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Like-Kind Exchanges and Avoiding Dealer Status (PowerPoint)

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LIKE-KIND EXCHANGES AND AVOIDING DEALER STATUS

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Avoiding Dealer Status
Sale Versus Other Income

- A sale for income tax purposes includes a transaction that is in substance a sale.
  - State law characterization is not controlling.
  - Federal income tax principles apply in determining substance.

- A sale is not:
  - Performance of services.
  - Interest.
  - Rent or royalty.
Character of Income or Loss from Sale

▷ Capital gain or loss.
  ▷ From sale of asset held for investment.
  ▷ Can be long-term or short-term.

▷ Section 1231 gain or loss.
  ▷ Gain or loss from the sale of a depreciable asset or land held for use in a trade or business.
  ▷ Asset must be held for more than one year.
Character of Income or Loss from Sale

- Ordinary income or loss.
  - Includes gain or loss from the sale of:
    - Personal property that is inventory; and
    - Real or personal property that is “held primarily for sale to customers in the ordinary course of [a] trade or business.” See §1221(a).

- Other statutory rules:
  - Depreciation recapture, e.g., §1245 and §1250.
  - Other ordinary income provisions, e.g., §707(b)(2), §1239 and §1260.

- Judicial decisions.
Determination of Dealer Status

- The determination of whether property is held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business ("dealer property") is a factual determination.
  - Based on an analysis of all the surrounding facts and circumstances.

- The courts generally have considered a number of factors in determining whether real property is "dealer property."
  - No bright line test – it is unclear:
    - Which factors are to be accorded the greatest weight.
    - The extent to which activity of affiliates are imputed to the taxpayer.
Determination of Dealer Status

- Common law factors:
  - Mode of and purpose underlying the acquisition of the property.
  - Holding period for the property.
  - Nature and extent of property sales and/or marketing efforts of the taxpayer.
  - Nature and extent of promotional selling activities, inclusive of broker sales.
  - Number, extent, frequency, and substantiability of property sales.
Determination of Dealer Status

- Common law factors (continued):
  - Purpose underlying a sale or other disposition of property.
  - Extent and timing of capital improvements and betterments.
  - Extent of subdivision, development, and advertising activities.
  - Character and degree of supervision of the sales representatives, if any.
  - Time and effort expended by the taxpayer and devoted to sales.
Determination of Dealer Status

 Courts emphasize that no one factor is determinative and that each case must be considered based upon the particular facts applicable to a given situation.

 Courts have not consistently applied the factors in the same manner.

 Courts have acknowledged that these determinations are inherently subjective and inexact.


 U.S. v. Winthrop, 417 F.2d 905 (5th Cir. 1969).

 Fargo v. Commissioner, TC Memo 2015-96.
Determination of Dealer Status

- Other factors to consider:
  - Explanation of change in intent from hold to sell.
  - Liquidation of investment?
  - Statements regarding intent to hold versus sell in:
    - Purpose clause in LLC or partnership agreement.
    - Offering documents.
    - Investment committee minutes.
    - Financial projections.
  - Term of acquisition financing – short-term versus permanent.
  - Business code in tax returns.
  - Characterization on tax balance sheet.
  - Characterization and statements in financial statements.
Section 1031 – General Rules
General Rules

➢ To qualify as tax-free under §1031:
  ➢ relinquished ("old") property must be exchanged for
  ➢ replacement ("new") property of "like kind" held for
    investment or use in a trade or business.
➢ Can be viewed as three separate requirements:
  ➢ Exchange.
  ➢ Like kind.
  ➢ Held for investment or use in a trade or business.
Gain realized in a like-kind exchange is still recognized (taxable) to the extent taxpayer receives cash or other property that is not of a like-kind ("boot").

Any excess of debt on relinquished property over debt on replacement property ("debt relief") is boot.

Boot from debt relief is offset by cash given.

Replacement property takes a substituted basis.

Adjusted for difference in debt on relinquished property versus debt on replacement property and other boot.
Exchange Requirement

- An “exchange” is a direct exchange with one party.
  - Sale for cash followed by reinvestment of cash in like-kind property does not qualify under §1031.
    - Crandall v. Commissioner, TC Summary Opinion 2011-14 (failure to use qualified intermediary or qualified escrow, discussed below, resulted in actual receipt).
  - Buyer of relinquished property is unlikely to hold property that taxpayer wishes to acquire.
  - Long ago, taxpayers began to use a “straw” to perform the exchange.
Qualified Intermediary

The exchange party cannot be the “agent” of the taxpayer.

- If property is exchanged through an agent, the agent’s receipt of cash from sale of relinquished property is imputed to the taxpayer.
  - Taxpayer’s receipt of cash will generally bust the exchange.

- Reg. §1.1031(k)-1 provides a “safe harbor” for exchanges through a qualified intermediary (“QI”).
  - Certain security or guarantee arrangements, a qualified escrow account or qualified trust are also permitted and can be combined with QI arrangement; Reg. §1.1031(k)-1(g).

- Taxpayer’s receipt of cash may bust the exchange.
  - But see *Peter Morton v. US*, 98 Fed. Cl. 596 (Ct. Fed. Cl. 2011) (accidental actual receipt by taxpayer through no fault of taxpayer did not render the transaction taxable).
Qualified Intermediary

Under the “safe harbor” regulations, the QI cannot be a “disqualified person.”

Reg. §1.1031(k)-1(k): A disqualified person is one who:

- has been taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker in the two years before transfer of first relinquished property; or
- is related to the taxpayer or any service provider prohibited above using 10% test under §267(b) or §707(b).

Taxpayer’s son was a disqualified person even though son was an attorney.


Rulings on “disqualified person.”

PLRs 200338001, 200803003, 200803014, 201030020, 201234018, 201308020 and 201332010.
Like-Kind Real Estate

“Like kind” for real estate is defined very broadly.
- Real estate is generally of “like kind” to other real estate, e.g., vacant rural land for office building.
- Past rulings looked to state law definition.
- However, current IRS view is that state law property classification does not control whether exchanged properties are considered of “like kind” for purposes of § 1031.
- Rather, federal income tax law controls, and requires consideration of all facts and circumstances, including state law and federal tax law classifications, as appropriate.
- ILM 201238027.
- Exchange of cell towers for fiber optic and copper cable signal distribution assets. See PLR 201706009.
- Reg. §1.856-10 defines real property for REIT purposes.
  - But does not apply outside the REIT rules unless expressly incorporated.
Like-Kind Real Estate

- Lease Exchanges - fee title for 30-year+ leasehold.
  - Reg. §1.1031(a)-1(c); example in PLR 8453034.
  - Renewal options count toward 30 years.
- Exchange of tenant’s interest in lease with remaining term of less than 30 years can be exchanged for tenant’s interest in another lease with remaining term of less than 30 years.
- Exchange of leasehold interest in real property with 21 years remaining for fee interests in real property did not qualify as a like-kind exchange.
Like-Kind Real Estate

- Other examples of lease exchanges.
  - Tenant’s interest in building on land already owned by taxpayer was replacement property of like kind under §1033.
  - Tenant’s interest in newly-issued lease may qualify as replacement property.
    - PLR 200842019.
    - See also Rev. Rul. 66-209, 1966-2 CB 299.
    - Consider impact of §467.
    - Consider use of EAT (defined below).
Like-Kind Real Estate

- Other examples of "like kind" for real estate.
  - Development rights for fee interest in real property.
    - Approved in PLR 200805012.
    - Approved again in PLR 200901020.
    - Development rights vary widely under state and local law.
  - Exchange of cellular tower properties for certain cable telecommunications properties.
    - Approved in PLR 201706009.
Not Like-Kind Real Estate

Not all real estate is of “like kind.”

- Construction of new building on land already owned by taxpayer.
  - *Bloomington Coca-Cola Bottling Co. v. Commissioner,* 189 F.2d (7th Cir. 1951)
  - Rev. Rul. 67-255.
- Fee title for 50-year water rights not of like kind.
- U.S. and foreign real property are not of like kind.
  - §1031(h)(1).
“Held for” Requirement

Section 1031 also requires that both relinquished and replacement properties are:
- Held for investment; or
- Used in a trade or business.

Thus, “held for” requirement is violated if either relinquished or replacement property is:
- Ordinary income (dealer) property.
- Personal use property.

“Held for” requirement may be jeopardized if relinquished or replacement property is transferred to an affiliate or unrelated party soon before or after the exchange.
Dealer Real Property

- Dealer property does not qualify for like-kind exchange treatment.
  - Definition of dealer property is somewhat broader under §1031 than under standard definition under §1221(a).
    - See also ILM 201025049 (dual use property held for rental and for sale ruled held primarily for sale).
Vacation and Personal Use Real Property

Personal use real property.
- Court looked to primary purpose in holding the property.
  - "The mere hope or expectation that property may be sold at a gain cannot establish an investment intent if the taxpayer uses the property as a residence."
- Failure to offer for rent or sale.
- No claim of investment interest deductions or maintenance expenses on tax returns.
- Goolsby v. Commissioner, TC Memo 2010-64.

Safe harbor - Revenue Procedure 2008-16.
- Adopts personal use/fair rental value test of §280A for 24 months before and after exchange.

Change from Rental to Personal Use after Exchange.

Lease at Fair Rental to Son.
Right to put fractional interests

- Taxpayer holding real property through a disregarded entity has the right to put fractional interests in the property to an unrelated buyer in stages over five years.
- Sales of fractional interests qualify as relinquished property in a like-kind exchange.
- Buyer has the option to acquire any remaining interest in the property after seven years.
- Put exercise price fixed at inception and increasing by a constant percentage each year implicitly approved as true option, not recast as sale of the entire property at inception.
Fragmentation

Taxpayer enters into a sale agreement for the sale of multiple properties.

- If taxpayer is unable to acquire sufficient replacement property, taxpayer will want to exchange some properties and sell other properties for cash so that the cash can be offset with the basis in properties sold.

Can taxpayer fragment the transaction this way?

- The sale agreement provides a clear allocation of the sale prices of the individual properties;
- The exchange properties are not physically or functionally integrated with, or geographically adjacent to, the cash sale properties; and
- The sale agreement permits an assignment of the rights to sell the exchange properties to a QI with no assignment of the cash sale properties.
Timing of Exchanges

▸ Simultaneous Exchange.
▸ Deferred Exchange: old property transferred first, new property received later; §1031(a), enacted in response to Starker v US.
  ▸ 45-day identification requirement.
  ▸ 180-day closing requirement.
▸ Reverse exchange.
  ▸ New property is received before old property is transferred.
  ▸ Case law is generally unfavorable.
  ▸ See discussion of parking transactions below.
45-Day Identification Requirement

- Replacement property must be identified within 45 days of transfer of the relinquished property.
  - No extension for week-ends or holidays.
  - Number and value of replacement property identification.
    - Three replacement properties with any value.
    - Unlimited number, but fair market value no more than 200% of relinquished property.
    - Unlimited number and value; taxpayer actually acquires 95% by value.
    - Property acquired within 45-day identification period.
  - Unambiguous description of each replacement property.
  - Notice must be delivered to seller or certain other non-disqualified parties to the transaction.
  - Reg. §1.1031(k)-1(c).
**180-Day Closing Requirement**

Replacement property must be acquired by the taxpayer within 180 days of transfer of the relinquished property.

- If sooner, extended due date for tax return
- No extension for week-ends or holidays.
- Taxpayer must acquire replacement property that is “substantially the same” as identified.
  - Reg example: acquisition of only 75% of vacant land that was identified.
- Reg. §1.1031(k)-1(d).
Additional QI Requirements

- QI agreement must require that QI cannot transfer any exchange funds or other boot to taxpayer unless and until:
  - Expiration of 45-day identification period, if taxpayer has not identified any replacement property at that time; or
  - Taxpayer has received all replacement property to which taxpayer is entitled.
  - Reg. §1.1031(k)-1(g).
- In general, taxpayer cannot change QI mid-exchange.
  - PLR 200908005.
    - IRS rules that change of ownership of QI does not invalidate pending exchange.
Depreciation Calculations

- Regulations address depreciation of replacement property acquired in:
  - a like-kind exchange under §1031 or
  - involuntary conversion under §1033.

- General approach.
  - Step-in-the-Shoes to extent of substituted basis.
  - Restart depreciation to extent of additional basis.
  - Reg. §1.168(i)-6.
Proposed Legislation
Proposed Legislation

▶ Obama Administration proposal to limit §1031.
  ▶ Limit deferral of gain for exchanges under §1031 to $1,000,000 (indexed for inflation) per taxpayer per year.
  ▶ Released February 2016 (same as 2015 proposal but expanded to cover not only real estate but all like-kind exchanges).

▶ Legislative proposals to repeal §1031.
  ▶ House Ways and Means Committee Proposal.
  ▶ Ways and Means Committee Chair Dave Camp (R-MI) released a tax reform proposal on February 26, 2014.
  ▶ Senate Finance Committee proposal.
  ▶ Then Senate Finance Committee Chair Max Baucus (D-MT) released a series of proposals in November 2013.

▶ EY study of impact of repeal on the economy.
▶ September 27, 2017 framework is silent on §1031.
Distressed Property Exchanges and Related Issues
Exchange of Underwater Real Property

- Can relinquished property held subject to nonrecourse debt in excess of its fair market value qualify for exchange treatment?
  - PLR 201302009.
- Analogous authority for tax-free transfer of property without equity.
  - Does such relinquished property qualify as “property”?
  - See, e.g., §351.
- Clearly preferable in context of deed in lieu transfer rather than actual foreclosure transaction.
  - Lender cooperation.
Exchange of Underwater Real Property: Other Issues

➤ There is no sales contract in foreclosure.
  ➤ Can property be deeded directly to lender?
    ➤ Regs permit a direct deed.
    ➤ But can transferor’s rights be assigned to a QI?
  ➤ Perhaps property can be first deeded to QI.
    ➤ But transfer to QI may raise other issues.
      ➤ Bad boy loan covenants: does unauthorized transfer convert to recourse loan?
      ➤ Transfer taxes.
Exchange of Underwater Real Property: Other Issues

In exchange of underwater property, the taxpayer receives no exchange proceeds to fund cash portion of purchase price of replacement property.

To minimize cash portion of replacement property, taxpayer may acquire credit net lease property.

- Debt on replacement property should equal or exceed debt balance on relinquished property.
- Loan fees?
- Lease terms should be reviewed to confirm true ownership issue.
Exchange of Underwater Real Property: Timing

➢ What is the date of the transfer for federal income tax purposes?
➢ General Rule: sale occurs when benefits and burdens of ownership pass to buyer.
➢ State law redemption period for foreclosure.
  ➢ Is debt recourse or nonrecourse?
  ➢ *R. Odell & Sons Co. v. Commissioner*, 169 F.2d 247 (3d Cir. 1948): transfer occurs upon expiration of redemption period.
➢ Form 1099-B instructions.
Installment Sales and Busted Exchanges

- Taxpayers may be unable to acquire replacement property.
- Failure to acquire replacement property will result in taxable sale treatment.
- However, taxpayer may be entitled to report gain from an installment note issued by the buyer of the relinquished property under §453 installment method.
  - Special rule overrides general rule that installment method is allowed only for indebtedness of the buyer, which would otherwise be the QI under the fiction of Reg. §1.1031-1(k).
  - Reg. §1.1031(k)-1(j).
Installment Sales and Busted Exchanges

- If sale and receipt of cash from QI straddle two taxable years, Reg. §1.1031(k)-1(j) permits taxpayer to report taxable gain under §453 installment method.
- Assumes taxpayer transfers property through a QI and still has a bona fide intention to complete a like-kind exchange at end of year one.
Installment Sales and Busted Exchanges

- Installment gain is generally taxable in year cash is received.
  - However, gain is triggered in year one to extent of:
    - Liabilities in excess of basis.
    - Depreciation recapture under §1245, §1250 and §291(a)(1).
  - Interest charge under §453A(c).
    - Applies at partner level.
      - Announcement 89-33.
Loss Disallowed in Section 1031 Exchanges

- Taxable loss is disallowed in a §1031 exchange.
- Section 1031 is not elective.
  - Regardless of presence or absence of boot.
  - *Redwing Carriers, Inc. v. Tomlinson*, 399 F.2d 652 (5th Cir. 1968).
    - Taxpayer sought to recognize gain to obtain basis step-up at capital gain rates for gain before enactment of §1245.
Loss Disallowed in Section 1031 Exchanges

➢ To avoid loss disallowance under §1031:
  ➢ Use different taxpayers to transfer and receive property.
    ➢ Did not work in *Redwing Carriers*.
  ➢ Separate agreements.
    ➢ No cross default provisions.
    ➢ Better yet, no cross references.
  ➢ Separate closing dates.
Reverse Exchanges and Parking Transactions
Reverse Exchanges

“True reverse” exchange.

- Taxpayer receives new property before relinquishing old property.
- Situation typically arises when:
  - Seller of new property will not postpone sale; or
  - No buyer has been located for old property.
Reverse Exchanges

“True reverse” exchange.
- Statute and regulations are silent.
- Preamble to regulations are unfavorable.
- Case law is unfavorable:
  - Many cases have held reverse exchange is taxable.
  - Few favorable cases:
    - *In Re Exchange Tiles*, bankruptcy court, unusual facts.
- Private rulings are not helpful:
  - PLR 9814019: direct reverse exchange was tax-free.
  - TAM 200039005: failed parking transaction.
- Advisable to avoid true reverse exchange.
Parking Transactions

Alternative to a “true reverse” exchange:

► First, new property is acquired by (parked with) accommodator, which later completes a simultaneous exchange (“Park First”); or

► Simultaneous exchange first, then old property parked with accommodator until sale (“Park Last”).

► Park First is more common; lender may require Park Last.
  ► Park First: Less risk ownership imputed to taxpayer.
  ► Park Last: Allows more new property.
Parking Transactions

Two alternative types of parking transactions:

- Safe harbor parking.

- Parking outside the safe harbor.
  - Based on general income tax principles.
Non-Safe Harbor Parking

- Accommodator recognized if tax owner of the parked property.
  - Tax ownership is based on benefits and burdens of ownership.
    - Generally requires accommodator to have some real upside and downside.
    - Weigh factors discussed below.
  - FAA 20050203F.
  - Conversely, IRS ruled in PLR 200110025 sufficient that accommodator is not the agent of the taxpayer.
    - IRS would not necessarily grant another such PLR.
Non-Safe Harbor Parking

**Estate of George H. Bartell, et al. v. Commissioner, 147 TC No. 5 (2016).**

- Taxpayer victory!
- Facts were similar to parking arrangements permitted under safe harbor of Rev. Proc. 2000-37.
- Safe harbor was unavailable because the parking transaction preceded the effective date of Rev. Proc. 2000-37.
- Also, parking period of 17 months exceeded 180-day parking period permitted under Rev. Proc. 2000-37.
- Court relied on agency analysis under §1031 case law despite acknowledging that taxpayer was the owner of the parked property under general tax law principles.
Non-Safe Harbor Parking

- Relationship of accommodator to owner.
  - Cannot be agent of exchanger.
    - Case law deferred exchange safe harbor for a qualified intermediary may not apply.
    - Agency would result in true reverse exchange.
  - Should not be related to exchanger.
    - Legislative history to §1031(f)(4) apparently prohibits acquisition through a QI from related party.
Non-Safe Harbor Parking

- Financing purchase of parked new property.
  - Direct loan by exchanger to intermediary.
    - Repayment of loan may be boot.
  - Third party loan on commercially reasonable terms.
    - Intermediary will require nonrecourse loan.
    - Lender will require exchanger guarantee.
    - Exchanger lease may provide lender assurance.
    - Seller financing is best, if available.
Non-Safe Harbor Parking

- Operation of parked property.
  - Net lease to exchanger.
    - True lease required to avoid true reverse exchange.
    - Minimizes upside and downside to accommodator.
  - Exchanger manages parked property.
    - Easier to avoid tax owner status.
    - Exposes accommodator to upside and downside.
  - Accommodator, as property owner, reports property income and deductions.
Non-Safe Harbor Parking

- Transfer of parked property between exchanger and accommodator.
  - Exchanger desires call option.
    - Beware of possible recast as ownership by exchanger if exercise of option is economically compelled.
  - Accommodator desires protection.
    - Put option, with exchanger's call option, would create major pressure on tax ownership.
    - Accommodator may be satisfied with increasing rents.
      - Must avoid long-term lease subject to §467.
Non-Safe Harbor Parking

Bottom line.

- Accommodator tax ownership requires real upside and downside in parked property operations or value.
- Conversely, taxpayer does not wish to give accommodator upside, and accommodator does not wish to assume downside.
- Thus, it is generally difficult to structure non-safe harbor parking arrangement for which tax advisor can opine at any high level of comfort.
- As a result, a group of private practitioners requested Treasury and IRS to grant a safe harbor for parking.
Safe Harbor Parking

- In Rev. Proc. 2000-37, the IRS announced that, for parked property held in a qualified exchange accommodation arrangement ("QEAA"), it will not challenge:
  - Qualification of the property as replacement or relinquished property; or
  - Treatment of the exchange accommodation titleholder as beneficial owner.
- Effective for transactions after 9/14/2000.
- No inference for parking outside safe harbor.
Safe Harbor Parking

Safe Harbor Requirements:

- Title held by EAT:
  - Not the taxpayer or disqualified person.
  - At least 90% held by taxable holders.
- Bona fide intent for like-kind exchange.
- Written QEAA within 5 business days.
- Relinquished property identified within 45 days.
- Transfer to taxpayer or third party within 180 days.
- EAT cannot hold property for more than 180 days.
Safe Harbor Parking

Safe Harbors Permitted:

EAT may also serve as QI. Taxpayer may lease/manage parked property. Puts/calls at fixed/formula prices may be used. Taxpayer can use contrary treatment for regulatory, GAAP, state, local or foreign tax purposes. PLR 200148042 permits statement that EAT is taxpayer’s agent for all purposes other than federal income tax purposes.
Safe Harbor Parking

- Timing traps: identification and holding periods.
  - 5 days to enter into QEAA.
    - Must identify specific taxpayer and EAT.
      - In PLR 201242003, the Service ruled that the QEAA is valid even though a related party also entered into a QEAA for the same property.
      - PLR 201416006: same ruling for two related parties.
  - 180 days to close.
    - If not complete, transfer of partially completed building.
    - Must decide at inception whether parking will be within or outside safe harbor.
Safe Harbor Parking

Timing traps: identification and holding periods.

- 45 days to identify.
  - 3 properties or 200% value tests under the regulations.
  - Relinquished property sold within but identified outside 45 day-period: approved in PLR 200718028, but reliance unclear.

- If the relinquished property is a portfolio of properties, the value of which exceeds twice the value of the parked replacement property, identification of the entire portfolio may exceed both the three-property and 200% limitations.
  - The 95% rule may be unavailable if properties representing more than 5% of the value of the portfolio must be dropped from the transaction.

- Identify specific relinquished properties?
- Identify an undivided interest in each portfolio property?
Safe Harbor Parking

- Combined “reverse” and deferred exchange.
  - IRS approved exchange into two replacement properties:
    - One replacement property parked under safe harbor;
    - Second replacement property acquired in deferred exchange.
      - ILM 200836024.
    - IRS refers to the transaction as “two separate exchanges.”
Safe Harbor Parking

➢ Rev. Proc. permits parking only for direct interest in replacement property.

➢ Parking of 50% interest in real estate partnership permitted where exchanging taxpayer held the other 50% partnership interest

➢ PLR 200909008.

➢ REIT stock acquired by EAT, which soon thereafter liquidates the REIT and conveys the assets to the taxpayer?
Safe Harbor Parking

The safe harbor was modified by the IRS in Rev. Proc. 2004-51:

Rev. Proc. 2000-37 will not apply if the parked replacement property was previously owned by the taxpayer at any time in the 180 days before the transfer to the EAT.

- Rule clearly applies to transfer of fee title by exchanging taxpayer to EAT.
- Rule is intended to apply to ground lease of land by exchanging taxpayer to EAT ("disappearing lease").
- Rule does not apply to lease from related party to EAT (IRS now studying the issue).

Effective for transfers on or after 7/20/2004.
Exchanges into Build-to-Suit Property
Replacement property can be "build-to-suit." Construction cannot be performed by taxpayer. Construction by affiliate is vulnerable to anti-abuse rule of §1031(f)(4) unless direct exchange. Thus, construction must be performed by seller-developer, QI or EAT. Because of greater restrictions on a taxpayer's dealings with a QI, use of an EAT is generally preferred if unrelated party is not used.
Build-to-Suit (cont’d)

Building on Land Owned by Taxpayer or Affiliate.

- IRS view: land and building cannot be exchanged for new building built on land already owned by taxpayer.
  - Rev. Rul. 67-255.

- Transfer of taxpayer’s land to another party for construction period followed by transfer back to taxpayer.
  - Estate of Bartell v. Commissioner, 147 TC No. 5 (2016), nonacq., AOD 2017-06 2017-33 IRB

- Approved and suggests that DeCleene’s benefits and burdens test for non-safe harbor parking arrangement is limited to DeCleene’s unique facts - taxpayer cashes out.
Build-to-Suit (cont’d)

Taxpayer generally cannot acquire land from affiliate as replacement property through QI under §1031(f)(4).

Teruya Bros., Ltd. v. Comm’r, 124 TC 45 (2005), aff’d 580 F.3d 1038 (9th Cir. 2009).

Ocmulgee Fields, Inc. v. Comm’r, 132 TC 105 (2009), aff’d 613 F.3d 1360 (11th Cir. 2010).

North Central Rental & Leasing, LLC v. US, DCND (9/3/13), aff’d 779 F.3d 738 (8th Cir. 2015).

Malulani Group v. Commissioner, TC Memo 2016-209.
Build-to-Suit (cont’d)

- Rev. Proc. 2004-51: Rev. Proc. 2000-37 will not apply if the parked replacement property was previously owned by the taxpayer at any time in the 180 days before the transfer to the EAT.
  - Rule clearly applies to transfer of fee title by exchanging taxpayer to EAT.
  - Rule is intended to apply to ground lease of land by exchanging taxpayer to EAT ("disappearing lease").
  - Rule does not apply to lease from related party to EAT (IRS now studying the issue).
  - Effective for transfers on or after 7/20/2004.
Building on Land Owned by Taxpayer or Affiliate (cont’d)

Thus, if new building is to be built as replacement property on land already owned by taxpayer or affiliate, preferred approach is to use a ground lease to the EAT during construction, which is later transferred to taxpayer in the exchange.

The law is undeveloped on this approach; still may be vulnerable to disregard of lease grant and transfer, particularly on taxpayer-owned land under the IRS position in Rev. Proc. 2004-51.

Can taxpayer transfer fee interest in land to an affiliate, age for 180 days and than have EAT acquire a leasehold interest and construct improvements?
Build-to-Suit (cont’d)

IRS has approved exchanges into build-to-suit property on land leased from an affiliate of exchanging taxpayer.

- PLR 200251008.
- PLR 200329021.
- PLR 201408019.

- Is the “study” mentioned in Rev. Proc. 2004-51 now complete?
Build-to-Suit (cont’d)

Facts

- Taxpayer enters into QEAA with EAT.
- EAT enters into (acquires) > 30 ½ year lease in land owned (or leased) by affiliate and pays no consideration for leasehold interest.
- EAT constructs improvements.
- Within 180 days of EAT’s acquisition of the leasehold interest:
  - Taxpayer sells relinquished property through a QI and
  - Taxpayer acquires leasehold interest and partially/fully constructed building from EAT through the QI.
Build-to-Suit (cont'd)

- IRS Rulings
  - Exchange involves a related party, but no gain recognized under §1031(f) unless taxpayer or affiliate disposes of interest in the property within 2 years.
    - Affiliate did not cash out its interest in the property.
    - Reimbursement of certain affiliate costs may be permitted.
Build-to-Suit (cont’d)

Construction of replacement real property need not be complete.

Completion of identified property in deferred exchange is required only for personal property.

Reg. §1.1031(k)-1(e)(3).

Safe harbor parking limited to 180 days.

Post-exchange construction costs do not count toward value of replacement property.

Prepaid construction costs: weak position.
Related Party Exchange Issues
Background

- Benefits of related party exchanges:
  - Shift basis to property to be sold earlier.
  - Shift basis to depreciable property.
- Historically, tax-free like-kind exchange treatment has been permitted for exchanges between related parties.
  - IRS ruled that §1239 does not override §1031, but only applies to gain recognized under §1031.
  - PLRs 8038099 and 8646036: tax-free exchanges between taxpayers and wholly-owned corporations.
- In 1989, Congress enacted §1031(f).
General Rule

- Basic related party exchange limitation: deferred exchange gain is triggered upon a transfer (a "second disposition") within two years of a tax-free related party exchange. §1031(f)(1).
- Gain is triggered to both parties upon a second disposition by either party:
  - taxpayer disposition of replacement property; or
  - related party disposition of relinquished property.
Related Person

- Defined by §1031(f)(3).
  - Incorporates §267(b).
    - Affiliated and commonly controlled entities.
    - Family includes spouse, ancestors, issue, siblings.
  - Also incorporates §707(b)(1).
    - Partnership and person owning >50% interest.
    - Two partnerships owned >50% by same persons.
    - Capital or profits.
    - Section 267 attribution of indirect ownership.
- Private rulings on related person status under §1031(f)(3): PLRs 200920032 and 200919027.
Suspension of Two-Year Period

The two-year period is suspended under §1031(g) while the holder's risk of loss is substantially diminished by:

- Holding a put.
- Another person holding a right to acquire.
- Short sale or any other transaction.

Similar to §453(e)(2)(B).
What is a Disposition?

- Section 1031(f)(1) applies to a second disposition of property.
  - However, the term “disposition” is not defined.
  - A sale or exchange is generally a “disposition.”
  - A “true” lease of property should not be a “disposition.”
  - Nontaxable transfers, e.g., under §351, 721, 731?
  - Gifts?
  - Demolition of property?
  - Disposition of a portion of property?
  - Cutting and disposition of timber is not a disposition of the underlying land.
    - PLR 200541037.
      - Citing Rev. Rul. 2001-50 (not a disposition for purposes of §1374 tax under §337(d)).
Exceptions to General Rule

- **Section 1031(f)(2) permits exceptions for:**
  - Death of either taxpayer or related party.
  - Compulsory or involuntary conversion.
    - As defined in §1033.
    - If exchange occurred before threat or imminence of such conversion.
  - “it is established to the satisfaction of [the IRS] that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.”
  - Legislative history permits exchanges of undivided interests to consolidate ownership in a single property.
    - See PLR 200730002
    - Advance IRS ruling required?
  - Other private rulings: PLRs 199926045 and 200706001.
Application of Two-Year Rule

Two-year rule seems to impose a mechanical limitation. If so, taxpayers can plan for dispositions two years and one day after initial exchange.

- PLRs under §708(b)(1)(B) permit taxpayers to avoid technical termination of a partnership through transfers separated by one year and one day.

- See anti-abuse rule discussed below.

But no abuse if related party sells exchange property more than two years after original exchange, even if intended at time of exchange. FSA 200137003.

- Beware of premature transfer of benefits and burdens of ownership.
Anti-Abuse Rule

- Deferred exchange treatment is denied under §1031(f)(4) anti-abuse rule if the exchange:
  - “is a part of a transaction (or series of transactions) structured to avoid the purposes of [section 1031(f)].”
  - Legislative history example: Replacement property acquired through QI from owner related to taxpayer who receives cash.
  - If anti-abuse rule applies, it appears that the entire exchange is fully taxable.
Anti-Abuse Rule

In general, the acquisition of replacement property from a related party through a QI will violate the anti-abuse rule of §1031(f)(4).

- TAM 9748006; FSA 199931002; Rev. Rul. 2002-83.
- *Teruya Brothers Ltd. v. Commissioner*, 124 TC 45 (2005), aff’d 580 F.3d 1038 (9th Cir. 2009).
- *Ocmulgee Fields, Inc. v. Commissioner*, 132 TC 105 (2009), aff’d 613 F.3d 1360 (11th Cir. 2010).
- Leaves door open if taxpayer can show, e.g., no basis shifting.
- *North Central Rental & Leasing, LLC v. US*, DCND (9/3/13), aff’d 779 F.3d 738 (8th Cir. 2015).
- ILM 201013038 (related part seller was a dealer).
Anti-Abuse Rule: Exceptions

- Presumably anti-abuse rule applies to replacement property acquired from a related person through a QI only if the related party receives cash or other non-like kind property.
- Otherwise, there appears to be no abuse whether or not transfers are made through a QI.
- The group has no more cash after the exchange than before.
Anti-Abuse Rule: Exceptions

- Purchase of replacement property through QI from related party as part of like-kind exchange by the related party itself approved by IRS.
  - PLRs 200440002, 200616005, 200810016-17, 201048025, 201216007 and 201220012.
  - Each party agreed not to sell for more than two years.
  - Boot up to 5% of gain realized permitted in PLRs 201216007 and 201220012.
- Two successive related party exchanges allowed under PLRs 201048025, 201216007 and 201220012.
  - Separate identification and replacement periods allowed under PLR 201220012.
Anti-Abuse Rule: Exceptions

Another possible exception: Related party has taxable gain that exceeds the gain exchanging taxpayer is seeking to defer.

- In effect, no shifting of basis.
- PLR 200730002: Exchange of undivided interests between brothers and trust for niece followed by sale by niece and one brother does not invalidate exchange of the other brother.
  - Selling brother had lower tax basis than exchanging brother.
  - IRS also cited legislative history under §1031(f)(2)(C) permitting exchanges of undivided interests to consolidate ownership in a single property.
- Teruya Brothers: Exception did not apply because related party taxable gain was partially sheltered by NOL.
  - Thus, little or no tax benefit allowable under this approach.
  - What if selling affiliate is subject to a lower tax rate?
Anti-Abuse Rule – Sale to Related Party

IRS has ruled that sale of relinquished property through a QI to related party for cash that QI uses to buy replacement property from unrelated party X does not trigger gain under §1031(f)(4).

- Cash leaves the related party group.
- Applies even if related party sells its property within two years.
- PLRs 200709036, 200712013, 200728008 and 201027036.

Taxpayer (REIT) sells relinquished property to related person (TRS) through a QI as part of a §1031 exchange even if the related person resells that property within two years.

- General related party rule of §1031(f)(1) does not apply because exchange was through an unrelated QI.
- Anti-abuse rule of §1031(f)(4) does not apply because IRS found no tax avoidance purpose.
Anti-Abuse Rule – Sale to Related Party

- Sale to related party must qualify as a “true sale.”
  - Fair market value pricing and terms.
  - Buyer adequately capitalized.
  - Transfer of benefits and burdens of ownership.

- Potential uses and benefits:
  - Condominium conversion – ordinary income.
    - *Bramblett* planning: freeze inherent gain as nondealer gain.
Partnership Exchange Issues
Partnership Planning

General rules.

- A partnership is an entity.
- The same entity generally must transfer the old property and receive the new property.

Exceptions
- Disregarded entities, e.g., SMLLCs.
- Successor in corporate transactions under §381.

§1031(a)(2)(D) generally prohibits §1031 swaps of partnership interests.
Exchanges - Partnership Interests

In general, §1031(a)(2)(D) provides that a partnership interest is not of like kind to any other property.

However, Rev. Rul. 99-6 treats the acquisition of a partnership interest as the acquisition of an undivided interest in the underlying assets of the partnership.

Seller is treated as selling partnership interest.

IRS ruled in PLR 200807005 (discussed below) that a partnership interest can serve as replacement property under Rev. Rul. 99-6 by looking through to the underlying partnership assets.

Exchanges - Partnership Interests

- Rev. Rul. 99-5: if seller S owns 100% of the interests in a disregarded single-member LLC and sells an interest in the LLC to buyer B, S is treated as:
  - Selling an undivided interest in each LLC asset to B followed by
  - S (and B) contributing its undivided interest in each LLC asset to a new partnership P.

- Even though a sale of an LLC interest under state law, sale qualifies as a sale of an undivided interest in each LLC asset under §1031.

- B’s acquisition of its 50% LLC interest may fail §1031 under the “held for” requirement.
Partnership Planning

Technical Termination under §708(b)(1)(B).

- Is the "new" partnership the same taxpayer as the "old" partnership for §1031 purposes?
  - Same taxpayer rule.
  - Held for requirement.
    - PLR 200812012.
      - Favorable ruling: technical termination of partnership did not violate §1031.
      - However, IRS would limit favorable ruling to highly unusual facts; termination of testamentary trust.
Partnership Planning

Exchange of Cash Proceeds Received in Part-Contribution, Part-Sale.

- Taxpayer contributes property to partnership in exchange for partnership interest plus cash treated as disguised sale consideration under §707(a).
- Can taxpayer take the cash through a QI and treat the cash as proceeds from the sale of relinquished property in a like-kind exchange?
  - Apparently yes - see Reg. §1.707-3(a)(2) (second sentence).
Simultaneous Partnership Exchanges

➤ Caveat: gain possible if shift in liabilities among partners.
➤ E.g., nonrecourse debt on old property is replaced with recourse debt on new property.
➤ Partners with no economic risk of loss on new debt face:
  ➤ Constructive distribution under §731.
  ➤ Minimum gain chargeback under Reg. §1.704-2.
➤ Possible solution: bottom dollar guarantee.
  ➤ Beware 2016 changes to the §752 regulations.
Deferred Partnership Exchanges

- Debt on old property relieved before debt taken on new property.
  - §752 gain from excess of liabilities over basis?
    - §1031 and regs silent.
    - Rev. Rul. 81-242: excess liabilities taxable in §1033 context.
    - Reg. §1.752-1(f): debt can be netted if one transaction.
    - Complete in single year - also avoid Reg. §1.704-2 issue.
  - Is gain triggered under §465(e)?
    - Generally no §465(e) recapture if old and new properties are treated as held in a single activity.
Partnership Exchange of Contributed Property for Boot

- Partnership acquires real property in tax-free §704(c) contribution.
- Partnership later exchanges the contributed real property for replacement property plus cash boot.
- Is the boot §704(b) or §704(c) gain?
  - PLR 200829023. IRS rules that taxable boot from a partially taxable like-kind exchange by a partnership can be treated as §704(b) gain allocable to all partners with only the balance of such gain treated as §704(c) gain or reverse §704(c) gain.
  - IRS permits partnership to order the boot gain as:
    - First §704(b) gain.
    - Then post-contribution (reverse) §704(c) gain.
    - Then pre-contribution §704(c) gain.
Partnership Split-Ups

- Often some partners wish to exchange property and others wish to take cash.
  - Partnership (P) exchanges for property plus cash; P distributes cash to redeem exiting partners' interests.
  - P distributes undivided interests in property to partners, who then sell or exchange at the individual partner level.
  - P first redeems interests of exiting partners, then exchanges property at P level.
  - P exchanges for property plus note, then distributes note to redeem exiting partners' interests.
Partnership Exchange and Distribution to Exiting Partners

- Partnership exchanges property for new like-kind property plus cash.
- Partnership specially allocates taxable boot gain solely to exiting partners.
- Partnership distributes cash to exiting partners in complete redemption of their partnership interests.
Does allocation of boot to exiting partners have substantial economic effect?

Position has facial appeal if exiting partners' capital accounts before the exchange are zero. Otherwise, allocation may lack economic effect.

Beware of capital account revaluation.

Substantiality - Reg. §1.704-1(b)(2)(iii).
Partnership Distribution, Then Sale or Exchange by Partners

» Base case:
» Partnership distributes a tenancy-in-common interest in the partnership real property to one (or all) partners.
» Then the partnership and/or some (or all) partners do their own exchanges.
» Some partners may sell for cash.
» If the transaction is respected, the (former) partners can go their own ways:
» The taxable gain to the cashing out partners cannot be allocated to the exchanging partners.
» Partners can acquire their own replacement properties.
Partnership Distribution, Then Sale or Exchange by Partners

➢ Is property treated as held by a partnership for tax purposes?
  ➢ Reg. §1.761-1(a): key is level of services.
  ➢ Powell.
  ➢ Rev. Rul. 75-374: all services must be customary.
    ➢ Net leased property should be OK.
  ➢ Avoid partnership characteristics:
    ➢ Confirm right of partition, no restriction on transfer.
    ➢ Does not apply because the property had previously been held by the partnership.
    ➢ Nevertheless, Rev. Proc. 2002-22 may serve as a useful checklist.
Partnership Distribution, Then Sale or Exchange by Partners

“Held for” requirement of statute.

- *Magneson v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985).
- *Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir. 1985).
- Former partners should hold separate interests in old property as long as possible before exchange.
- Exchanges completed before termination of testamentary trust approved in PLR 200521002.
  - IRS viewed as special situation.
  - Period of time remaining before trust termination was not disclosed.
Partnership Distribution, Then Sale or Exchange by Partners

- Transfer of old property imputed to partnership.
  - *Court Holding Company*, 324 US 331 (1945).
  - TAM 9645005.
- Observe formalities.
  - Notify mortgage lenders.
  - Record separate deed for each former partner.
  - Pay any applicable transfer tax.
  - Obtain updated title insurance.
- Negotiate transfers at partner level after distribution of old property.
- Former partners should hold interests in old property as long as possible before transfer.
Redemption of Exiting Partners Before Partnership Exchange

- Safest approach for tax purposes but increases requisite reinvestment in replacement property.
  - Partnership may not have sufficient cash.
  - Source of funds?
  - Continuing partners must replace the entire gross sale price of the partnership relinquished property.
  - Continuing partners assume risk that the exchange does not close.
Redemption of Exiting Partners Before Partnership Exchange

- Debt incurred in anticipation of exchange.
  - Proposed Reg. §1.1031(b)-1(c) held taxable boot.
  - Final regulations silent - but result unclear.
  - Case law favorable on good facts.

- Solution: Partnership retains liability for new debt, exchanging property free and clear of new debt.
Redemption of Exiting Partners Before Partnership Exchange

- Redemption for partnership note.
  - §736, not §453, governs.
  - Delayed §734 inside basis step-up.
  - Rev. Rul. 88-77: not true debt, no basis step-up.
- Disguised sale under §707(a)(2).
  - Purchase of exiting partners’ interests with funds supplied by continuing partners may be recast as disguised sale of partnership interests.
  - Technical termination may result in new entity ineligible to complete the exchange.
Partnership exchanges for property plus boot but, in lieu of cash, partnership takes buyer's installment note. Buyer's note may qualify for deferral to the partnership under §453. Partnership takes zero basis in note. Partnership must allocate all carryover basis first to the replacement property, leaving no basis to be allocated to the note.
Partnership Exchange for Property Plus Buyer's Note

- Partnership later distributes buyer's installment note.
  - Distribution of note is tax-free to partnership and exiting partners.
    - See Reg. §1.453-9(c)(2) and Prop. Reg. §1.453B-1(c)(1)(i)(C).
  - Exiting partner takes substituted basis in note.
- Section 734 inside basis step-down may be required.
  - Elective or mandatory §754 election.
  - To the extent the exiting partner takes stepped-up basis in note.
Partnerhsip Exchange for Property Plus Buyer's Note

Timing of partnership distribution of buyer's installment note.

- Distribution of note immediately or soon after exchange may be vulnerable to recast under step transaction doctrine.
  - See, e.g., Gregory v. Helvering.
  - Best to wait some period of time after sale before distribution.
- If recast, partnership receipt and distribution of note may be disregarded, so that note is taxable at partnership level.
  - See substantiability issue discussed above.