently acquired land which has a tax basis and a fair market value of \$10 million dollars. Taxpayer and the taxpayer's children own in a limited liability company a depreciable building with a fair market value of \$10 million dollars and a tax basis of \$1 million dollars. Taxpayer exchanges the taxpayer's land with the limited liability company so that after the exchange the taxpayer owns the building and the limited liability company owns the land.

The result of this transaction is that the taxpayer owns the building with a new tax basis of \$10 million dollars while the related party limited liability company owns land with a tax basis of \$1 million dollars. This exchange transaction qualifies for §1031 tax treatment and no gain will be recognized on the exchange so long as neither the taxpayer nor the limited liability company subsequently dispose of their respective properties within the §1031(f) requisite two-year holding period.

Section 1031(f)(1) imposes a two-year holding period requirement for related parties engaging in a §1031 exchange. Basically, §1031(f) requires that where a taxpayer exchanges property with a related party, both parties to that exchange must hold their respective properties for at least two years after that exchange in order to receive §1031 tax treatment.⁷² 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 which would have been recognized in the exchange by either party will be recognized on the date that the disqualifying disposition occurred.⁷³

7.1 Purpose of the §1031(f) Related Party Rules. The §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

⁷² The determination of who is a related party is based upon §§267(b) and 707(b)(1). Related parties include affiliated entities, partnerships and persons owning more than a 50% partnership interest; and two partnerships which are owned by more than 50% by the same persons.

⁷³ Section 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. Section 1031(f)(2).

accelerate a tax loss on retained property.⁷⁴ Without the related party rules of §1031(f), taxpayers could exchange low basis Relinquished Property with a related party who had high-basis Replacement Property, and the related party could then sell the Relinquished Property (which acquired a new high tax basis in the exchange) and receive the Relinquished Property's sale's cash proceeds tax-free.⁷⁵ This would result in the related party cashing out the Relinquished Property investment tax-free. Congress designed §1031(f) to prevent this result.

7.2 Section 1031(f) Has Broad Application and Applies to Indirect Transfers Between Related Parties. The §1031(f) related party rules cover "indirect" transfers between related parties. This "indirect" transfer rule may cause clients to unwittingly violate the related party rules, and thereby trigger taxable gain, when they utilize a qualified intermediary to do a deferred §1031 exchange.⁷⁶ Where the Replacement Property is acquired from a related party through a qualified intermediary the §1031(f)(4) anti-abuse rule will be applied by the IRS to deny §1031 tax treatment.

In *Teruya Brothers, Ltd.*⁷⁷ the Ninth Circuit affirmed the Tax Court's decision that using a qualified intermediary to purchase Replacement Property from the exchanging party's related entity was in fact structured to avoid the "purposes" under §1031(f)(4), and thus, the Court denied §1031 tax treatment. In *Teruya Brothers, Ltd.* there were two similar exchange

⁷⁴ 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).

⁷⁵ 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 §1031(d).

⁷⁶ 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. The IRS has successfully used §1031(f)(4) to attack exchanges where related parties are involved.

⁷⁷ 124 T.C. 45 (2005), *aff'd* 580 F.3d 1038 (9th Cir. 2009).

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. This subsidiary corporation had large NOLs. The subsidiary corporation retained the Replacement Property's cash sales proceeds and used the NOLs to shelter the gain from one of the Replacement Property's sale.⁷⁸ The Tax Court stated that §1031(f) should apply to deny §1031 treatment where the Relinquished Property is transferred to an unrelated party (*i.e.*, here the unrelated qualified intermediary), who then exchanges this Relinquished 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 the *Teruya Brothers, Ltd.* transaction was that the Relinquished Property investment was "cash[ed] out" immediately and the exchanger's related party subsidiary corporation ended up with the cash proceeds which used its NOLs to shelter the Replacement Property's gain. The Ninth Circuit found that the transactions were structured to avoid the "purposes" of the §1031(f) related party rules and, thus, did not qualify for §1031 tax-deferred 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

⁷⁸ 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.

the sale of the Replacement Property. However, this argument was unsuccessful since the taxpayer's subsidiary was a related party and had a large NOL.

In summary, the taxpayer in *Teruya Brothers, Ltd.* was denied §1031 like-kind exchange treatment based upon §1031(f)(4), and the taxpayer failed to satisfy the non-tax avoidance exception of §1031(f)(2)(C) since the later disposition of the property did in fact avoid income tax. It should be noted that the Ninth Circuit rejected the IRS's position that every deferred exchange between related parties involving a qualified intermediary should be recast as a direct exchange that fails under §1031(f)(4) if that exchange would otherwise fail under §1031(f)(1). Thus, under the *Teruya Brothers, Ltd.* case it arguably could be possible to utilize a qualified intermediary in exchanges between related parties and not automatically violate §1031(f)(4).

Similar to the facts in *Teruya Brothers, Ltd.*, is IRS Rev. Rul. 2002-83 where the property owner transferred its Relinquished Property to a qualified intermediary who then transferred that 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 party related to the taxpayer for cash. Thus, the related party retained the cash after the exchange was completed. The IRS, in Rev. Rul. 2002-83, ruled that the property owner exchanging low basis property would not receive §1031 tax treatment, since the related party disposed of the Replacement Property for cash within the required two-year holding period. This exchange, which was done through a qualified intermediary, was 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 from that exchange, then the §1031(f) related party rules apply to prevent §1031 tax-deferred exchange treatment.⁷⁹ However, note that this broad IRS interpretation of §1031(f) under Rev. Rul. 2002-83 of using a qualified intermediary was not accepted by the Ninth Circuit in the *Teruya Brothers, Ltd.*, discussed above.

Many times a client with related party entities owning real properties needs to exchange these properties between these entities in order to have the real properties owned by a certain related entity to accomplish a business purpose. However, based upon the IRS's position in Rev. Rul. 2002-83, §1031(f)(4) could unwittingly produce recognized taxable gain to the client in these circumstances, especially where a qualified intermediary is used.

In a later case of *Ocmulgee Fields, Inc.*,⁸⁰ the taxpayer entered into a contract to sell real property to an unrelated third-party. A qualified intermediary was utilized so that the Relinquished Property would be sold and a Replacement Property purchased under §1031. The taxpayer several years earlier had sold another piece of property to a party related to the taxpayer. In the new exchange the taxpayer elected to have the qualified intermediary acquire as the Replacement Property this old parcel that had previously been sold to that related party several years earlier. Thus, the qualified intermediary purchased Replacement Property from a related party and then distributed that Replacement Property to the taxpayer. The Tax Court found that this transaction violated the "purpose" of §1031(f) and therefore held that there was no like-kind

⁷⁹ However, see Priv. Ltr. Ruls. 200251008 and 200329021 where the IRS ruled that the §1031(f) 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 party related to the exchanging taxpayer. Both construction exchanges qualified under Rev. Proc. 2000-37.

⁸⁰ 132 T.C. 105 (2009), *aff'd*, 613 F.3d 1360 (11th Cir. 2010). In another case involving the exchange of equipment between related parties the Eight Circuit denied §1031 treatment because there was a tax avoidance purpose under §1031(f)(4). *North Central Rental & Leasing LLC*, 779 F.3d 738 (8th Cir. 2015).

exchange treatment under §1031(f)(4). The Tax Court held that the taxpayer failed to evidence that “tax avoidance” was not one of the principal purposes of this exchange between related parties and, thus, held that the taxpayer did not meet the non-tax avoidance exception of §1031(f)(2)(C). The Eleventh Circuit’s decision in *Ocmulgee Fields, Inc.* affirmed the Tax Court and found that this exchange was structured for tax avoidance purposes. The Eleventh Circuit found that this exchange allowed the taxpayer to receive cash from the sale of their low income tax basis real estate, and only pay income taxes on the sale of high tax basis real estate. The Eleventh Circuit further held that this exchange had the economic consequence of a direct related party exchange under §1031(f)(1).

7.3 How to Avoid Violating the §1031(f) Related Party Rules When Using a Qualified Intermediary for Exchanges Between Related Parties. One solution to avoid the tax results of *Teruya Brothers, Ltd.*, *Ocmulgee Fields, Inc.*, and Rev. Rul. 2002-83, where Replacement Property is acquired from a related party, is to structure the 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.

The IRS in PLR 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.

Similarly, the IRS in PLR 200616005 held that there was a qualified tax-free exchange where related parties engaged in two exchanges and neither party at the completion of the exchange “cashed out” their investments in their real properties. In PLR 200616005 a trust owned building I, and a related S corporation owned building II. The trust sold building I to an

unrelated third-party buyer in a sale utilizing a qualified intermediary and through that qualified intermediary utilized the building I sales proceeds to acquire in a §1031 exchange building II from a related S corporation. The S corporation then proceeded to utilize the proceeds that it had previously received from the trust for building II, to acquire other Replacement Property in another exchange. Upon the completion of both exchanges, the trust owned building II, the S corporation owned the S corporation's Replacement Property, and the unrelated third-party buyer owned building I. The IRS pointed out that after the completion of the exchange neither the trust nor the related S corporation are in receipt of cash proceeds from the exchange (or sale) of their respective Relinquished Properties.

7.4 Permitted §1031 Exchanges Involving Related Parties. A related party to the exchanging taxpayer may first acquire the Relinquished Property from that exchanging taxpayer; where second that exchanging taxpayer, in a §1031 exchange, acquires the Replacement Property from an unrelated party.

It is common for a person to sell their Relinquished Property to a related party for cash and then use that cash to consummate an exchange into a Replacement Property which is acquired from an unrelated party. Subsequent to completing this exchange the related party (that had acquired the Relinquished Property) can continue to own the Relinquished Property; or if the related party chooses, it can sell that Relinquished Property within the prohibited two-year period.

Normally, the §1031(f) related party rules prevent the taxpayer from receiving the Replacement Property from a related party. In the above illustration, a related party is instead acquiring the Relinquished Property from the taxpayer/seller, and then that taxpayer acquires the Replacement Property from an unrelated third party. Thus, this type of transaction is not avoiding

the §1031(f) rules pursuant to IRS Private Letter Rulings,⁸¹ and the exchange qualifies under §1031.

7.5 Exchanging Properties Between Related Family Members. Many times families with large real estate holdings need to split up those holdings in a tax-free manner. One tool to accomplish this split up is to do §1031 tax-deferred exchanges. However, an issue that often arises is that these family members are related to each other for purposes of the §1031(f) related party rules. To avoid the application of the §1031(f) related party rules to family split-ups, taxpayers should demonstrate that neither the exchange nor a later disposition of the properties by the related family members had as one of its principal purposes the avoidance of federal income tax under the §1031(f)(2)(C) exception rule.

In PLR 200706001, the IRS held that the §1031(f)(2)(C) non-tax avoidance exception to §1031(f) applied where there was no shifting of tax basis from one property to another property. The facts in PLR 200706001 were that the parent's death caused a step-up in basis of all of the properties and, thereby, prevented a basis shift on a subsequent §1031 exchange.

In PLR 200730002 related family members owned fractional interests in two real properties. The related parties exchanged their fractional interests so that one family member owned 100% of a property and then subsequently sold that property for cash. The IRS held in PLR 200730002 that there was no tax avoidance motive (and thus, the §1031(f)(2)(C) exception rule applied) based upon the legislative history that a non-tax avoidance will generally apply to a transaction involving the exchange of undivided interests in different properties that results in each

⁸¹ See Priv. Ltr. Ruls. 200709036; 200712013; 200728008; and 201027036.

taxpayer holding either an entire interest in a single property or a larger undivided interest in any of such properties.⁸²

Similarly, the IRS ruled in Priv. Ltr Ruls. 200919027 and 200920032 that an inter-family transaction was not structured for the purpose of avoiding the §1031(f) related party rules, and therefore the IRS did not apply §1031(f)(4).

8. **AVOIDING THE PROBLEM OF THE CLIENT NOT HAVING ENOUGH TIME TO IDENTIFY AND CLOSE ESCROW ON THE REPLACEMENT PROPERTY IN A DEFERRED §1031 EXCHANGE.**

A §1031 exchange may be structured as a “deferred exchange” so that the Replacement Property may be acquired at a later date under Reg. §§1.031(k)-1(a). In a deferred exchange the client first enters into a contract to sell the Relinquished Property. The client has an agreement with a qualified intermediary (sometimes referred to as a “**QI**”) who then exchanges the Relinquished Property for the Replacement Property under the rules of Reg. §1031(k)-1(g). Under these Treasury Regulations the client assigns its rights under the Relinquished Property sales contract and the Replacement Property sales contract to the QI.

Clients engaging in a deferred exchange must identify the Replacement Property within 45 days after closing the Relinquished Property’s sale (“**Identification Period**”). Also, in a deferred exchange, the client must receive Replacement Property on the earlier of (“**Exchange Period**”) the 180th day after the Relinquished Property is transferred or the due date of the client’s

⁸² See H.R. Rep. No. 386, 101st Cong., 1st Ses. 614 (1989).

tax return for the tax year of such transfer (including extensions).⁸³ Clients in certain cases may have difficulty meeting these time requirements.

8.1 How to Identify the Replacement Property in a Deferred Exchange. An exchanging seller 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 of the identified Replacement Properties 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.⁸⁴ 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.⁸⁵

Note that the IRS has taken the position that §7503 (relating to time for performance of acts when the last day for the performance falls on a Saturday, Sunday or legal holiday) does not apply to the Identification Period calculations. This IRS position is questionable. Clients should, however, err on the side of caution and have their Exchange Period and Identification Period end on the business day immediately preceding such period's end date if that end date falls on a Saturday, Sunday or legal holiday.

⁸³ See Reg. §1.1031(k)-1(b)(2)(i).

⁸⁴ See Reg. §1.1031(k)-1(c)(4)(i). The Identification Period and the Exchange Period commence on the date that a taxpayer transfers the Relinquished Property, but the Identification Period ends at midnight on the 45th day thereafter. The Exchange Period ends at midnight on the earlier of the 180th day thereafter or the due date (including extensions) for the taxpayer's tax return Reg. §1.1031(k-b)(2). Additionally, if more than one Relinquished Property is transferred as part of the same exchange and these Relinquished Properties are transferred on different dates, then the Identification Period and the Exchange Period are determined by reference to the earliest date on which a property transfer occurred.

⁸⁵ See Reg. §1.1031(k)-1(c)(4)(ii)(B).

8.2 Do Not Commit Tax Fraud By Backdating Documents. As some exchanging clients find themselves approaching the 45-day identification 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*,⁸⁶ 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.

8.3 Techniques for Clients to Obtain More Time 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 client/seller can obtain more time to identify the Replacement Property by including a provision in the Relinquished Property’s sale agreement giving the client/seller an option to extend the Relinquished Property’s escrow closing date.

Another alternative technique to extend the commencement date of the 45-day period is for the client/seller to first lease the Relinquished Property to the buyer, with the buyer purchasing the Relinquished Property at a later date.⁸⁷

8.4 The 45-Day and 180-Day Identification Time Periods Can Be Extended in the Event of a Presidentially Declared Disaster. Taxpayers who are “affected” by a Presidentially

⁸⁶ See *Dobrich v. Commissioner*, 188 F.3d 512 (9th Cir. 1999).

⁸⁷ The lease rent and the buyer’s purchase option terms should be at fair rental value and arms-length terms in order to avoid IRS attempts to re-characterize the lease and option as a sale for tax purposes. In the case of *Exelon Corp.* 147 T.C. No. 9 decided September 19, 2016, the leases were not recognized by the Tax Court because these leases were actually loans for tax purposes based upon a substance over form analysis.

declared disaster or other event (such as terrorism or combat) and have difficulty because of such event in meeting the 45-day and 180-day deadlines may obtain an extension of 120 days under §§7508 and 7508A and Rev. Proc. 2007-56.⁸⁸ 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.⁸⁹ The exchanging client only qualifies for this postponement if: (i) the Relinquished Property was transferred on or before the date of the Presidentially declared disaster⁹⁰, 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.⁹¹

9. **VERIFY THE CREDITWORTHINESS OF THE QUALIFIED INTERMEDIARY.**

Some clients engaging in a §1031 deferred exchange leave millions of dollars in the name of the qualified intermediary who is to complete their exchange. 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.⁹²

⁸⁸ See Reg. §301.7508A1(b)(1).

⁸⁹ Section 7508 postpones the 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.

⁹⁰ There are also provisions for reverse exchanges with EATS under Rev. Proc. 2000-37.

⁹¹ See Reg. §301.7508A-1(d)(1) for other ways the taxpayer is an “affected taxpayer.”

⁹² The Regulations prohibit the taxpayer to have an unrestricted right to receive money or other property before receiving the like-kind Replacement Property. Accordingly, where a trust agreement is utilized with a qualified intermediary, these agreements (or similar agreements) must limit the taxpayer’s ability to receive, pledge, borrow or otherwise obtain the benefits of the cash held by the qualified intermediary before the end of the Exchange Period.

There are several alternative solutions under the Regulations by which sellers can protect their exchange funds being held by the qualified intermediary.

9.1 Solution to Hold the 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 creditors or becoming insolvent. However, the §1031 Regulations permit the Relinquished Property's cash sale's proceeds to be held in an escrow or trust account to be used for the Replacement Property's purchase.⁹³ 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 such trust or separate account, except as permitted by the Regulations.

9.2 Solution to Use a Deed of Trust, Letter of Credit, Guarantee, or Qualified Escrows and Trusts 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.⁹⁴

Where a guaranty is issued, clients should review the guaranty carefully as to whether it is a normal commercial guaranty with adequate legal protections for the clients, and should verify the financial ability of the guarantor to perform under the guaranty.

Where a standby letter of credit is used, the standby letter of credit should be non-negotiable and should provide for the payment of the proceeds to escrow for the purchase of the Replacement Property rather than payment to the exchanging party.⁹⁵

If a qualified intermediary fails to acquire the Replacement Property and transfer it to the taxpayer within the 180 day required replacement period, even if that qualified intermediary went bankrupt or failed to perform, then the taxpayer does not receive §1031 tax exchange treatment.

⁹³ Reg. §1.1031(k)-1(g)(3).

⁹⁴ Reg. §1.1031(k)-1(g)(2).

Where a qualified escrow or a qualified trust is used, the Qualified Intermediary's duties are permitted to be secured by cash equivalent assets. To be a qualified escrow holder or trustee, that person must not be a taxpayer or a "disqualified person", and the taxpayer's right to receive, pledge, borrow or otherwise obtain the benefits of the cash and cash equivalent held in such escrow or trust must be limited to items specified in Reg. §1.1031(k)-1(g)(3).

10. **USING §1031 WITH A PERSONAL RESIDENCE.**

A residence (whether a principal residence or a vacation home) held solely for personal use will not qualify for §1031 tax treatment. To qualify under §1031, the residence must have been "held" for investment or productive use in a trade or business. Just because a vacation or personal residence might appreciate in value or that the residence might be sold for a profit does not mean that the residence is held for investment under §1031. The "investment" purpose must be the primary purpose to hold that residence in order to qualify under §1031.

10.1 **Tax Plan of Converting the Residence into an Investment Property.** A personal residence or vacation home can be converted into rental or investment property and then exchanged tax-free under §1031. Unproductive real estate held for future use or future realization of the increment in value can be deemed held for investment under the Treasury Regulations.⁹⁶

In *Moore*⁹⁷ the taxpayer attempted to exchange one vacation home for another vacation home. The taxpayer utilized the vacation homes regularly, never rented out the vacation homes and did not claim any income tax deductions for maintenance, repairs or for investment

⁹⁵ 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 in an otherwise tax-free exchange. See Treas. Regs. §1.1031(k)-1(f)(2) and §15A.453-1(b)(3).

⁹⁶ Reg. §1.1031(a)-1(b).

⁹⁷ T.C. Memo 2007-134.

interest. The Tax Court in *Moore* stated that: (i) the Relinquished Property and the Replacement Property must have been both "held primarily" for investment; and (ii) that the "investment purpose" cannot just be one of many purposes for which the taxpayer held the vacation home. Thus, the taxpayer in *Moore* was denied §1031 treatment.

In *Goolsby*⁹⁸, the Tax Court held that there was no §1031 tax-free treatment where the taxpayer moved into, and lived in, the Replacement Property home after failing to rent that Replacement Property home to a third party for two months. The Tax Court in *Goolsby* found that the taxpayer did not have a primary motivation to hold the Replacement Property for investment purposes, since the taxpayer prior to acquiring that Replacement Property home never researched rental opportunities for the Replacement Property home. The taxpayer's only effort to show that the Replacement Property home was held for investment was by placing an advertisement in a newspaper for several months. In *Goolsby* the taxpayer moved into the Replacement Property home for personal use two months after acquiring the home, and the taxpayer pulled building permits for finishing the basement of the Replacement Property home within a few weeks of purchasing the home.⁹⁹

10.2 Safe Harbor for a Residence under §1031. Because of the numerous taxpayers attempting to do a §1031 tax-free exchange of their homes, the IRS issued Rev. Proc. 2008-16, to provide a "safe harbor" for exchanging dwelling units on or after March 10, 2008. A dwelling unit will be deemed to have been held for productive use in a trade or business or for investment

⁹⁸ T.C. Memo 2010-64.

⁹⁹ However, in the case of *Reesnik*, T.C. Memo 2012-18, the taxpayer prevailed in showing the Replacement Property was, in fact, held for "investment purposes" where the taxpayer evidenced their efforts to rent the Replacement Property house. Where the taxpayer rented to his son the Replacement Property house in *Adams* T.C. Memo 2013-7, the Replacement Property house qualified for §1031 treatment because the taxpayer intended to hold that house for rent at the time of the exchange and because the rent paid by the taxpayer's son was at fair rental value (after considering the son's contribution to renovating the house and the son doing repairs on the house).

for §1031 purposes even if that taxpayer “occasionally” uses that dwelling unit for personal purposes. The IRS will not challenge the holding of that dwelling unit under §1031 if that dwelling unit meets the qualifying use standard test described as follows: A dwelling unit that is the Relinquished Property will be deemed held for productive use in a trade or business or for investment if that dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange; and within that 24 month period, in each of the two 12-month periods immediately before the exchange, the taxpayer rents the dwelling unit to another person at a fair rental amount for 14 days or more, and the period of the taxpayer’s personal use of the dwelling does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

The Replacement Property dwelling unit meets the §1031 test of being held for productive use in a trade or business or for investment if that dwelling unit is owned by the taxpayer for at least 24 months immediately after the exchange, and within that 24-month period, in each of the two 12-month periods immediately after the exchange, the taxpayer rents the dwelling unit to another person at a fair rental for 14 days or more, and the period of the taxpayer’s personal use of the dwelling does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

10.3 Apply both §1031 and §121 When Selling a Principal Residence Which is Currently Being Held as Investment Property. What happens when the client sells a residence which is currently being held by the client as investment property, but which was previously the client’s principal residence?

Under §121 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. To qualify under §121, 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 residence's sale.¹⁰⁰

The IRS issued Rev. Proc. 2005-14 to outline the tax consequences where real property qualifies for both §1031 and §121 treatment. The following is a summary of these Rev. Proc. 2005-14 rules:

- To use §1031 at the time of the house's sale, the house must on the date of the sale be held for trade or business or for investment purposes.
- Section 121 is applied first before applying §1031. The taxpayer first calculates the excluded gain under §121 (\$250,000 for an individual return and \$500,000 for a joint return), and then any remaining gain is deferred by applying §1031.
- The gain that is excluded by applying §121 does not include gain attributable to prior depreciation deductions. Pursuant to §121(d)(6), the gain which is excluded under §121 cannot apply to gain attributable to depreciation. However, the client can still defer this "depreciation gain" pursuant to §1031.
- If the client receives "boot" (such as cash), then the client can exclude gain represented by that boot under §121. The client who receives "boot" such as cash in the sale of the residence that is subject to both §121 and §1031, only has to recognize such received cash as taxable income to the extent that this cash exceeds the amount of gain which is excluded under

¹⁰⁰ Vacation homes do not qualify under §121, since §121 only applies to a principal residence. However, a vacation home can still qualify under §1031 if the taxpayer holds that vacation home for investment.

§121. Thus, the client can receive cash boot tax-free and still use §1031. Therefore, the client can exclude their gain under §121 (\$500,000 for a client filing a joint return) and still receive cash. This tax result is much more favorable than solely applying §1031, which would result in gain recognition.

- The client receives a step up in their Replacement Property's tax basis for the amount of gain which is excluded under §121. Any gain excluded under §121 is deemed to have been "recognized" effectively by the client in order to determine the client's tax basis in the Replacement Property received in the §1031 exchange. Section 1031(d) provides that the tax basis in the Replacement Property is decreased by any money received and increased by any gain recognized, with the remaining basis in the Replacement Property reflective of the prior basis in the Relinquished Property. Thus, the ability to increase this Replacement Property's tax basis by the amount of gain excluded under §121 allows the client to increase their property's basis without having to report that basis increase as recognized gain.

Example of Applying §121 to an Investment Residence Being Exchanged Under §1031: Assume the client (who is single) buys a house for \$210,000 which the client has used as the client's principal residence from 2012 to 2014. From 2014 until 2016, the client rents out the residence to tenants and claims depreciation deductions of \$20,000. In 2016 the client exchanges under §1031 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 (\$460,000 + \$10,000 less \$190,000 adjusted basis). The client's exchange of the client's principal residence which the client has rented out 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 Relinquished Property 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 sale and 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.

2005-14¹⁰¹, the client first 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 under §1031, including the \$20,000 gain attributable to depreciation. Although the client receives \$10,000 cash (boot), the client is not required to recognize this \$10,000 of cash as 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).

10.4 **Limits on Using §121 When Selling a Personal Residence Which was Previously Received (as Replacement Property) in a §1031 Exchange.** The American Jobs Creation Act of 2004 amended 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. The §121 gain exclusion does not apply if the principal residence was acquired in a §1031 exchange in which any gain was not recognized within the five years prior to that principal residence's sale.¹⁰²

Nothing in this article shall be deemed legal or tax advice to any person or as to any transaction. Please feel free to contact Robert A. Briskin at (310) 201-0507 if you wish to discuss any items contained in this article.

¹⁰¹ IRB 2005-7.

¹⁰² See §121(d)(10).