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# CREATIVE USES OF SECTION 1031 TAX-FREE EXCHANGES

**by**

**Robert A. Briskin**

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# CREATIVE USES OF SECTION 1031 TAX-FREE EXCHANGES

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Clients contemplating exchanging their real estate 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, and instead sold their 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%. Additionally, California imposes a 13.3% maximum tax rate[1] and in some cases the alternative minimum tax may apply.

## 1. PARTNERSHIPS DOING TAX-FREE EXCHANGES.

When partnerships[2] desire to split up, they sometimes first liquidate and distribute all of the 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 ñdrop and

[1] 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.

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

swapò arrangement risks violating a basic requirement of Section 1031, which is that exchanging partners must ñholdò both the Replacement Property and the Relinquished Property for ñproductive use in a trade or business or for investment.ò Although there is no specified length of time that the exchanging former partners must ñholdò the Relinquished Property before entering into an exchange, the former partners should own the Relinquished Property as tenants-in-common long enough to evidence their intention to hold the property for investment, or trade or business purposes. The former partners want to hold the Relinquished Property long enough to be classified as a valid tenancy-in-common relationship after the liquidation of the Relinquished Property and not be classified as a ñpartnershipò for federal income tax purposes.

1.1 **Dissolution and Liquidation of the Partnership, Immediately Followed By a Section 1031 Exchange of the Property.** The IRS has ruled that taxpayers did not ñholdò the Relinquished Property for the required qualified use, where the property was received by the taxpayer as a liquidating distribution from a legal entity and then immediately exchanged for the Replacement Property.[3] Contrary to this IRS ruling, the Tax Court in ***Mason***[4] held that exchanges by partners who received the Relinquished Property in a partnership liquidation qualified for tax-free exchange treatment. Similarly, in ***Bolker***[5], the Ninth Circuit Court of Appeals held that shareholders qualified for tax-free exchange treatment even though the shareholders exchanged the Relinquished Property after they received that property in a corporate liquidation. The Ninth Circuit in ***Bolker*** held that Section 1031 only requires a taxpayer to own

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

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

[5] 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.

the Relinquished Property before entering into the exchange and to <u>have no intent</u> either to liquidate the Relinquished Property or to use the Relinquished Property for personal purposes.[6]

1.2 **<u>Solution to First Liquidate the Partnership and Then the Former Partners Hold the Liquidated Relinquished Property as Tenants-In-Common Before Doing an Exchange.</u>** 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 an <u>extended time period</u> before they exchange those interests for the Replacement Property. However, for tax purposes the former partners' tenancy-in-common relationship must be structured so as not to be treated as a partnership for tax purposes.7 Thus, the formalities of a tenancy-in-common relationship should be observed. To formalize the appearance of a tenancy-in-common, the individual tenants-in-common names should be titled on the property's deed, and the partnership's liquidation

[6] Taxpayers who desire to split up partnerships must also be aware that the IRS could attack the ñdrop and swapò 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 F2d 472 (5th Cir. 1971), to find that a transaction did not qualify as a §1031 exchange where the taxpayer exchanged the property shortly after the taxpayer acquired the property in a partnership distribution.

The IRS may also attack a drop-and-swap transaction under a ñsubstance-over-formò argument as it successfully did in ***Chase***, 92 TC 874 (1989).

[7] The Regulations allow a co-tenancy to avoid being classified as a partnership if the co-tenancy is simply maintaining, repairing and renting the property. *See* Treas. Regs. §301.7701-1(a)(2). Management activities by the co-tenancy should be limited as much as possible in order that the relationship does not rise to a business relationship resulting in partnership tax status. There should be a written co-tenancy agreement which preserves the normal rights of a co-tenancy under state law.

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.[8]

1.3 **<u>Alternative Solution For the Partnership To First Do the Exchanges Into the New Properties, Followed By a Distribution of the Properties to the Former Partners.</u>** An alternative solution is that the partnership first completes the Section 1031 tax-free exchanges at the partnership level into multiple Replacement Properties; then the partnership liquidates and distributes each Replacement Property to a specific group of partners. This alternative solution has several tax issues which must be addressed. <u>First</u>, the IRS may argue that the distributed Replacement Property was not held after the exchange for investment purposes since it was immediately distributed out of the partnership. If each Replacement Propertyôs income and distributions are allocated and distributed to only certain partners at the partnership level then the IRS might assert that there has been an effective liquidation of the partnership (and a violation of the ñhold forò rules). <u>Second</u>, since many exchanges utilize the Section 1031 deferred exchange 45-day identification rules, there will be limits on the number of identified Replacement Properties, which could then prevent this alternative solution from working.

1.4 **<u>IRS Guidelines On How to Be Classified as a Tenancy-in-Common and Not as a Partnership For Tax Purposes.</u>** The IRS issued Rev. Proc. 2002-22 to list the conditions under which the IRS will consider a revenue ruling request that a tenancy-in-common interest (sometimes known as a ñTICò) will <u>not</u> be treated as a partnership interest for tax purposes under Section 7701 (in order to qualify for Section 1031 purposes). Rev. Proc. 2002-22 was issued in

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

response to the real estate syndication industry that has grown up to market tenancy-in-common interests in large real estate properties to those persons needing Replacement Property to complete their Section 1031 exchanges.

(a) **Consequences of Not Complying With Rev. Proc. 2002-22**. Rev. Proc. 2002-22 states that its conditions are ñnot intended to be substantive rules and are not to be used for audit purposes,ò, 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, many 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's 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 ñputò). 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 of the Property; (iii) the disposition or lease of the property; or (iv) creation of a 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 ñimplied consentò 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 ñtime period to objectò can only be applied to the manager's agreement (and such ñobjection methodò 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). Query: Does a ñmaster leaseò violate Rev. Proc. 2002-22?

(c) **Rev. Proc. 2002-22 By Its Terms Does Not Apply to Liquidating Partnerships**. Having a partnership liquidate its properties to partners as tenants-in-common (followed by the property's sale) is probably the most frequently used technique when some partners want to exchange for property and others want to cash out. Taxpayers have relied on ***Bolker*** (discussed above) for the Section 1031 ñholdingò 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 property interests through a partnership. This prohibition on previously owning the property through a partnership, contained in Rev. Proc. 2002-22, sends a ñwarningò of how the IRS might treat a partnership liquidation followed by a Section 1031 exchange.

(d) **<u>Why Has the IRS Not Issued Many Revenue Rulings Under Rev. Proc. 2002-22</u>?** 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 <u>not</u> 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 have not obtained a revenue ruling from the IRS. Instead, many TIC sponsors obtain tax opinion letters from law firms to indicate whether their particular TIC arrangement complies with tax laws to be a valid tenancy-in-common.

There have only been a few private letter rulings in the TIC area.[9] 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 <u>unanimous TIC owner consents</u> to enter into any leases of the property, sale of the property, reappointment of a property manager or the incurrence of debt on the property. For all other 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 that this co-ownership arrangement <u>satisfied all</u> of the conditions set forth in Rev. Proc. 2002-22. The

**9** See PLR 200327003.

structure satisfied 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 ñbusinessò because the activities of the management company and the TIC owners were only those customarily done in triple-net leasing. Thus, the IRS held that the property did not constitute an interest in a partnership.

(e) **Application of Rev. Proc. 2002-22 to Syndicated TICs**. 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 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 ñexit strategyò). 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.[10]

1.5 **<u>Using Disregarded Entities to Own Tenancy-In-Common Interests.</u>** Persons owning tenancy-in-common interests in the Replacement Property may wish to limit their personal liability by not owning the TIC 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. Owning the TIC 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 ñbankruptcy remoteò entities), since this will remove the TIC interest from the risk of an individual's creditor problems, bankruptcy or death. Additionally, if the 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 creditors outside of the property's lender.

1.6 **<u>Using a Delaware Statutory Trust to Own Property in an Exchange.</u>** When a Delaware statutory trust, which is a grantor trust, engages in a Section 1031 exchange, the trust

[10] 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, *Section 1031 Exchanges and Tenancy-in-Common Interests,* **Real Property Law Reporter**, Continuing Education of the Bar of California, July 2006.

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 could be used instead of a TIC ownership arrangement in certain circumstances.

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 ñtrustò for tax purposes under Reg. Section 1.7701-4 or when it will be classified as a ñbusiness entity.ò Where the trust entity is classified as a ñtrust,ò then this trust must also satisfy the grantor trust rules under Section 671 in order for the trust to be deemed to own an interest in the property for purposes of Section 1031. If a Delaware statutory trust is not treated as a ñtrustò 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 Section 7701, which in turn would not constitute valid like-kind ñReplacement Propertyò under the Section 1031 rules.[11] In summary, a Delaware statutory trust qualifying under Rev. Rul. 2004-86 can have its beneficial interests exchanged tax free for real property under Section 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:

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

(ii) The trustee cannot enter into new leases.

[11] 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.

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

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

(v) The trustee cannot renegotiate any existing debt.

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

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

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

These ñseven deadly sinsò 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. Thus, 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 construction of the improvements).

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

Commonly, real estate partnerships desire to split up with certain partners receiving cash (referred to as the ñcash-out partnersò), 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-free 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 tax-free exchange treatment) being taxed on the property's sale's recognized gain if the partnership agreement allocates gain to all partners in proportion to their percentage interests.

2.1 **<u>Attempting to do a Special Allocation of the Partnership's Gain to the Cash-Out Partners</u>.** Partners may consider amending their the partnership agreement to specially allocate all of the gain on a property's sale to only the cash-out partners, and none of the gain to the remaining partners who do a Section 1031 exchange. However, this special gain allocation is likely to fail Section 704(b)'s substantial economic effect test, because the special gain allocation would have to be reflected in the cashed-out partners' capital accounts, which in turn could alter the economic deal among the partners.[12]

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

In the unpublished California State Board of Equalization decision of ***Ahlers***, there was a special allocation of cash and gain on a sale of a real property to only certain partners, while the partnership engaged in a Section 1031 tax-free exchange with the remaining cash proceeds. The California State Board of Equalization held that such ñspecial allocationò of guaranteed cash payments to only certain partners did <u>not</u> have substantial economic effect under the §704 rules and the Treasury Regulations promulgated thereunder. Instead, the California State Board of Equalization held that the partnershipôs income and gain must be allocated in proportion to the partnersô percentage interests in the partnership.[13]

2.2 **<u>Solution of Redeeming the Cash-Out Partners For Cash Before the Exchange.</u>** 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-free exchange.

2.3 **<u>Have the Cash-Out Partners Receive a Promissory Note in the Sale of the Relinquished Property.</u>** Another alternative tax structure is for the partnership to sell the Relinquished Property for cash and a promissory note. After the Relinquished Property's sale, the cash-out partners receive a distribution of the promissory note in exchange for the redemption of their partnership interests. The promissory note is structured to pay the cash-out partners principal and interest in the year of the exchange and in the following calendar year.[14] Thus, only

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

[14] If an installment promissory note is received in a §1031 exchange, then any gain recognized is deferred under the installment method of reporting until the note payment is received. The distribution of the promissory note to the partners will not accelerate the

those partners who receive a distribution of the promissory note will have to recognize gain. Those partners desiring to receive tax-free exchange treatment then continue as partners in the partnership and have the partnership use their share of the Relinquished Property's sales proceeds to engage in a Section 1031 tax-free 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 three percent or less of the promissory note's principal amount) made immediately after the beginning of the immediately next tax year, in order to qualify for installment sale treatment under Section 453(b)(1). Thus, distribution of the promissory note to the cash-out partners will not trigger recognized gain to the partnership nor to those partners until they receive payments. [See Sections 453 and 731.] For Section 731 purposes, ñunrealized receivablesò are defined under Regs. Section 1.751-1(c)(1) as rights to payment for property other than a capital asset. Accordingly, an installment note sale of a capital or Section 1231 asset, and its distribution by the partnership, would not be subject to Section 751(a), except perhaps to the extent gain on a Section 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 is not treated as a payment 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

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

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 Property) then engage in a sale of the Relinquished Property. In the sale, the cash-out partners retain their cash sales proceeds (and report the sale's gain thereon), while the partnership uses its portion of the Relinquished Property's sales proceeds to enter into a tax-free exchange.

The 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). The Section 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 Section 1031 exchange.

### 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-free exchange may attempt to pool their property's equity with other persons by: first, receiving their Replacement Property in a complete tax-free exchange; and second, the contributing that Replacement Property (or a tenancy-in-common interest in that Replacement Property) to a partnership with other persons. However, contributing Replacement Property to a partnership immediately following an exchange risks violating the ñholdingò requirement of Section 1031 discussed above.[15] In other words, the

[15] 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

Replacement Property was not ñheldò for productive use in a trade or business or for investment purposes. Instead, the Replacement Property was immediately disposed of by the Replacement Property's contribution to a partnership.

3.1 **Asserting That the "Holding" of Replacement Property is Attributed to the Original Exchanging Party.** Clients who contribute their interests in the Replacement Property to a partnership immediately after an exchange could rely upon the Ninth Circuit Court of Appeals ***Magneson***[16] decision to attribute the partnership's holding of the Replacement Property to the clients. Relying on ***Magneson***, however, could be a risky tax strategy. The Ninth Circuit in ***Magneson*** stated that the taxpayer's contribution of the Replacement Property to a partnership did not violate the ñhold forò requirement because the taxpayer intended to, and did continue to, ñholdò the Replacement Property through its ownership of a partnership interest. According to the Ninth Circuit, there was a ñmere changeò in the form of the taxpayer's ownership of the Replacement Property. Since ***Magneson*** was decided four tax years before the enactment of Section 1031(a)(2)(D), the IRS might today argue that based upon a step transaction, a ñswap and dropò transaction is in substance a taxpayer's acquisition of a partnership interest as Replacement Property which violates Section 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

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exchange treatment because the Replacement Property had not been ñheldò for a permissible use.

[16] 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 California partnership statutes, which have since been amended.

interest in exchange for real estate, which does not satisfy Section 1031's like-kind property requirement.

**3.2 <u>An Alternative Safer Tax Structure is For the Exchanging Party to Hold the Replacement Property as a Tenant-in-Common After Completing the Exchange.</u>** An alternative and safer tax plan would be for the exchanging party to <u>hold</u> the Replacement Property as a tenant-in-common with the partnership <u>for a substantial time period</u> after completing the exchange and <u>not</u> to immediately contribute the 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 the Replacement Property to the partnership. [17] 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.

## 4. <u>USING SECTION 1031 TO EXCHANGE INTO REPLACEMENT PROPERTY TO BE CONSTRUED IN THE FUTURE</u>.

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 ***<u>not</u>*** like-kind to real property for Section 1031 tax-free exchange treatment.[18]

[17] *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.

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

4.1 **<u>Improvements Constructed in a Deferred Exchange</u>**. In a deferred exchange, a client may acquire Replacement Property to be improved during the 180-day deferral period (or due date of the client's return, if sooner). Under Regs. Section 1.1031(k)-1(m)(3)(iii), improvements not completed before the end of the deferred-exchange period will still be deemed substantially the same as the Replacement Property identified by the client within the 45-day identification period, if: (i) the improved Replacement Property would have been considered substantially the same property as identified by the client, had it been completed when received by the client; and (ii) when the Replacement Property is received, the partially completed improvements constitute the real property under applicable state law.

4.2 **<u>Use a Reverse Tax-Free Exchange to Acquire Future Constructed Improvements</u>**. To construct improvements on the Replacement Property which will qualify for like-kind exchange treatment, sellers often will have the Replacement Property's improvements constructed by an independent party (sometimes known as an ñaccommodatorò), and then at a later date exchange into that Replacement Property which will also include the constructed improvements.

For example, the seller may do a ñreverse tax-free exchangeò by first having the Replacement Property acquired by an independent accommodator (who must <u>not</u> be classified as the seller's agent for tax purposes) and then have this independent accommodator construct the improvements upon the Replacement Property. When the improvements are fully constructed and <u>become part of</u> the replacement real property, the Replacement Property (including the newly constructed improvements) are then exchanged for the Relinquished Property.

For construction exchanges, there are generally two ways to do a reverse exchange: the first way is to qualify under the ñsafe harborò provisions of Rev. Proc. 2000-37; and the second way is to do a ñnon-safe harborò reverse exchange.

4.3 **Doing a "Safe Harbor" Reverse Exchange Under Rev. Proc. 2000-37.** A safe harbor reverse exchange is a ñparking arrangementò whereby the Replacement Property is first acquired or ñparkedò with a third party, who is referred to in Rev. Proc. 2000-37[19] as an ñexchange accommodation titleholderò or ñEAT.ò 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.

In Rev. Proc. 2004-51,[20] the IRS stated that Rev. Proc. 2000-37 does not apply to Replacement Property held in a qualified EAT if the Replacement Property had been owned by the taxpayer within the 180-day period ending on the date of the transfer of the Replacement Property to the EAT. Thus, Rev. Proc. 2004-51 follows the theme of the Tax Court's ***DeCleene***[21] decision. In ***DeCleene*** the taxpayer was denied tax-free exchange treatment when the taxpayer transferred taxpayer-owned land to a third party who then was required to construct the improvements and transfer that land with the newly constructed improvements back to the taxpayer. To avoid the

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[19] 2000-40 I.R.B. 308. The Revenue Procedure allows several alternative safe harbor parking arrangements using a third-party ñexchange accommodation titleholder.ò

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

[21] Donald DeCleene, 115 T.C. 457 (2000).

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.

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 client allowing client loans, leases and indemnification agreements with the EAT that effectively makes the EAT the client's agent. In other words, if all the requirements of 2000-37 are not satisfied (and only a portion of the requirements are satisfied), then the client, by using this Rev. Proc., can unwittingly create an agency relationship with the EAT, thereby denying the client Section 1031 treatment.

One of the difficult requirements of Rev. Proc. 2000-37 (which many clients fail to satisfy) is the requirement that the exchanging party receive the Replacement Property within 180 days of the EAT acquiring title to the Replacement Property. Because of potential construction delays, the EAT likely may take longer than 180 days to construct the improvements.[22] 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 ñagency relationshipò with their EAT, which will in turn cause the client to not satisfy the Section 1031 exchange requirement. Therefore, if the client/seller desires to exchange into improvements which will be

[22] 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.

constructed over a period longer than 180 days, the client/seller should instead choose to do a non-safe harbor construction exchange.[23]

4.4 **Solution of Doing a Reverse Exchange Outside of Rev. Proc. 2000-37 (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 still be structured to qualify under Section 1031 based upon case law.[24] In a typical non-safe harbor transaction, an independent accommodator[25] first acquires the Replacement Property on which the improvements are to be constructed. The accommodator's acquisition financing and the construction financing may come from either the client or the client's lender. In many cases, the client has an option to acquire the Replacement Property after the improvements are constructed in order to complete the exchange. When the client is prepared to sell the Relinquished Property to the third party buyer,

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

24 *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.

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

the client then closes the exchange by using a qualified intermediary to transfer the Relinquished Property to the third party buyer and acquire the Replacement Property from the accommodator.[26]

(a) **Accommodator Must Not Be the Taxpayer's Agent in a Non-Safe Harbor Exchange**. In ***J. H. Baird Publishing Co.***[27], an accommodator who acquired the Replacement Property and constructed improvements thereon on the exchanging party's/taxpayer's behalf was not held to be the taxpayer's ñagent.ò Similarly, in ***Fredericks***[28], an accommodator who acquired the Replacement Property was not classified as the taxpayer's ñagent,ò even though the accommodator was owned and controlled by the taxpayer, who acquired the Replacement Property. On the other hand, in ***DeCleene***[29], the taxpayer was denied tax-free exchange treatment when the taxpayer transferred land to a third party that constructed improvements and transferred the improved land back to the taxpayer. The ***DeCleene*** holding is similar to Rev. Proc. 2004-51, where the IRS ruled that Section 1031 will not apply to taxpayers who already own the Replacement Property that the taxpayer intends to exchange into. The IRS

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26 Generally, a qualified intermediary will not want to serve directly as the accommodator for the construction of the improvements because of liability concerns. A qualified intermediary is a person who enters into a written exchange agreement with the taxpayer and, as required by the agreement, acquires Relinquished Property from the taxpayer, transfers it and acquires like-kind Replacement Property and transfers the Replacement Property to the taxpayer. The qualified intermediary cannot be the taxpayer or the taxpayer's agent, nor be related to the taxpayer or to the taxpayer agent; see Regs. §1.1031(k)-1(g)(4)(iii).

27 See footnote 25 above.

28 See footnote 24 above.

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

in Priv. Ltr. Rul. 200111025 emphasized that for a reverse exchange to qualify under Section 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.***[30] 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.

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

(c) **Evidence an Intent to Achieve a Qualified Section 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 Section 1031 exchange to be realized in a parking arrangement is that: (i) the exchanging party demonstrates an intention to achieve a Section 1031 exchange; (ii) the steps in the various transfers of property are part of an integrated plan to exchange the

[30] 336 U.S. 422 (1949)

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) **Shift the Benefits and Burdens of Ownership to the Accommodator in a Non-Safe Harbor Exchange**. Even though Priv. Ltr. Rul. 2001110025 did not directly apply a ñbenefits and burdensò test to a reverse exchange, the IRS in Field Advice Memorandum 20050203 (discussed below) suggested that such a test should be applied to reverse exchanges. Additionally, the IRS argued in the ***Bartell*** Tax Court case, which is currently pending a decision (discussed below), that this benefits and burdens test should apply to the accommodator. The California State Board of Equalization has also held that a benefits and burdens test should apply to non-safe harbor reverse exchanges.

Accordingly, exchanging parties should attempt to satisfy this ñbenefits and burdensò test. Under this test, the Replacement Property acquisition should be structured to shift the ñburdens and benefitsò of the Replacement Property's ownership (such as having some risk of loss and some profit potential in the accommodator) to the accommodator so that the accommodator, and not the exchanging client, will be recognized as the Replacement Property's owner for tax purposes until the exchange is completed.

How long can you have all of the Replacement Property's appreciation go only to the client and no benefits of ownership go to the accommodator? The accommodator can be given a risk of loss by having the accommodator contribute money to the Replacement Property's acquisition or make an economic outlay for the Replacement Property. Arguably, ten percent invested by the accommodator should be enough of any investment. What about an investment of only three to five percent of the Replacement Property's cost?

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

(e) **IRS Field Advice Memorandum on Non-Safe Harbor Reverse Exchanges**. The IRS chief counsel issued a Field Advice Memorandum FAA20050203, which discussed a construction exchange predating Rev. Proc. 2000-37. This Field Advice Memorandum discusses which factors evidence the accommodator's beneficial ñownershipò of the Replacement Property. The IRS concludes that the taxpayer (and not the accommodator) had beneficial ownership of the Replacement Property for tax purposes (thus causing the taxpayer to not qualify under Section 1031), even though the accommodator had legal title to the Replacement Property. This Field Advice Memorandum found that the taxpayer (and not the accommodator) had all of the economic benefits and economic burdens of ownership. The IRS found that the taxpayer bore the risk of economic loss and physical damage to the property and received the benefits of profits from the property's operations and appreciation, rather than the accommodator. The accommodator invested no money in the Replacement Property and the accommodator paid none of the costs of construction.

(f) **IRS Continues to Study the Reverse Exchange Area**. The IRS in issuing Rev. Proc. 2004-51 stated that the IRS continues to study parking transactions, including transactions in which a person related to the taxpayer: (i) transfers a leasehold in land to an accommodation party; (ii) the accommodation party makes improvements to the land; and (iii) the accommodation party then transfers the leasehold with the improvements to the taxpayer in exchange for other real estate. Thus, the IRS continues to study construction exchanges and future IRS pronouncements on reverse exchanges are probable.

(g) **<u>There Has Been Pending for Decision a Tax Court Case on Construction Exchanges</u>**. Currently, the ***Bartell*** Tax Court case (if decided), dealing with construction exchanges, has been fully briefed, and argued over six years ago. The ***Bartell*** case (if and when decided) should determine if the accommodator must invest money in the Replacement Property and assume the economic burdens of constructing improvements on the Replacement Property.

## 5. <u>PROPERTY BEING EXCHANGED MAY INCLUDE BOTH REAL ESTATE AND PERSONAL PROPERTY.</u>

A basic Section 1031 exchange requirement is that the property sold (the ñRelinquished Propertyò) and the property received (the ñReplacement Propertyò) must be ñlike-kind.ò Generally, real estate is classified as like-kind to other interests in real estate. The Regulations state that the words ñlike-kindò, in the case of real estate, refers to the ñnature or character of the property and not to its grade or quality.ò[31]

In the case of real estate, land can be exchanged for improved real estate and a 30-year or more leasehold can be exchanged for a fee interest in real estate.[32]

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[31] Treas. Regs. §1.1031(a)-1(b). However, domestic real estate <u>cannot</u> be exchanged for foreign real estate under §1031(h).

[32] Treas. Regs. §1.1031(a)-1(c). Options to renew a lease are counted in determining

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, ñlike-classò personal property to the Relinquished Property's tangible personal property.[33] Depreciable tangible personal properties are of a like-class if they are within the same ñGeneral Asset Classò or ñProduct Class.ò Product classes are based on the North American Industry Classification System (ñNAICSò) under Regs. §1.1031(a)-2(b)(3).

Real estate cannot be exchanged tax-free for personal property. Unfortunately, some owners unwittingly violate this like-kind requirement by failing to recognize that personal property is often included as part of the building being exchanged (such as refrigerators, washers and moveable stoves in apartment buildings), or where cost segregation studies have been performed.[34]

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 Properties Are "Like-Kind".** Exchanging parties sometimes mistakenly believe that the ñincidental property exception,ò under Reg. Section

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whether a lease has 30 years or more to run under Rev. Rul. 78-72, 1978-1 CB 258.

[33] *See* Treas. Regs. §1.1031(a)-2(b)(1). When exchanging multiple classes of personal property, then 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. Regs. §1.1031(j).

[34] 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.

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 Section 1031.[35] However, this ñincidental property exceptionò 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 like-kind personal property must also be received in the exchange in order to satisfy Section 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 recover period for commercial real property or the 27½ year straight line period for residential real property.[36] Reclassified personal property can be amortized and depreciated over shorter time periods (usually five or seven years) using the double declining method. [See §168(c).] Most personal property associated with real estate will

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[35] For purposes of the deferred-exchange rules, ñincidental propertyò 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 ñincidental propertyò must relate to the larger item of property.

[36] The IRS in Rev. Rul. 2003-54, I.R.B. 2003-23, explained how to classify property as personal property. ñPersonal propertyò includes tangible personal property as defined in the former investment tax credit rules of Treas. Regs. §1.48-1(c). Rev. Proc. 87-56, 1987-2 C.B. 674 sets forth the class lives of various types of property. For an example of IRS approvals of cost segregation studies, see the IRS internal memorandum issued on December 6, 2003 on ñPlanning and Examination of Cost Segregation Issues in Restaurant Business.ò

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.[37] These cost segregation studies are based upon the tax rules outlined in ***Hospital Corp. of America***.[38] The reclassified personal property is then depreciated over a shorter recovery life than the real property.[39] Specialized refrigeration, restaurant, medical, manufacturing or computer equipment, and the plumbing, electrical, ventilation, and flooring systems in connection with specialized systems may be classified as personal property to be depreciated over short recovery periods.[40] Also, office cabinetry, carpeting, special lighting fixtures,[41] gasoline pump canopies[42] and retail signs[43] may

[37] 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.

[38] 109 T.C. 21 (1997), *nonacq*. 1999-35 I.R.B. 314.

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

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

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

[42] 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 classified as personal property to be depreciated over a much shorter time than real estate. In certain real estate projects such as a shopping center, the project's name may have value to be amortized over 15 years under Section 197.

5.4 **<u>Recapture Rules of Sections 1245 and 1250 Can Also Trigger Gain On An Exchange.</u>** In addition to satisfying the Section 1031 ñlike-kindò property rules, in order for the gain on exchanged Section 1245 property to be deferred, the provisions of Section 1245(b)(4) must be complied with. Section 1245(b)(4) states that when Section 1245 property is exchanged, the property's Section 1245 recapture will <u>not</u> be recognized <u>only</u> to the extent like-kind Section 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 Section 1245 property. Thus, when real estate with Section 1245 property (created by cost segregation studies or otherwise) is exchanged, then Section 1245 property must be part of the Replacement Property to avoid gain recognition under Section 1245(b)(4).

Similarly, Section 1250(d)(4) recaptures excess depreciation deductions over straight-line deductions when improved real property is exchanged. For example, this issue can arise when 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, Section 1250(d)(4) will not be an issue since the Replacement Property improvements should protect recognizing gain under Section 1250(d)(4).

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be recovered over five or nine years, depending on the depreciation system used.

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

5.5 **<u>Solutions Where the Relinquished Property Contains Personal Property.</u>** Even minor amounts of personal property involved in real property exchanges can trigger gain recognition. To meet the Section 1031 ñlike-kindò 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.[44]

One tax strategy used by some exchanging parties to avoid recognizing gain when only the Relinquished Property (or 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, as well as include a provision in the property's sales agreement with the Relinquished Property's buyer which states that any personal property has no value (however, the Relinquished Property's buyer may refuse to include this provision, instead preferring a high value for its purchased personal property to increase the buyer's personal property's tax basis, and thus the buyer's own depreciation deductions).

An alternative tax strategy for exchanging into like-kind property following a cost segregation study is to argue that the <u>reclassified personal property</u> remains ñreal propertyò for purposes of the Section 1031 like-kind exchange rules based upon the definition of real property

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[44] 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.

under California state law. Exchanging parties can argue that reclassified ñpersonal propertyò is still ñreal estateò for purposes of the §1031 like-kind exchange rules based upon the fact that it is only the special federal statutory tax rules under §§168 and 167, that allow parts of buildings to be classified as personal property for cost segregation purposes. For §1031 purposes, however, state law determines if property is personal or real.[45] California law classifies items (including prior personal property) which is permanently affixed to the building as ñreal property.ò [See California Civil Code §658.]

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45 *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. ***Peabody*** supports the tax position that personal property attached to real estate and which becomes real property for state law purposes is ñlike-kindòto other Replacement Property real property.

The IRS reaffirmed that the determination of whether property is real or personal is made under state law in Priv. Ltr. Rul. 200631012. In this Private Letter Ruling 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 Priv. Ltr. Rul. 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.

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

## 6. **<u>HOW TO USE THE SECTION 1031 LIABILITY RULES TO HAVE THE EXCHANGING PARTIES RECEIVE CASH TAX FREE.</u>**

6.1 **<u>Section 1031 Rules on Indebtedness.</u>** Gain on a Section 1031 exchange is recognized to the extent of the cash and the fair market value of other property received (known as ñbootò).[46] If the Relinquished Property is subject to a deed of trust, 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 ñbootò <u>received</u> by the exchanging party under Section 1031.[47]

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.[48] The seller is permitted to 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.[49]

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

[47] *See* I.R.C. §1031(b) and Treas. Regs. §1.1031(b).

[48] Treas. Regs. §1.1031(b)-1(c).

[49] *See* Priv. Ltr. Rul. 9853028 and TAM 8003004 along with ***Barker***, 74 T.C. 555 (1980).

Replacement Property indebtedness for purposes of the ñnetting rulesò 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 seller/client in an exchange cannot be netted against the consideration given in the form of assumed liabilities on the Replacement Property.[50]

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

6.3 **Consequences of Reducing a Partner's Share of Partnership Liabilities When Doing an Exchange.** What are the tax consequences 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 partnership. Any decrease in a partner's share of liabilities is considered as a distribution of money to the partner by the partnership under Section 752(b). On a distribution of property to a partner, that partner must recognize gain to the extent that such deemed distribution exceeds such

[50] Treas. Regs. §1.1031(d)-2.

partner's adjusted basis in its partnership interest immediately before the distribution [see Section 731(a)]. Thus, on the first leg of an exchange when the Relinquished Property (which is encumbered by a loan) is conveyed to the qualified intermediary, there is a reduction in the partner's share of liabilities. Upon the second leg of the exchange, where there is the acquisition of the Replacement Property subject to a loan, there would be an increase in the partner's share of liabilities.

In Rev. Rul. 2003-56 the IRS ruled on the tax consequences of partnership liabilities in Section 1031 exchanges that occur over two taxable years. This Revenue Ruling states that if the partnership enters into a deferred like-kind exchange in which the Relinquished Property subject to a liability is conveyed in year one, and Replacement Property subject to a liability is acquired in year two, the liabilities are netted for purposes of the Section 752 rules.[51] Similarly, under Rev. Rul. 2003-56, if the Relinquished Property has relief of liability in excess of the Replacement Property's liabilities, the resulting gain is 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 exchange covering two taxable years is recognized as taxable income in year two (and not in year one).

6.4 **Client Can Receive Cash Tax Free in a Section 1031 Exchange By Refinancing the Relinquished Property Before an Exchange.** Sellers of real estate 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 ñboot.ò However, instead of receiving taxable cash as

[51] 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.

part of the exchange, the client/seller could refinance the Relinquished Property before the exchange and receive these refinancing loan proceeds tax free.[52]

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

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

6.5 **Client Can Receive Cash Tax Free in a Section 1031 Exchange By Refinancing the Replacement Property After an Exchange.** An alternate tax strategy is for the seller to first complete the tax-free exchange and then refinance the Replacement Property at a later date after the exchange closes. The seller is able to receive these refinancing loan proceeds tax free. The refinancing of the Replacement Property after completing the exchange allows the taxpayer to withdraw tax free the equity inherent in the Replacement Property. In order to avoid an IRS challenge that the financing proceeds received from the Replacement Property are ñbootò to the taxpayer, 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 should be done by a separate loan escrow and separate closing statement.

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

6.6 **<u>Clients Must Avoid a Step Transaction When Refinancing the Property.</u>** The refinancing of the Replacement Property after the exchange or the Relinquished Property before the exchange should not be tied to the exchange by written or oral understandings or prearranged loans, in order to avoid IRS assertions that the received loan proceeds are instead taxable ñbootò from the Section 1031 exchange under a step-transaction theory.[53]

## 7. <u>HOW TO AVOID APPLICATION OF THE RELATED PARTY EXCHANGE RULES</u>.

Clients who have related legal entities owning real estate might want to exchange this real estate between their legal entities 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.

Properties <u>may be exchanged tax free</u> between related parties.[54]

> **Example**: 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 Section 1031 tax-free 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 requisite two (2) year holding period.

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[53] In Priv. Ltr. Rul. 200019014, the IRS ruled that liabilities placed on Replacement Property which do not have a bonafide business reason apart from the exchange, may <u>not</u> be applied under the liability ñnettingò rules.

[54] *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.

Section 1031(f) imposes a two-year holding period requirement for related parties engaging in a Section 1031 exchange. Basically, Section 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 Section 1031 tax-free exchange treatment.[55] Thus, if either related party to the exchange disposes of the property which they received in the exchange before the end of this two-year holding period, any gain or loss which would have been recognized in the exchange by either party will be recognized on the date that the disqualifying disposition occurred.[56]

7.1 **Purpose of the Section 1031(f) Related Party Rules.** The Section 1031(f) related party rules were added to the Internal Revenue Code to prevent taxpayers from exchanging low-basis property for high-basis property to avoid the recognition of gain on subsequent property sales or to accelerate a loss on retained property.[57] Without the related party rules of Section 1031(f), taxpayers could exchange low basis Relinquished Property with a related party who had high-basis Replacement Property, and the related party could then sell the Relinquished Property (which acquired a new high tax basis in the exchange) and receive the sale's cash proceeds tax

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

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

[57] 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 ñcashed outò of the investment, and thus §1031 non-recognition treatment should not apply. S. Fin. Rep. No. 56, 101st Cong., 1st Sess. 151 (1989).

free.[58] This would result in the related party cashing out the Relinquished Property investment tax free. Section 1031(f) was designed by Congress to prevent this result.

7.2 **<u>Section 1031(f) Has Broad Application and Applies to Indirect Transfers Between Related Parties.</u>** The Section 1031(f) related party rules cover ñindirectò transfers between related parties. This ñindirectò 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 Section 1031 exchange.[59]

In ***Teruya Brothers, Ltd.***[60] the Ninth Circuit affirmed the Tax Courtôs decision that using a qualified intermediary to purchase Replacement Property from the exchanging party's related entity was in fact structured to avoid the ñpurposesò under Section 1031(f)(4). In ***Teruya Brothers, Ltd.*** there were two similar exchange transactions. In both exchanges the taxpayer first transferred Relinquished Properties to a qualified intermediary. The qualified intermediary then proceeded to sell these Relinquished Properties to unrelated third parties. However, the qualified intermediary then used the Relinquished Properties' sales proceeds (along with additional monies contributed by the taxpayer) to purchase Replacement Property from the taxpayer's subsidiary corporation, which was related to the taxpayer. This subsidiary corporation had large NOLs. The subsidiary corporation retained the Replacement Property's cash sales proceeds and used the

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

[59] Furthermore, §1031(f)(4) states that transactions structured to <u>avoid</u> the ñpurposesò of the related party rules of §1031(f) will <u>not</u> qualify for §1031 tax-free exchange treatment.

[60] 124 T.C. 45 (2005), affôd 580 F.3d 1038 (9th Cir. 2009).

NOLs to shelter the gain from one of the Replacement Property's sale.[61] The Tax Court stated that Section 1031(f) should apply to deny Section 1031 treatment where the Relinquished Property is transferred to an unrelated party (*i.e.*, here the unrelated qualified intermediary), who then exchanges this property with a related party within the two-year period. The Tax Court held that these transactions are ñeconomically equivalentò to direct exchanges of properties between related parties. The economic result in ***Teruya Brothers, Ltd.*** was that the Relinquished Property investment was ñcashed outò 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 ñpurposesò of the Section 1031(f) related party rules and, thus, will not qualify for Section 1031 tax-free exchange treatment. The taxpayer argued that the exchange did not have as one of its principal purposes the ñavoidance of Federal income tax,ò since there was recognized gain on the sale of the Replacement Property. However, this argument was unsuccessful since the subsidiary related party had a large NOL. In summary, the taxpayer in ***Teruya Brothers, Ltd.*** was denied Section 1031 like-kind exchange treatment based upon Section 1031(f)(4) in that the taxpayer failed to satisfy Section 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 IRSôs position that every deferred exchange between related parties involving a qualified intermediary should be recast as a direct exchange that fails under Section 1031(f)(4) if that exchange would otherwise fail under Section 1031(f)(1). Thus, it is possible to utilize a qualified intermediary in exchanges between related parties and not automatically violate Section 1031(f)(4).

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[61] 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.

Similar to the facts in ***Teruya Brothers, Ltd.***, is IRS Rev. Rul. 2002-83[62] where the property owner transferred its Relinquished Property to a qualified intermediary who then transferred the Relinquished Property to an unrelated third party for cash sales proceeds. The qualified intermediary then utilized the cash proceeds from the Relinquished Property's sale to enter into a deferred exchange to acquire the Replacement Property from a 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 property owners exchanging low basis property would not receive Section 1031 tax-free exchange treatment, since the related party disposed of the Replacement Property for cash within the required two-year holding period. This exchange, which was done though a qualified intermediary, is characterized by the IRS as being a prohibited disposition of the Replacement Property by the related party within the required two-year holding period. Rev. Rul. 2002-83 can be interpreted to mean that if a qualified intermediary is utilized in connection with exchanges between related parties and either related party receives cash from that exchange, then the Section 1031(f) related party rules apply to prevent tax-free exchange treatment.[63] However, this broad IRS interpretation of Section 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 the

[62] 2002-49 I.R.B. 927.

[63] *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.

correct related entity. Based on the IRS's position in Rev. Rul. 2002-83, Section 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.***,[64] another related taxpayer case, 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 Section 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 sold several years ago. 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 Section 1031(f) and thereby there was no like-kind exchange treatment under Section1031(f)(4). The Tax Court found that the taxpayer failed to evidence that "tax avoidance" was not one of the principal purposes of this exchange between related parties. This taxpayer did not meet the non-tax avoidance exception of §1031(f)(2)(C). The Eleventh Circuit affirmed the Tax Court in ***Ocmulgee Fields, Inc.*** 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 found that this exchange had the economic consequences of a direct related party exchange under Section 1031(f)(1).

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[64] 132 T.C. 105 (2009), *aff'd* , 613 F.3d 1360 (11th Cir. 2010).

7.3 **How to Avoid Violating the Section 1031(f) Related Party Rules When Using a Qualified Intermediary.** One solution to avoid the 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 Priv. Ltr. Rul. 200440002 held that where related parties successfully engaged in a Section 1031 exchange using a qualified intermediary and neither party ñcashed outò of its respective exchanged real property, no gain was recognized.

Similarly, the IRS in Priv. Ltr. Rul. 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 ñcashed outò their investments in their real properties. In Priv. Ltr. Rul. 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 Section 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 Exchange Involving Related Parties.** A related party to the taxpayer may first acquire the Relinquished Property from that taxpayer; and second the taxpayer, in an exchange, acquires the Replacement Property from an unrelated person.

Commonly a person will sell their Relinquished Property to a related party for cash and will then use that cash to consummate an exchange into Replacement Property from an unrelated party. Subsequent to completing this exchange the related party (that had acquired the Relinquished Property) then sells that Relinquished Property within the prohibited 2-year period.

Normally, the Section 1031(f) related party rules are to prevent the taxpayer from receiving the Replacement Property from a related party. In the above illustration, the related party is acquiring the Relinquished Property from the taxpayer/seller, and then the taxpayer acquires the Replacement Property from an unrelated third party. Thus, this transaction does not ñavoidò the Section 1031(f) rules pursuant to three IRS Private Letter Rulings released in 2007[65], and the exchange qualifies under Section 1031. In several Private Letter Rulings, the IRS has allowed unlimited exchanges of real properties, where each Replacement Property is held for at least two years (and any cash received is not material).

7.5 **Exchanging Properties Between Related Family Members.** Many times families with large real estate holdings need to split up these holdings in a tax-free manner. One tool to accomplish this split up is to do Section 1031 tax-free exchanges. However, an issue that often arises is that these family members are related to each other for purposes of the Section 1031(f) related party rules. To avoid the application of the Section 1031(f) related party rules to family split-ups, demonstrate that neither the exchange nor a later disposition of the properties by

[65] See Priv. Ltr. Ruls 200709036; 200712013; and 200728008.

the related family members ñhad as one of its principal purposes the avoidance of federal income tax.ò [See Section 1031(f)(2)(C)].

In Priv. Ltr. Rul. 200706001, the IRS held that the Section 1031(f)(2)(C) non-tax avoidance exception to Section 1031(f) applied where there was no shifting of tax basis from one property to another property. The facts in Priv. Ltr. Rul. 200706001 was 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 Section 1031 exchange.

In Priv. Ltr. Rul. 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 Priv. Ltr. Rul. 200730002 that there was a lack of tax avoidance motive under Section 1031(f)(2)(C) based on 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 taxpayer holding either an entire interest in a single property or a larger undivided interest in any of such properties.[66]

Similarly, the IRS held in Priv. Ltr Ruls 200919027 and 200920032 that an inter-family transaction was not structured for purposes of avoiding Section 1031(f), and therefore did not apply Section 1031(f)(4).

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

8. **<u>AVOIDING THE PROBLEM OF THE CLIENT NOT HAVING ENOUGH TIME TO IDENTIFY AND CLOSE ESCROW ON THE REPLACEMENT PROPERTY IN A DEFERRED TAX-FREE EXCHANGE</u>.**

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

8.1 **<u>Rules For Identifying the Replacement Property.</u>** Sellers can identify: (i) three alternative Replacement Properties within 45 days of the Relinquished Property's sale without regard to the fair market value of the Replacement Properties; or (ii) any number of Replacement Properties as long as the aggregate fair market value as of the end of the 45-day identification period does not exceed 200 percent of the aggregate fair market value of the Relinquished Property.[67] 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

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[67] *See* Treas. Regs. §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 §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.

Replacement Properties before the end of the Exchange Period.[68] Note that the IRS has taken the position that Section 7503 (relating to time for performance of acts when the last day for the performance falls on a Saturday, Sunday or legal holiday) does <u>not</u> apply to the Identification Period calculations. This IRS position is questionable. Caution, however, dictates that taxpayers should err on the side of caution and have their Exchange Period and Identification Period end on the business day immediately preceding such periodõs end date if that end date falls on a Saturday, Sunday or legal holiday.

8.2 **<u>Do Not Commit Tax Fraud By Backdating Documents.</u>** As some exchanging clients find themselves approaching the 45-day identification deadline without having yet identified their Replacement Property, they may be tempted to ñbackdateò 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***,[69] 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 **<u>How Clients Can Obtain More Time to Identify the Replacement Property.</u>** One technique for a client to gain more time to identify the Replacement Property is to <u>delay</u> 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 seller an option to extend the Relinquished Property's escrow closing date.

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

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

Another alternative solution to extend the commencement date of the 45-day period is for the seller to first lease the Relinquished Property to the buyer, with the buyer purchasing the Relinquished Property at a later date.[70]

8.4 **<u>The 45-Day and 180-Day Time Periods Can Be Extended in the Event of a Presidentially Declared Disaster.</u>** Taxpayers who are ñaffectedò by a Presidentially declared disaster or other event (such as terrorism or combat) and have difficulty because of the event in meeting the 45-day and 180-day deadlines may obtain an extension of 120 days under Section 7508 and 7508A and Rev. Proc. 2007-56.[71] 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.[72] The exchanging client only qualifies for this postponement if: (i) the Relinquished Property was transferred <u>on or before</u> the date of the Presidentially declared disaster[73], and (ii) the taxpayer is ñaffected.ò ñAffectedò 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.[74]

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[70] The lease should be at fair rental value and terms in order to avoid the IRS trying to recharacterize the lease as a sale for tax purposes.

[71] See Regs. §301.7508A1(b)(1).

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

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

[74] See Reg. §301.7508A-1(d)(1) for other ways the taxpayer is an ñaffected taxpayer.ò

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

Some clients engaging in a deferred tax-free exchange leave millions of dollars in the name of the qualified intermediary who is to complete their exchanges. Surprisingly, property owners who are careful to obtain title insurance policies, perform due diligence on the Replacement Property, and verify the credit worthiness of their tenants often fail to verify the financial viability of their qualified intermediary. Exchanging sellers should investigate the financial condition of the qualified intermediary which is holding and investing their exchange funds.[75]

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 Relinquished Property's Sales Proceeds in a Separate Escrow or Trust Account.** Most qualified intermediaries do not put the exchange funds into a separate trust or escrow account, which could protect these funds from the qualified intermediary's bankruptcy or creditors. However, the Section 1031 Regulations permit the Relinquished Property's cash sale's proceeds to be held in an escrow or trust account for which the Replacement Property is later purchased.[76] The exchange documents must, however, limit the exchanging

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[75] The Regulations prohibit the taxpayer or 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 single 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.

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 intermediary went bankrupt or failed to perform, then the taxpayer does not receive §1031 tax-free exchange treatment.

[76] Treas. Regs. §1.1031(k)-1(g)(3).

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 **<u>Solution to Use a Deed of Trust, Letter of Credit, Guarantee, or Qualified Escrows and Trusts as Security.</u>** 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.[77]

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.

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 owner.[78]

The taxpayerös Qualified Intermediaryös duties are permitted to be secured by a cash equivalent held in a qualified escrow or in a qualified trust. To be a qualified escrow holder or trustee that person must <u>not</u> be a taxpayer or a ñdisqualified person,ò and the taxpayerös 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 specific items specified in Reg. §1.1031(k)-1(g)(3).

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77 Treas. Regs. §1.1031(k)-1(g)(2).

78 Payment of the letter of credit proceeds to the exchanging party will result in the exchanging party receiving cash (*i.e.*, ñbootò), 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).

## 10. **USING SECTION 1031 WITH A PERSONAL RESIDENCE.**

A residence (whether a principal residence or a vacation home) held solely for personal use will not qualify for Section 1031 tax-free exchange treatment. To qualify under Section 1031, the residence must have been ñheldò for investment or productive use in a trade or business.

### 10.1 **Solution of Converting a Personal Residence to Investment Property.** A personal residence can be converted into rental or investment property and then exchanged tax-free under Section 1031. Unproductive real estate held for future use or future realization of the increment in value is deemed held for investment under the Treasury Regulations.[79]

In ***Moore***[80] 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 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 ñinvestment purposeò cannot just be one of many purposes for which the taxpayer held the vacation home. In ***Goolsby***[81]***,*** the Tax Court held that there was no Section 1031 tax-free treatment where the taxpayer moved into, and lived in, the Replacement Property after failing to rent that Replacement Property 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 the Replacement Property never researched rental opportunities for the Replacement Property, the taxpayerôs only effort to show that the Replacement Property was held

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79 Treas. Regs. §1.1031(a)-1(b).

80 See T.C. Memo 2007-134.

81 T.C. Memo 2010-64.

for investment was by placing an advertisement in a newspaper for several months, the taxpayer moved into the Replacement Property for personal use two months after acquiring the Replacement Property, and the taxpayer pulled building permits for finishing the basement of the Replacement Property within a few weeks of purchasing the Replacement Property.

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 for Section 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 Section 1031 if that dwelling unit meets the <u>qualifying use standard</u> test described as follows: A dwelling unit that is the <u>Relinquished Property</u> 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 Section 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 <u>after</u> 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, <u>and</u> 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.

10.2 **Apply Both Sections 1031 and 121 to Sell a Prior 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 Section 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 Section 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.[82]

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

- To use Section 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 before applying Section 1031. The taxpayer first calculates the excluded gain under Section 121 ($250,000 for an individual return and $500,000 for a joint return), and then any remaining gain is deferred by applying Section 1031.

[82] 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. Prior to Rev. Proc. 2008-16 many taxpayers took the position that their vacation homes were investments where there was substantial appreciation in value and the taxpayer used that vacation home a de minimus amount of time during the year.

- The gain that is excluded by applying Section 121 does not include gain attributable to prior depreciation deductions. Pursuant to Section 121(d)(6), the gain which is excluded under Section 121 cannot apply to gain attributable to depreciation. However, the client can still defer this ñdepreciation gainò pursuant to Section 1031.

- If the client receives ñbootò (such as cash), then the client can exclude gain represented by that boot under Section 121. The client who receives ñbootò such as cash in the sale of the residence that is subject to both Section 121 and Section 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 Section 121. Therefore, the client can exclude their gain under Section 121 ($500,000 for a client filing a joint return) and still receive cash. This tax result is much more favorable than solely applying Section 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 Section 121. Any gain excluded under Section 121 is deemed to have been ñrecognizedò effectively by the client in order to determine the client's tax basis in the Replacement Property received in the Section 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 Section 121 allows the client to increase their property's basis without having to report that basis increase as recognized gain.

10.3 **Example of Applying Section 121 to an Investment Residence Being Exchanged Under Section 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 2002 to 2004. From 2004 until 2006, the client rents out the residence to tenants and claims depreciation deductions of $20,000. In 2006 the client exchanges the house for $10,000 in cash and a townhouse with a fair market value of $460,000 that the client intends to rent out. The client realizes gain of $280,000 on the exchange ($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 Sections 121 and 1031. Section 121 does not require that the residence be used as the client's principal residence on the sale or exchange date. Because the client owned and used the residence as the client's principal residence for at least two years during the five-year period prior to the exchange, the client may exclude gain under Section 121. Because the residence is investment property at the time of the exchange, the client may also defer gain under Section 1031. Under Rev. Proc. 2005-14[83], the client applies Section 121 to exclude $250,000 of the $280,000 gain before applying the non-recognition rules of Section 1031. The client may defer the remaining $30,000 of gain under Section 1031, including the $20,000 gain attributable to depreciation. Although the client receives $10,000 cash (ñbootò), the client is not required to recognize this $10,000 of cash as gain because the boot is taken into account for purposes of Section 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 Section 121 of $250,000, and reduced by the $10,000 cash that the client receives).

10.4 **Selling A Personal Residence Which Was Previously Received in a Section 1031 Exchange.** The American Jobs Creation Act of 2004 amended the Section 121 rule of when

[83] IRB 2005-7.

a taxpayer can exclude gain from the sale of their principal residence where such residence was acquired in a like-kind exchange. The Section 121 gain exclusion does not apply if the principal residence was acquired in a Section 1031 exchange in which any gain was not recognized within the five years prior to the principal residence's sale.[84]

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84 See §121(d)(10).